Chapter 1: Select Trust Topics

Please note. Corrections were made to this workbook through January of 2022. No subsequent modifications were made.

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About the Author

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Various issues can arise when tax practitioners prepare income tax returns for trusts. While there are similarities in the preparation of income tax returns for estates and trusts, unless tax topics which impact estate income tax returns are specifically mentioned, this chapter concentrates on select topics which impact practitioners in the preparation and planning for trust income tax returns.

Note. This chapter assumes practitioners have familiarity with preparing trust returns. For a review of the basics of trusts, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust Essentials.

Throughout this chapter, the terms **fiduciary** and **trustee** are used with a small distinction. When using the term **fiduciary** in this chapter, the actions being described apply to both trusts and estates. When the term **trustee** is used, it only applies to actions related to the trust.

Several examples within this chapter are based upon a story about Jack and Diane, a pair of kids living in America's breadbasket.

Example 1. Jack and Diane are a married couple. Jack is a former high school football star and a successful rock and roll singer. Diane manages their home and raises their five children. They are concerned that after they die, their children may not have the maturity to manage a perceived sizeable inheritance.

After meeting with an attorney, they draft wills which include the creation of trusts with estate assets upon their demise. All their children have different needs that Jack and Diane want to be able to address even after death. Some years later, after the thrill of living was gone, Jack and Diane die peacefully in their sleep within two weeks of each other.

GETTING STARTED

Form 1041, *U.S. Income Tax Return for Estates and Trusts*, cannot be prepared properly without first reading the governing document for provisions regarding taxation and thus preparation of the Form 1041. A will governs for an estate or testamentary trust, and a trust agreement governs for a trust. For this section, assume either the trust terminates on the death of the grantor with distribution to beneficiaries (known as a **terminating trust**), or it continues for a period of time before termination (known as a **continuing trust).**

Caution. Be very careful not to advise a trustee client concerning matters of trust administration. This unauthorized practice of law exposes tax practitioners to potential malpractice claims by beneficiaries. It is the trustee's responsibility to seek competent legal advice. That should not prevent a tax practitioner, however, from possibly cautioning a trustee client who appears to be acting in disregard of trust provisions that they may be doing so and should consider seeking proper legal advice.

State laws governing trusts and their administration often provide default rules that can be modified in a trust agreement. It is therefore important to be familiar with the principal and income act of the state whose law governs the trust.[1]

Caution. There are several ways fiduciary accounting income (FAI) can be determined under state law and therefore for federal income tax purposes. There can be definitions in the trust document; to the extent not covered in the trust, the state principal and income act will govern. Many of these acts, however, while containing traditional income-principal allocations, also permit equitable adjustments between principal and income to reflect total return investing or may permit the use of unitrust elections.[2] Although more states are starting to consider allowing total return investing and unitrust elections, these are beyond the scope of these materials and are rarely encountered in typical trust situations.

Note. For additional information regarding FAI and the effect of total return investing and the unitrust election, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Essentials.

PARTIES TO THE WILL OR THE TRUST

Tax practitioners should read the will or trust carefully. The following are some of the most important items that may be relevant to the preparation of a Form 1041.

Will Maker or Settlor

The intentions of the will maker (testator/testatrix) or of the settlor of a trust govern administration of the instrument. In a trust agreement, practitioners should look for the statement of the purpose of the trust.

Executor/Executrix/Personal Representative or the Trustee

Upon the death of the grantor, the grantor's living trust (or the grantor's portion of a joint trust) will become irrevocable and therefore a separate taxable entity. There should be a successor trustee or co-trustees named or nominated in the trust agreement; otherwise, the successor fiduciary(s) should be appointed by a court.

The fiduciary (executor/executrix/personal representative/successor trustee) is the client for purposes of preparing the Form 1041 fiduciary return. Beneficiaries have no right to influence the preparation of the Form 1041 and a preparer has no right to discuss the entity's taxes with them.[3] It is the duty of the trustee to keep beneficiaries informed on trust matters.[4]

Practitioner Planning Tip

If there are co-trustees, tax practitioners should look for trust provisions describing how co-trustees must act and, especially, any dispute resolution mechanism. When a trust instrument identifies two or more co-trustees, a provision in the engagement letter designating one co-trustee as the trust representative for tax matters may avoid future conflict. All co-fiduciaries should sign the engagement letter.

1. IRC §643(b).
2. Ibid; For trusts administered in Illinois, see Illinois Trust Code §1113 (760 ILCS 3/1113).
3. See IRC §7216.
4. Uniform Trust Code (UTC) §813.

Beneficiaries

There are generally two types of beneficiaries: **income beneficiaries** and **remainder beneficiaries**.[5] In a terminating trust, there is usually no current income beneficiary, only remainder beneficiaries. However, there is a period of winding up that may require filing one or more additional Forms 1041.

A continuing trust usually has current income beneficiaries who are entitled to distributions of income prior to termination of the trust.

- If all income is required to be distributed currently, income beneficiaries are required to report their shares of trust income regardless of whether it is actually distributed.[6]
- If the trustee is required to distribute all income currently but has discretion over how much to distribute among beneficiaries, then income is taxable to the income beneficiaries only to the extent trust income is actually distributed.[7]

Reporting to beneficiaries is done on Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*

> **Example 2.** Use the same facts as in **Example 1.** After Jack and Diane die, their oldest son Hud, locates their wills and schedules an appointment with their family attorney. Hud is assigned as executor of the estate. The attorney explains that the wills create five distinct trusts, one for each of Jack and Diane's children. The attorney explains that three of the trusts provide income to the named beneficiaries for their lifetime. Any remaining assets pass to their children. If the named beneficiary has no heirs, the remaining assets are distributed to the deceased child's remaining living siblings.

NEXUS FOR STATE TAXATION

Tax practitioners must determine which state(s) has nexus (jurisdiction) to tax the estate or trust. Although a will or a trust agreement may express which state's laws govern administration of the estate or trust, nexus for purposes of state taxation is usually based on the location of real property held in the estate or trust, of the principal place of administration of the estate or trust, and transactions and other income flows involving the estate, trust, and beneficiaries. If a trust has beneficiaries in a state who have a present right to income or other distributions from a trust, there may be nexus to tax the trust on the share of their interest even though administration is in another state.[8]

> **Example 3.** Use the same facts as in **Example 2.** During their life, Jack and Diane lived in Central Illinois. Hud is currently a resident of South Carolina. His estate and trust administrative duties are conducted from there. The attorney explains to Hud that when it comes time to file tax returns for the trusts, South Carolina filing may be required, regardless as to where the beneficiaries reside.

FILE FORM 56

Taxpayers should file Form 56, *Notice of Fiduciary Relationship*, with the IRS to ensure notices with respect to the decedent will be sent to the appropriate fiduciary. If necessary, they should also file a Form 2848, *Power of Attorney and Declaration of Representative*. If one is filed, the fiduciary named on the Form 56 is the individual who must sign the Form 2848.

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5. Treas. Reg. 1.642(h)-3.
6. Treas. Reg. §1.651(a)-1.
7. Bogert. *The Law of Trusts and Trustees.*, §228 (2d ed. 1965); GCM 36185 (Mar. 10, 1975).
8. In *North Carolina Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust,* 139 S. Ct. 2213 (2019), the Supreme Court held that North Carolina could not impose income tax on a trust solely on the basis of beneficiaries residing in that state who received no trust income distributions or right to demand income or assets from the trust. This is a very limited exclusion.

Practitioner Planning Tip

Practitioners should make sure that powers of attorney for more than one person, such as attorney and CPA, do not act to supersede prior powers.

TRUST CATEGORIES

Note. Although tax practitioners are generally advised to not intentionally or accidentally practice law, the more a practitioner knows about trusts, the better equipped they are to alert fiduciary clients to potential problems and possible solutions. Taxpayers may not have a lawyer advising them who is competent in trust administration for both state law and income tax purposes. A practitioner may not prepare a nonjudicial settlement agreement (explained later) for a client, but it would be proper to suggest that a trustee speak to a lawyer about using one as a possible tool for solving a trust administration issue.

Terminating Trusts

A revocable trust terminates upon the death of the grantor at which time it becomes an irrevocable trust. An irrevocable trust terminates based on some other event, such as beneficiaries attaining a certain age, death of a surviving spouse, or expiration of a period of time. There is a period of winding up during which the trust is taxed as an irrevocable trust.

It is important to distinguish between how trust assets are to be distributed between specific bequests and the residue (what is left over after payment of specific bequests, administrative expenses, etc.) and which beneficiaries are entitled to receive them.

Losses on a Property Bequest. If a beneficiary entitled to receive a pecuniary (amount of money) bequest receives that value in property instead, the trust is taxed as if it sold the property. If the estate or trust has gain property and has losses or excess deductions it may otherwise be unable to use, taxpayers can consider funding a pecuniary bequest with appreciated assets to offset the losses, especially if the beneficiaries are unlikely to benefit from excess deductions passed through to them. On the other hand, if the trust has loss property, trustees and tax practitioners should consider that losses incurred on funding a pecuniary bequest with an asset that has declined in value is disallowed to a trust under IRC §267 because trusts and their beneficiaries are related parties under §267(b)(6). A loss incurred by an estate in funding a pecuniary bequest is not disallowed, however.[9]

9. IRC §267(b)(13).

Example 4. Use the same facts as **Example 1.** The trusts to be funded for the children of Jack and Diane call for $250,000 of assets to be allocated to each trust. Hud, the trustee, decides the best way to satisfy his parent's wishes is to sell all assets and allocate cash to each trust.

One of the beneficiaries, Michelle, immediately after her parent's death, began arguing with Hud that she wanted her dad's vintage Porsche automobile instead of cash. When the issue is finally settled after two years of discussion, the vintage auto is distributed to Michelle. The auto was appraised at $250,000 on the date of death but it was valued at $300,000 when it was distributed to Michelle.

Note. Had the asset been distributed to Michelle and its value was $200,000, for example, the trust would not be able to deduct the loss.

The estate of Jack and Diane has a taxable gain of $50,000 to report ($300,000 value of the vintage Porsche at the time of distribution less the $250,000 value as of the date of death). However, Hud also sold Jack's football memorabilia that was appraised at $75,000 at the date of death but sold for $50,000. This $25,000 loss is available to offset part of the gain from the distribution of the vintage Porsche.

Nonfungible Trust Assets. In the absence of a specific direction to the contrary, nonfungible (not easily divided) trust assets, such as real estate, are distributed to the remainder beneficiaries as tenants in common in proportion to their interests under the trust. Unless the trust permits the trustee to make disproportionate distributions, beneficiaries may have a taxable event if they agree to disproportionate distributions of assets. This is because the beneficiaries are treated for income tax purposes as having given up a partial interest in one asset in exchange for an interest in a different asset unless such exchange qualifies for nonrecognition as a like-kind exchange under IRC §1031. The fiduciary or counsel should identify the shortfall. The tax practitioner identifies excess deductions as a possible resolution and alerts the fiduciary or counsel to the potential §1031 issue.

Bequests and Gifts to Charity. If a charity receives a distribution, it is important to distinguish between a specific bequest to the charity and a gift of a share of the residue of the trust. A **specific bequest** is not deductible as an income tax charitable contribution; it is deductible only on a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. A **gift** of a share of the residue, however, may generate an income tax deduction to the extent the charity's share includes gross income. See the separate section in this chapter on charitable contribution deductions for a discussion of the charitable deduction under IRC §642(c).

Distributions During Winding Up Period. Generally, there are no trust provisions addressing distributions during the period of winding up. This means the trust is a complex trust and entitled to a distribution deduction only to the extent distributions are actually made (taking into account the 65-day rule).[10]

Practitioner Planning Tip

Tax practitioners may wish to discuss with the trustee preparing a tentative tax calculation before or shortly after the end of the trust's tax year. The tentative tax calculation can determine whether, and the extent to which, distributions are in order before the end of the tax year or under the 65-day rule to reduce trust income taxes.

10. See IRC §663(c) and Treas. Regs. §§1.663(b)(1) and 1.663(c)-(1).

Observation. The terms of a trust may be modified through a nonjudicial settlement agreement (NJSA) (discussed later) to require during the period of winding up that all income (including all retirement benefits) be distributed currently to the beneficiaries. If desired, capital gains could also be included. Generally, a practitioner would not initiate an NJSA.

Sale of Personal Residence. It is not uncommon for the personal residence of the decedent to be sold by the estate or trust soon after the decedent's death. In most cases, this results in a loss because, if the sale is close enough to date of death, the gross sales price is the fair market value (FMV) of the house for date of death purposes and the expenses of sale result in a loss. In a significant Service Center Advice (SCA), the National Office discussed the issue of deducting these losses, noting that many fiduciary returns are filed with service centers reporting losses in such transactions.[11] The SCA said that an estate or trust is required to compute its taxable income in the same manner as an individual. Individuals are not permitted under IRC §165(c) to deduct losses on the sale of personal-use residences. Instead, the property must have been converted to income-producing property. The SCA cites no authority for its conclusion other than the loss rules applicable to individuals but seems to impute the personal use of the decedent to the estate, thereby placing a burden on the estate to prove conversion.

There are cases, however, that have rejected the SCA position, saying that property acquired by inheritance has a neutral status; that is, neither proving nor disproving whether it is held for personal use or for profit.[12] There are cases dealing with whether losses on the sale of a decedent's personal residence are deductible. Although results vary based on the facts of particular cases, there seems to be a common theme that the decedent's personal use of the residence is not imputed to those who acquire the residence by virtue of the decedent's death. However, sufficient personal use by the heir may operate to convert it to personal use.[13]

Example 5. Use the same facts as in **Example 1.** When Jack and Diane died, they left a personal residence that was titled jointly. No one occupied the home during the period of estate administration. Hud had the property appraised at the date of his parent's death for $560,000. The house sold for $480,000 six months later. The estate of Jack and Diane may be able to deduct the loss of $80,000 ($560,000 appraisal – $480,000 sales price) assuming facts and circumstances support that the use of the property by the estate was as an investment and not for personal use.

Example 6. Use the same facts as in **Example 5.** After Jack and Diane died, their youngest child, Speck, asked to remain living in her parent's home for a couple of years until she was ready to move on.

The estate did not charge Speck rent while she lived in the home. Two years later, Speck moved from the home and Hud sold it for $480,000. Facts and circumstances would appear to support the property was being used personally by the estate. Therefore, the $80,000 loss from the sale ($560,000 appraised value – $480,000 actual selling price) is not deductible because the use was personal.

Caution. Had Speck paid less than fair market rent, the circumstances regarding the disallowance of loss would not have changed because related-party rules prevent the loss from being deductible.

11. SCA 1998-012 (Apr. 7, 1998).

12. See *Marx v. Comm'r,* 5 TC 173 (1945).

13. For example, see *Estate of Waterman v. Comm'r,* 195 F.2d 244 (2d Cir. 1952); *Watkins v. Comm'r,* TC Memo 1973-167 (Jul. 30, 1973).

Continuing Trusts

A continuing trust is one which, by its terms, does not terminate after the death of the grantor. Instead, it generally continues in existence to provide income to one or more income beneficiaries — usually for life — with a remainder thereafter to descendants or others. For estate tax avoidance purposes, the trust may also create one or more new trusts or sub-trusts. An example of this is the classic marital deduction formula that allocates the maximum applicable exclusion amount to a bypass trust (also known as credit shelter) to use up a decedent's available applicable exclusion amount, with anything in excess of that going to a separate marital deduction trust or to the surviving spouse. The combination of the two ensures both spouses can use their full applicable exclusion amounts, although this is rarely necessary under current law. At some point, continuing trusts generally become terminating trusts. When this occurs, they may face many of the issues previously identified for terminating trusts. Another example of a continuing trust is one that pays income to descendants of the grantor for a period of time before terminating and distributing the remainder.

ELECTIONS

Tax practitioners need to be aware of possible trust elections and income tax issues to alert the fiduciary and counsel about potential tax effects. The following selections of elections and issues are nonexclusive but cover some of the more commonly encountered issues that practitioners face.

IRC §645 Election

A trust is taxed as a probate estate during the period of a §645 election especially if there is no related estate and the trust alone is making the election. As discussed later in the section on §645 elections, there are important differences in some income tax rules between estates and trusts that could result in failure to take advantage of certain income tax benefits.

S Corporation Elections

If a trust holds subchapter S stock, the trustee needs to be informed that the shares must be distributed to eligible shareholders or to a qualified subchapter S trust (QSST) within two years of the grantor's date of death (four years if there is a §645 election). Otherwise, an election must be made for an electing small business trust (ESBT). Until that point, the S corporation Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*, is reportable on the fiduciary return.[14]

It is important to alert the trustee that a timely QSST or ESBT election needs to be filed. If S corporation stock is allocated to a bypass trust, practitioners should verify that there are no sprinkle powers or other provisions permitting distributions under any circumstances from being made to anyone other than the current income beneficiary. Those would prevent a QSST election, thereby losing the subchapter S election.[15]

IRC §754 Election

If a trust holds a partnership interest, tax practitioners should analyze whether a §754 election is in order (or is required if the partnership previously made the election) to step up the inside bases of partnership assets.

Portability Election

Although not an income tax issue, a tax practitioner may consider advising a surviving spouse whether a portability election should be made by filing a timely Form 706.[16]

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14. See the discussion of S corporations under Income Tax Effects of §645 Election.

15. See Treas. Reg. §1.1361(j).

16. Treas. Reg. §20.2010-2.

POSSIBLE INCOME TAX ISSUES

Trust as an IRA Beneficiary

If a trust is a beneficiary of an individual retirement arrangement (IRA) or a qualified benefit plan, unless it is a conduit trust with the surviving spouse as a sole beneficiary, full distribution must be made no later than the end of the 10th calendar year after the grantor's death (five years if the trust is not a qualified trust).[17] This is discussed in detail later in the section covering the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act). For nonspousal beneficiaries, tax practitioners should consider advising the fiduciary to do a direct trustee-to-trustee transfer of the retirement benefit to IRAs for each beneficiary. These become inherited IRAs subject to the same 10- or 5-year distribution requirement, but this avoids having benefits paid to the trust and the corresponding need to make distributions to the beneficiaries to avoid trust-level income taxes.

Personal Residence of Surviving Spouse

If a surviving spouse is the sole beneficiary, practitioners should advise trustees to consider whether the personal residence should be given to the spouse outright or in trust under an arrangement treated as a grantor trust to the spouse. Although there is a step up in basis for any portion of the residence includable in the estate of the deceased spouse (usually half), a nongrantor trust — for example, a credit shelter trust — is not eligible for the IRC §121 exclusion from gain on sale of a principal residence. Furthermore, the fiduciary cannot deduct costs of administration pertaining to the residence (with the probable exception of mortgage interest and real estate taxes) unless the portion of the residence owned by the fiduciary is rented to the surviving spouse or any other individual at FMV.[18] The disallowance of expenses applies to any beneficiary using the residence for less than fair market rent.

Separate Share Rule

Practitioners should determine whether the separate share rule applies to the trust. The **separate share rule** treats separate and independent shares of different beneficiaries in the same trust as separate trusts for the purpose of calculating the beneficiaries' distributable net income (DNI).[19] The rule is mandatory, not elective, and could result in an unexpected trust-level income tax liability.[20]

Increased Applicable Exclusion Amounts

Many trusts have not been updated to reflect increased applicable exclusion amounts and still contain unnecessary marital deduction formula clauses requiring the funding of a bypass trust with assets equal in value to a deceased spouse's unused applicable exclusion amount. In most cases, this means all trust assets of the deceased spouse will be in the bypass trust and taxable under the normal rules of subchapter J. If clients want to avoid this, a proper solution is to refer them to an attorney who can seek a court-approved termination of the trust or possibly to use an NJSA. If clients choose simply to ignore the trust, a preparer will have to decide how comfortable they are preparing returns in that manner.

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17. IRC §401(a)(9)(H).

18. See *DuPont Testamentary Trust,* 62 TC 38 (1974), *aff'd per curium* 574 F.2d 1332 (5th Cir. 1978).

19. IRC §663(c).

20. See Treas. Reg. §1.663(c)-5.

Invading Principal

Distributions of income from a continuing trust may be completely discretionary, mandatory, or based on some other standard. In addition, a trustee may have discretion to invade principal for the benefit of a beneficiary under some standard. The most common standard for invasion is the ascertainable standard relating to the health, education, support, or maintenance of the individual.

> **Note.** If the trust document uses other words than "ascertainable standard relating to the health, education, support, or maintenance," it is necessary to show that, under the state law that governs the trust, the words used would, in fact, be limited to a standard related to health, education, support, or maintenance.

Failure to satisfy the ascertainable standard requirement means the trust assets become treated as a grantor trust to the beneficiary as the equivalent of a general power over principal under IRC §678(a). For example, the use of the word "comfort" without any limitation is treated by the regulations and courts as not satisfying the ascertainable standard. Placing the word "reasonable" in front of comfort, on the other hand, changes the whole complexion of the standard according to the courts which have interpreted it.[21]

> **Note.** When a trust document indicates that distributions are at the discretion of the trustee, this discretion makes the trust a **complex** trust.

If any language governing discretionary distributions does not comply with the ascertainable standard above or if there is a five-and-five power that would be better eliminated, it may be possible for the beneficiary to disclaim the power of the trustee to make distributions under the offending standard.

Income in Respect of a Decedent (IRD)[22]

Income in respect of a decedent is taxed in the same manner by the estate or trust as it would have been in the hands of the decedent/grantor. Wages that were earned prior to death but not paid until after death is a prime example of IRD. IRD can present problems to a trustee. Although IRD collected by the trustee is considered taxable income and goes into the calculation of DNI, it is not necessarily distributable to the beneficiaries. Whether it is distributable depends on whether the IRD is allocable to principal or income under the trust instrument or state fiduciary accounting laws. Retirement plan distributions paid to an estate or trust illustrate this type of problem. While typically allocable to principal, the distributions are likely taxable as ordinary income yet may not represent DNI. If it is allocable to principal, DNI is greater than FAI. In the case of a simple trust that is required to distribute all income currently, a distribution of FAI in a situation such as this is not sufficient to carry out the excess DNI that represents the IRD. A trustee who has discretion to make distributions can avoid this problem by making distributions in excess of FAI, which carries out the extra DNI because the trust is then treated as a complex trust due to the principal distribution and is entitled to a distribution deduction of the DNI rather than being limited to FAI.[23]

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21. See Treas. Reg. § 20.2041-1(c)(2).

22. IRC §691.

23. See Treas. Regs. §§1.661(a)-2(a) and (c).

Example 7. In 2015, Harold Green forms the Green Trust, a grantor trust with a trust instrument that specifically allocates capital gains to principal and is set up to qualify as a simple trust. The trust does not address IRD, but Harold lives in Illinois which has a principal and income act that states the following.

> *. . . income which is earned or accrued to the date of death of the decedent but not yet payable, including, but not limited to, income in respect of a decedent, or which is due but not yet paid, shall be added to principal when received.*[24]

Harold's niece, Tabitha, is the sole beneficiary of the trust. Soon after setting up the trust, Harold transfers 500 shares of Consolidated Electric Company (Consolidated) with a total basis of $5,000, into a brokerage account in the name of the Green Trust.

On August 16, 2021, Harold agrees to sell all 500 shares of Consolidated stock to a private investor for $20,000 with a closing on August 23, a week later. Both parties to the sale are aware that on August 3, Consolidated's directors declared a regular dividend of $0.50 per share to stockholders of record on August 10. The dividend was scheduled to be paid on September 3. Unfortunately, Harold passed away on August 17, the day after both parties signed the agreement. The Green Trust has no other income for 2021.

The Green Trust, now irrevocable, has the following as IRD.

- Long-term capital gain IRD: $15,000 ($20,000 – $5,000 basis)
- Dividend IRD: $250 ($0.50 × 500 shares)

Normally, dividend income in a simple trust is taxable to the trust's beneficiaries whether it was distributed or not. However, state law indicates that IRD income is added to principal, not the income of the trust. Therefore, the Schedule K-1 that the Green Trust sends to Tabitha in early 2022 does not show either dividend income from Consolidated's dividend declaration or capital gain income from the August sale.

NONJUDICIAL SETTLEMENT AGREEMENTS

Upon the death of the grantor of a revocable trust, the trust automatically becomes irrevocable (for this purpose ignoring joint trusts or when a surviving co-grantor retains a right of revocation). Historically, **irrevocable** has meant that with rare exceptions the trust was not capable of being changed or amended, and amended only through judicial processes. There has been a steady erosion of this concept in recent years through such things as the use of trust protectors (unrelated third parties who have the power to make specified changes to irrevocable trust), NJSAs, expansion of the ability of courts and beneficiaries to modify irrevocable trusts, and trust decanting. Perhaps the easiest of these is the NJSA.

> **Note.** Trust protectors, court modification, and trust decanting are beyond the scope of these materials and are not discussed here.

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24. 760 ILCS 15/5(b).

If the state in which the trust is domiciled has adopted the Uniform Trust Code (UTC), it may be possible to use an NJSA among the beneficiaries to make modifications to an irrevocable trust after the death of the grantor. An NJSA eliminates involving the courts and has relatively minimal costs compared to other methods. As of January 2020, 34 states plus the District of Columbia have adopted the UTC. If a state has not adopted the UTC or a comparable provision, the **standard** solution is a judicial proceeding for declaratory judgment or modification of the trust.

Note. An up-to-date listing of the states that have adopted the UTC can be found at **uofi.tax/21b1x1** [www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d].

UTC §111(b) allows **interested persons** (of which there is no definition unless added by state law) to enter into an NJSA with respect to **any matter involving a trust.** If this sounds too good to be true, it is. The first limitation is in §111(c), which says that an NJSA "is valid only to the extent it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court under this [Code] or other applicable law." There is no definition of material purpose because this is a matter of interpretation of the grantor's intent. The only discussion of material intent in the UTC is found in comments to UTC §411, dealing with spendthrift trusts. There it says the following.

> *A finding of such a purpose generally requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to the beneficiary's management skills, judgment, or level of maturity. Thus, a court may look for some circumstantial or other evidence indicating that the trust arrangement represented to the settlor more than a method of allocating the benefits of property among multiple beneficiaries, or a means of offering to the beneficiaries (but not imposing on them) a particular advantage.*[25]

UTC §111(d) has a nonexclusive list of the types of matters that can be addressed with an NJSA.

1. The interpretation or construction of the terms of the trust
2. The approval of a trustee's report or accounting
3. Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power
4. The resignation or appointment of a trustee and the determination of a trustee's compensation
5. Transfer of a trust's principal place of administration
6. Liability of a trustee for an action relating to the trust

Unfortunately, to say this is a "uniform" law is a mistake. It is a model law that states are free to adopt and adapt. It is doubtful that any of the 34 states that currently have enacted the UTC did so without alteration. This means what can be done with an NJSA depends on the state law. For example, Kansas has severely restricted the use of an NJSA to just four specific actions: approval of a trustee's report or accounting; resignation or appointment of a trustee and the determination of a trustee's compensation; transfer of a trust's principal place of administration; and liability of a trustee for an action relating to the trust.[26]

25. UTC, comment to §411 (Unif. Law Comm'n 2010).

26. KSA §58a-111.

As long as a state law does not contain a list of exclusive purposes for which an NJSA can be used, the actual parameters within which they can be used are not clear. For example, if there is no prohibitive language in a state statute, it should be possible for a terminating trust to use an NJSA to make clear that all income and capital gains are required to be distributed each year to the beneficiaries and that, if necessary, the full amount of any retirement distributions also must be distributed. This would effectively turn the trust from a complex trust into a simple trust. There is debate about whether an NJSA can terminate an unnecessary bypass trust resulting from the grantor failing to update their estate plan. Again, unless expressly prohibited under state law, there is a strong argument that doing so would not violate a material purpose of the trust if the sole reason for the bypass trust was avoidance of estate tax.

In the final analysis, however, the agreement of the beneficiaries in an NJSA is unlikely to cause problems, because they must all be in agreement in the first place. And if the agreement solves problems that otherwise result in higher income taxes and significant inconvenience, taxpayers should certainly consider it. This is not something the beneficiaries or return preparer should be trying to do themselves. Instead, they need to seek competent legal help.

CHARITABLE CONTRIBUTION DEDUCTION

Example 8. Use the facts as **Example 1.** After Jack and Diane die, the children gather with the family attorney to hear what instructions Jack and Diane left. They were all surprised that there was no instruction to leave money to "Little Pink Houses," a charity their dad was passionate about and always said he wanted to leave $50,000 when he passed away. The children are unanimous that this should happen, and the attorney draws up an agreement to make the contribution. Charitable contributions from estates and trusts are discussed in more detail next.

REQUIREMENTS

Estates and complex trusts are allowed unlimited charitable contribution deductions for amounts paid, or treated as paid, during the year for charitable purposes.

To qualify, however, contributions must satisfy all the following requirements. They must be made:[27]

1. Pursuant to the terms of the governing instrument,
2. From gross income, and
3. For a qualifying charitable purpose.

The charitable contribution deduction for trusts under §642(c) is instead of the deduction allowed individuals by IRC §170(a). Regulations under §170 state specifically that, "The provisions of section 170 do not apply to contributions by an estate; nor do they apply to a trust."[28] Charitable contributions by trusts are not limited by any contribution base and trusts are not permitted to carry over excess charitable contributions. Trusts are also not required to satisfy the substantiation requirements applicable to individuals.[29]

27. IRC §642(c).

28. Treas. Reg. §1.170A-1(j)(1).

29. The IRS issued Prop. Reg. §1.642-1(a)(1) in 1988 that would make the substantiation and contemporaneous written acknowledgement requirements of §170 regulations applicable to trusts. Given the Code provisions and existing regulations, one has to wonder whether such a regulation in final form would be valid.

Pursuant to Trust Instrument

The trust instrument or will must state specific authority for the fiduciary to make contributions to charities. Furthermore, any contributions made must conform to the authority. The fact that a fiduciary has discretion with respect to contributions does not disallow the deduction, but the discretion must be exercised within the authority given. For example, when a trustee has the power to terminate a trust at any time and pay the entire principal or income after termination to charities, a donation to a charity made from trust income prior to a decision to terminate the trust is not pursuant to the governing instrument and no deduction is allowed.[30]

In a slight departure from the written instrument requirement, the IRS ruled that a trust can claim a charitable contribution deduction for its distributive share of a partnership charitable contribution, even if the trust instrument itself does not authorize charitable contributions.[31] The contribution by the partnership must be made for a qualifying charitable purpose (discussed later) if the trust made it directly. In addition, the contribution deduction derived from the partnership is subject to reduction by the extent it is allocable to unrelated business income under the limitations of IRC §681.[32]

Gross Income

Only amounts payable from gross income are allowed as a contribution deduction. Gross income is determined for federal income tax purposes rather than for FAI. Although charitable payments must be made from gross income, they do not have to come out of current year's gross income. Thus, a trust or estate that has accumulated income in prior years can make a contribution to the extent of the accumulated income and the current year's gross income if no deduction was allowed for any previous tax year to the estate or trust, or in the case of a §645 election, to a related estate.[33]

Gross income includes all forms of gross income. Thus, capital gains and IRD constitute gross income under §642(c) even though they may be allocated to principal under state Principal and Income Acts.[34] Capital gains may also be treated as specifically distributed to a charity. In Rev. Rul. 78-24[35], for example, a terminating trust sold certain assets at a gain in satisfaction of a requirement in the trust that it pay a bequest of a specified dollar amount in a single payment to a noncharitable trust. The remainder of the trust was payable to a charity. The IRS ruled that the trust was entitled to deduct as a charitable contribution the lesser of the amount of the charitable trust distribution or the capital gain. The amount paid to the noncharitable trust was not entitled to a distribution deduction under IRC §661 and was not includable in the noncharitable trust's gross income because it was a specific bequest.

Tax-Exempt Income. Because a contribution must be from gross income, tax-exempt income cannot be considered in determining the charitable contribution deduction. This prevents a double tax benefit: a deduction for income that is not subject to taxation in the first place. In the absence of specific provisions in the trust document, the charitable contribution must be allocated among the different types of income the trust has, both taxable and nontaxable. The contribution is allocated to each of the classes to the extent of that class's proportion of the total amount of income.

30. Rev. Rul. 55-92, 1955-1 CB 390.

31. Rev. Rul. 2004-5, 2004-3 IRB 295.

32. FSA 200140080 (Sep. 4, 2001).

33. Treas. Reg. §1.642(c)-1(a)(1).

34. For example, see *Estate of Whiteley v. Comm'r,* 10 BTA 1385 (1928); Ltr. Rul. 200221011 (Feb. 12, 2002).

35. Rev. Rul. 78-24, 1978-1 CB 196.

Example 9. Use the same facts as **Example 6.** Under the terms of the trust agreement established for Speck, her trust is required to distribute half of its FAI each year to a qualified charity. For the year, the trust has \$12,000 total income comprised of \$2,000 of tax-exempt municipal bonds, \$4,000 of dividends, and \$6,000 of rental real estate. Hud, the trustee, distributes half the fiduciary income, \$6,000, to the charitable beneficiary. To determine the charitable contribution deduction, the \$6,000 is allocated between gross income and tax-exempt income.

$$\$2{,}000 \times \frac{\$6{,}000}{\$12{,}000} = \$1{,}000 \text{ tax-exempt}$$

$$\$4{,}000 \times \frac{\$6{,}000}{\$12{,}000} = \$2{,}000 \text{ dividends}$$

$$\$6{,}000 \times \frac{\$6{,}000}{\$12{,}000} = \$3{,}000 \text{ rental}$$

Thus, \$1,000 of the contribution is deemed to derive from tax-exempt income and is not deductible as a charitable contribution by the trust. The remaining \$5,000, allocated to the items of gross income, is deductible.

Observation. If the trust instrument directed distributions to the charitable beneficiary only from gross income and not from tax-exempt income, the entire \$6,000 would be deductible.

If the governing instrument or state law specifically provides the source for amounts paid or set aside for charitable purposes, that controls for federal income tax purposes only to the extent it has economic effect (similar to the substantial economic effect test of partnership allocations).[36] If there is no such provision, the income allocable to the charity is allocated among the different items of trust income on a proportionate basis in the same manner as for DNI.[37]

Phantom FAI. The fact that an amount may be included in a trust's gross income does not necessarily mean that it is "income" that can be taken into account for a charitable contribution deduction if it is phantom FAI. **Phantom FAI** is income only for federal income tax purposes and not actually received by the trust. Thus, the following types of gross income were ruled not to constitute income for purposes of the set-aside charitable deduction.

- Distributive share of income from an S corporation when no actual distributions were made[38]
- Consent dividends for personal holding company purposes that were never actually paid[39]
- Full-year distributive share of a deceased partner was taxable to the estate as IRD except to the extent of the portion actually paid in excess of their draws[40]

Tracing. Income allocated to principal under the instrument or state law does not affect its status as gross income for purposes of a subsequent charitable contribution deduction.[41] It is advisable to maintain separate income tax accounts for accumulated income that was added to principal because tracing is required for charitable contribution deductions under §642(c) to prove the source of the contribution is from gross income.[42]

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36. Treas. Reg. §1.642(c)-3(b)(2).
37. Ibid.
38. *Sid W. Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir 1970).
39. *Estate of Esposito v. Comm'r,* 40 TC 459 (1963).
40. *Estate of Freund v. Comm'r,* 303 F.2d 30 (2d Cir. 1962).
41. *Estate of Holdeen v. Comm'r,* TC Memo 1975-29 (Feb. 19, 1975).
42. *Van Buren v. Comm'r,* 89 TC 1101 (1987).

Gifts from Principal. In a seeming paradox, some cases say that gifts made from trust principal do not qualify for a deduction under §642(c). The term **principal** can have two meanings under §642(c). Any portion of principal originating from the gross income of a trust is considered gross income for contribution purposes. For a contribution out of income accumulated as principal to be a deductible contribution, the governing instrument must specifically say it must be made from income. If the trust fails to state whether contributions are to be made from income or principal, the applicable state law governs.[43] If not, it is treated as a gift of principal, meaning it is a specific bequest rather than a charitable contribution. Specific bequests to charities are deductible only on Form 706 and not on the Form 1041.

Example 10. Use the same facts from **Example 7.** The estate of Jack and Diane directs the executor to distribute $50,000 to the Little Pink Houses charitable organization. There is no direction in the governing document that the $50,000 be paid out of gross income. The contribution is a specific bequest deductible only on the Form 706 for estate tax purposes and not on Form 1041 for income tax purposes.

Conversely, if the estate directs the executor to pay $50,000 out of the estate's gross income, the contribution is deductible for income tax purposes rather than as a specific bequest.

If specific property is bequeathed to a charity, but earns income prior to distribution to that charity, the income earned must also be distributed. Because the earned income is gross income to the trust, the distribution generates a deduction under §642(c). A §645 election can prevent a mismatch between the trust's reporting and paying tax on the earned income and taking a deferred deduction.

Example 11. Use the same facts from **Example 10.** Rather than donate cash, the estate bequeaths 100 shares of stock worth $50,000 to Little Pink Houses. In year 1 and year 2, $1,000 of dividends are paid on the shares. In year 3, the shares and $2,000 of dividends are distributed to the charity. If there is no set-aside deduction, the trust pays income tax on the dividends in years 1 and 2.

The trustee can make a charitable carryback election (discussed later) to treat the $1,000 dividend from year 2 (distributed in year 3) as having been contributed in year 2, and receive a refund of any tax already paid. However, the tax paid in year 1 cannot be recovered, other than through the year 3 deduction. Even worse, to the extent the $1,000 contribution (or $2,000, if no charitable carryback election is made) in year 3 exceeds trust income, the deduction is wasted.

There is another aspect of principal that may not be so apparent. In Rev. Rul. 2003-123,[44] a trust had two parcels of real property that were original principal of the trust, meaning they were contributed to the trust as assets. The trust donated a qualified conservation easement on one of the parcels to a state agency and took a charitable contribution deduction of $10x. For the year of the contribution, the trust had $20x of gross income and no distributions to beneficiaries. The IRS, citing case authority, stated that, "because §642(c) specifically requires that a charitable deduction is available only if the source of the contribution is gross income, tracing of the contribution is required in determining its source." It then ruled that the conservation easement was not traceable to the trust's gross income because it was made from trust principal. Although not explained in the ruling, the problem was that the parcel on which the easement was given was original contributed principal to the trust and was not acquired using the trust's gross income.

43. Rev. Rul. 71-285, 1971-2 CB 248.

44. Rev. Rul. 2003-123, 2003-2 CB 1200.

This is more fully explained in a later 10th Circuit case.[45] A trust purchased certain improved real estate and donated it to charitable organizations. Because the real estate appreciated in value and was a long-term capital gain asset, the trust deducted its FMV. On examination, the IRS limited the deduction to the trust's basis in the properties. The trust paid the deficiency, then sued for refund in U.S. District Court, which awarded the refund. On appeal, the 10th Circuit reversed, holding that the deduction was limited to basis because that was the amount of the trust's gross income represented by the properties as a result of the trust's purchase of the properties. None of the unrealized appreciation in value of the properties was attributable to gross income, and therefore was not deductible (although it would have been for an individual).

Charitable Purpose

The charitable contribution deduction is permitted when amounts are paid for a **purpose** specified in §170(c). It is **not** necessary that the amounts be paid to an organization specified in §170(c). These purposes are religious, charitable, scientific, literary, educational, fostering national or international amateur sports competition, and the prevention of cruelty to children or animals.[46] As a practical matter, however, most contributions are probably made to organizations described in §170(c), which should present no problem. However, the purpose test allows deduction of a contribution to an organization not qualifying for deduction of individual contributions if the contribution is used for one of the specified purposes. Nor does the disallowance of individuals' deductions for contributions to foreign organizations apply.[47]

SET-ASIDE DEDUCTION

A charitable **contribution** deduction for amounts required by the terms of the governing instrument to be set aside permanently for a purpose specified in §170(c) or to be used by certain organizations is commonly referred to as a **set-aside deduction.**[48] To qualify, it must be clear that income is being set aside permanently for the ultimate benefit of a qualified beneficiary. Because the amount is determined based on the governing instrument, it does not matter how the fiduciary actually allocates income for fiduciary accounting purposes. In most other respects, the same requirements apply for amounts permanently set aside as for amounts paid currently out of income.

Estates are entitled to the set-aside charitable deduction. The set-aside deduction is **not** available to trusts (except certain pre-1969 trusts, which will not be discussed), which are entitled to charitable contribution deductions only when an amount is actually paid for a charitable purpose. However, if a trust made a §645 election, it is treated as an estate and is therefore entitled to an estate set-aside deduction during the period of the election regardless of whether there is a related estate.[49]

If there is an actual distribution of income to a charitable organization, the contribution is "paid" under §642(c). Problems can arise with the set-aside deduction, however. By its very nature, the set-aside deduction applies to distributions that will be made to a charitable organization at some future time or event. All that is necessary for a current set-aside deduction is gross income the governing instrument directs to be distributed to a charitable organization in the future rather than in the current year. No actual payment or crediting on the fiduciary's books is necessary to support the deduction.[50] However, the regulations contain the following limitation on the set-aside deduction.[51]

> *No amount will be considered to be permanently set aside . . . unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible.*

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45. *Green v. U.S.,* 880 F.3d 519 (10th Cir. 2018).

46. IRC §170(c)(2)(B).

47. Treas. Reg. §1.642(c)-1(a)(2).

48. Treas. Reg. §1.642(c)-2(a).

49. See Treas. Regs. §§1.642(c)-1(a)(1) and 1.642(c)-2(a).

50. For example, see *Bowers v. Slocum,* 20 F.2d 350 (2d Cir. 1927).

51. Treas. Reg. §1.642(c)-2(d).

This does not mean that the actual amount set aside must ultimately be distributed to a charitable organization. In one case, for example, money and property were left to the State of Florida for certain charitable purposes. During administration of the trust and before any distributions were made to the state, however, there were claims against the estate greatly exceeding the income of the estate, all of which were eventually settled. The IRS, however, denied the set-aside deductions on the basis that the magnitude of the claims made it too uncertain that the income could be considered permanently set aside for charity. In holding for the estate, the Tax Court noted there was no issue of whether the governing instrument required income to be set aside for charitable purposes. The uncertainty of whether the charity will ever actually receive the income must arise **from the governing instrument itself, not from unrelated outside events.**[52]

Similarly, in another case, the IRS denied the set-aside deduction to a trust because the trust had to pay income taxes and legal obligations as part of its agreement in acquiring certain contributed assets, leaving net income that was less than the set-aside amount deducted by the trust. The IRS argued that there could not be a set-aside deduction with respect to income that was not available for the set-aside because it was used to pay trust obligations. In its arguments, the IRS relied on the rule that there was a probability under the terms creating the trust that obligations assumed by the trust in its creation made the amount ultimately available for charitable purposes not capable of ascertainment so that no amount could be said to be set permanently aside.

In holding for the trust, the court said, "We think that a distinction must be made between cases where the provisions of the instrument itself render uncertain whether the charitable donees will actually take, in cases where there is no uncertainty under the provisions of the instrument that net income **must** be used for charitable purposes, but valid claims and charges against the trust render uncertain for the time being the exact amount of the net income which is committed to charitable purposes."[53]

Powers of Invasion or Allocation

Tax practitioners should be aware of trusts that contain provisions to invade principal or the power to adjust the allocation between interest and principal, and consider potential consequences. The analysis courts developed in such cases consists of two steps: (1) determining whether there is a sufficiently definite standard to make the value of the charitable gift ascertainable; and (2) if there is such a standard, determining whether, under that standard, the likelihood of invasion is sufficiently remote that the charity is reasonably assured of receiving the gift.[54]

This was the approach taken in Rev. Rul. 66-360[55] in which a will established a testamentary trust to pay income to the beneficiary for life, with remainder to a charity. The terms of the trust also authorized the trustee to invade principal if necessary, in its judgment, to support and maintain the beneficiary in the manner to which she had become accustomed. The issue was whether the power of invasion created sufficient uncertainty about whether the charity would ultimately receive the set-aside principal that the charitable deduction should be denied.

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52. For example, see *Rockland Oil Co. Transferee, et. al. v. Comm'r,* 22 TC 1307 (1954) (citing other cases).

53. *Comm'r v. The Leon Beeghly Fund,* 310 F.2d 756 (6th Cir. 1962), *affirming* 35 TC 490 (1960); see, also*, Hartwick College, et al v. U.S.,* 588 F.Supp. 926 (ND NY 1984), *aff'd on other issues,* 501 F.2d 608 (2d Cir. 1986).

54. For example, see *Newton Trust Co. v. Comm'r,* 217 F.2d 287 (2d Cir. 1954).

55. Rev. Rul. 66-360, 1966-2 CB 228.

The IRS said that the test to determine if an amount is permanently set aside under §642(c) is whether, based on the terms of the governing instrument and the circumstances of the particular case, it can be reliably predicted that no invasion of principal will occur. The ruling noted that a power of invasion based on a beneficiary's accustomed manner of living during their lifetime was held to fix a standard capable of being stated in definite terms of money. Therefore, there is no uncertainty that the charity will receive the remainder if the income of the trust is more than sufficient to provide for the necessary support.[56] The IRS then said that determining the likelihood of invasion and the extent of such, is a facts-and-circumstances analysis in each case. In this instance, it examined the following factors in concluding that the power to invade principal was not likely to be exercised.[57]

- Whether the trust instrument set a definite or ascertainable standard
- The life expectancy of the life income beneficiary
- The annual cost of the beneficiary's present standard of living
- The income of the trust after reinvestment of gains from dispositions of principal
- The expected income of the beneficiary from sources other than the trust

On the other hand, when the trustee could invade principal liberally for the "comfort, support, maintenance, and/or happiness" of the surviving spouse with remainder to charitable beneficiaries, the Supreme Court ruled that no set-aside deduction was available to the trust. While the mere possibility of an invasion of principal does not defeat the set-aside deduction, in this case there was no ascertainable standard by which to measure possible diversions and therefore no ascertainable amount permanently set aside for charity.[58] This case involved both an estate tax charitable deduction for the charitable remainder interest and a fiduciary income tax deduction for capital gains allocated to principal. The Supreme Court made no distinction between the ascertainable standard test to be used for the two different deductions, although it did not directly state that this was the rule. A later Tax Court case, however, did say that the same ascertainable standard applies in both instances.[59] Therefore, estate tax precedents on ascertainable standards are relevant in determining fiduciary income tax deductions for set-aside deductions when there is a power of invasion of principal under a support standard.

Rev. Rul. 73-95[60] may have created a potential landmine for the set-aside deduction for certain trustee discretion often found in boilerplate trust provisions describing trustee powers. A testamentary trust was to pay all income to two beneficiaries until the death of the last beneficiary. The remainder went to charitable beneficiaries. The terms of the will creating the trust provided that any gains from the sale or other disposition of property constituting principal could, in the absolute discretion of the trustee, be allocated either to income or to principal. The provision was not contrary to the applicable state law. In accordance with this, the trustee credited two-thirds of capital gain to the income beneficiary in one year and the remaining one-third to principal, claiming a set-aside deduction for the one-third.

The revenue ruling concluded that the set-aside deduction was not allowable because §642(c) requires income to be irrevocably set aside for charitable purposes pursuant to the terms of the governing instrument. If the amount set aside depends on the discretion of the trustee and, according to the ruling, "the trustee has discretionary power to allocate amounts received either to principal or income, it cannot be said to have been permanently set aside." The IRS then used the following example to illustrate that the trustee's authority meant that amounts of income previously set aside as principal could subsequently suffer diminution through losses affecting principal so that there was no assurance an amount previously set aside would ultimately be available to the charity.

56. Citing *Ithaca Trust Company v. U.S.,* 279 U.S. 151 (1929).

57. Rev. Rul. 66-367, 1966-2 CB 241.

58. *Merchants National Bank of Boston v. Comm'r,* 320 U.S. 256 (1943).

59. *Estate of Allen v. Comm'r,* 6 TC 597 (1946).

60. Rev. Rul. 73-95, 1973-1 CB 322.

Example 12. A long-term capital gain of $9,000 was previously set aside for charity. In a subsequent year, the trust sold two blocks of stock. One block had a basis of $1,000 and an FMV of $10,000, while the other block had a basis of $10,000 and an FMV of $1,000. In the year the blocks are sold, if the trustee allocates the $9,000 of gain from one block to income and distributes that $9,000 to the income beneficiary, only $2,000 of the previously set aside $9,000 will be left in principal ($11,000 sales proceeds – $9,000 distribution). The result is that principal is diminished and a substantial portion is no longer available to the charitable remainder beneficiary. The ruling therefore held that such discretionary power in the trustee to allocate gains means amounts set aside do not qualify under §642(c) as being permanently set aside.

This ruling appears to have been used in one letter ruling[61] and one U.S. District Court case[62] as a basis for denying set-aside deductions for trusts in which the trustee had discretion to allocate gains between principal and income. It certainly has not been raised as an issue as frequently as discretionary invasions of principal in support of a life income beneficiary, and it remains to be seen whether the Tax Court might agree with the IRS. It does, however, raise the issue of the extent to which boilerplate trust provisions giving the trustee discretion to allocate receipts between principal and income might be within its scope. Discretion based solely on "receipts" might very well be a problem if interpreted to allow receipts from capital gain transactions to be treated differently from receipts from capital loss transactions. Perhaps one way to avoid it is for the drafting attorney to limit the trustee's discretion to net capital gains. If that approach were used in **Example 12,** the existing $9,000 previously set aside would be protected because the net capital gain for the year in issue would be zero ($9,000 gain – $9,000 loss).

This does not necessarily mean a set-aside deduction cannot be claimed if there is trustee discretion in allocating receipts between principal and income. The revenue ruling assumed a fact pattern that seemed almost contrived to make the example work in a manner that supported its conclusion. There is no discussion, however, about how common or remote an occurrence such a fact pattern might be. For example, if a trust terminates following the death of the grantor and all assets are distributed, including a share of the remainder to a charitable organization, how likely is it that a trustee's discretion to allocate receipts between principal and income could ultimately reduce a capital gain set-aside deduction for the charitable remainder beneficiary? It seems extremely unlikely that such a discretionary power would be exercised, and a set-aside deduction should be permitted. If the trust is a longer-term continuing trust, the issue is more complicated. Perhaps the best approach is determining the likelihood of an exercise of discretion based on a discretionary power of invasion model discussed previously.

CHARITABLE THROW-BACK ELECTION

IRC §642(c)(1) permits the fiduciary to elect to treat current charitable contributions during any year as having been made the prior year. The payments must actually be made during the year from which the election back is being made and there must not have been any prior deductions with respect to any such amounts. The fiduciary is not limited, however, to only the income of the previous year, but may elect to treat any contributions of gross income as made in the prior year, no matter when the income was actually earned. The election is made by filing a statement containing the following information with the income tax return or amended return for the tax year in which the contribution is treated as paid.[63]

1. Name and address of the fiduciary
2. Estate or trust for which the fiduciary is acting
3. Statement that the fiduciary is making an election under §642(c)(1) in respect of contributions treated as paid during such tax year
4. Name and address of each organization to which any such contribution is paid
5. Amount of each contribution and the date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year

61. Ltr. Rul. 9714001 (Dec. 5, 1996).

62. *Samuel P. Hunt Trust v. U.S.,* No. 02-375-JD, (D.C. NH 2003).

63. Treas. Reg. §1.642(c)-1(b).

It is especially important to consider the election if property that is specifically bequeathed to a charity produces income in year one (e.g., 2021) but the property and income are not actually distributed to the charity until year two (e.g., 2022). Otherwise, there is a mismatch, with the income taxed to the trust in year one and the charitable deduction in year two. The IRS has granted extensions for the election, but these require the submission of a private ruling request.[64] See the previous example illustrating a situation in which a throwback election is appropriate.

NO DISTRIBUTION DEDUCTION

The regulations state that, "Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c)."[65] Therefore, a distribution deduction cannot be taken for an amount paid to a charity, even if the charitable contribution deduction itself is not allowed. This seems firmly established in various court cases.[66] There are arguments that the IRS position exceeds the scope of the statute. A discussion of the issues is beyond the scope of these materials, because the present position of the IRS and courts seems firmly against permitting a distribution deduction for amounts paid or set aside for charities. There is, however, an excellent and lengthy discussion of the issues in a Chief Counsel Advice.[67]

CAPITAL GAINS AND LOSSES

GENERAL RULE

Note. Trusts employing total return investing with equitable adjustments or unitrust elections as a method for determining FAI are affected by rules not discussed in this section. Those methods for determining income are generally used by commercial trustees and are beyond the scope of these materials.

Additionally, this section addresses only capital gain rules as applied to trusts. Because of their transitory nature and fundamentally different purposes, probate estates are relatively unaffected by these rules.

Capital gains and losses are normally attributable to dispositions of principal and are therefore allocable to principal and not to income. For this reason, they are also excluded from the definition of DNI. To the extent capital gains are paid, credited, or required to be distributed to any beneficiary during the tax year, or are paid, permanently set aside or to be used for a charitable beneficiary, they are included in DNI.[68] Although both fiduciaries and individuals have a maximum capital gain rate of 20% in 2021,[69] there is still a strong tax incentive for taxing capital gains to the individual beneficiaries of a trust. This is because the 0% and 15% long-term capital gain (LTCG) rates apply at much higher income levels for individuals than for trusts and estates, as shown in the following table.[70] Trustees and beneficiaries may be tempted to allocate capital gains to the beneficiaries in order to avoid the net investment income tax (NIIT) at the trust level. Practitioners should consult with the attorneys for the trust to ensure allocations are consistent with the terms of the trust or estate.

	2021 Income Brackets				
LTCG Tax Rate	**Single**	**MFJ**	**MFS**	**HoH**	**Trust/Estate**
0%	\$ 0– 40,400	\$ 0– 80,800	\$ 0– 40,400	\$ 0– 54,100	\$ 0– 2,700
15%	40,401–445,850	80,801–501,600	40,401–250,800	54,101–473,750	2,701–13,250
20%	Over 445,850	Over 501,600	Over 250,800	Over 473,750	Over 13,250

64. Treas. Reg. §301.9100-3(e)(5).

65. Treas. Reg. §1.663(a)-2.

66. See *Mott v. U.S.,* 462 F.2d 512 (Ct. Cl. 1972), *cert. denied,* 409 United States 1108 (1973), and cases following it.

67. CCA 201651013 (Sep. 8, 2016).

68. IRC §643(a).

69. Rev. Proc. 2020-45, 2020-46 IRB 1016.

70. Ibid.

While it may generally be more advantageous to tax capital gains to the individual beneficiaries, actually doing so may be more complicated. Taxing the individual involves limitations and interpretation of issues with tax law, the trust agreement, and state laws governing trustees and principal and income allocations. Pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law, the regulations state that capital gains are not ordinarily considered as paid, credited, or required to be distributed unless they are:[71]

1. Allocated to income ("allocated");
2. Allocated to principal but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary ("consistent use"); or
3. Allocated to principal but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary ("distributed").

Note. In the examples at the end of this section, these three exceptions are referred to as "allocated," "consistent use," and "distributed."

LTCG distributions from a mutual fund are treated as capital gains for fiduciary accounting purposes. Because this consists of the excess of a mutual fund's net LTCG over its net short-term capital loss, a capital gain dividend does not include any net short-term capital gain. Short-term capital gains, however, are included as part of ordinary dividends. The IRS ruled that, although LTCG distributions from mutual funds are treated as capital gains for determining whether they are included in DNI, short-term capital gains that are part of ordinary dividend distributions are not, and therefore constitute ordinary income includable in DNI.[72] The effects of whether capital gains and losses are includable in determining DNI are shown through the following examples (the personal exemption and any other deductions are ignored for simplicity).

Example 13. Use the same facts as **Example 2.** The trusts established by the wills of Jack and Diane grant Hud, the trustee, with discretion to distribute income or to accumulate it. In addition, they allow him discretion to invade principal on behalf of a beneficiary. The trust instruments are silent regarding capital gains and losses, and the trusts are governed by the current Uniform Principal and Income Act (UPIA). In 2021, one of the trusts has $5,000 of ordinary income and $5,000 of LTCG. If no distributions are made for 2021, there is no distribution deduction, and the trust is taxed on $10,000 of gross income.

Example 14. Use the same facts as **Example 13,** except the trust distributes $5,000 to beneficiaries. DNI remains $5,000, but the trust is now entitled to a $5,000 distribution deduction. The trust is therefore taxed on $5,000 of capital gain.

Example 15. Use the same facts as **Example 13,** except Hud distributes $10,000 for 2021. The trustee has not adopted a practice of distributing the net capital gains of the trust. The results are the same as **Example 14** because the capital gain does not enter the calculation of DNI. The coincidental matching of the distribution to the amount of trust capital gain does not by itself satisfy any of the three exceptions previously listed.

Example 16. Use the same facts as **Example 15,** except Hud adopts a practice of distributing the net capital gains of the trust. DNI is now $10,000 because the capital gain must be included. The trust is entitled to a $10,000 distribution deduction, the trust has no taxable income, and all income is taxable to the beneficiaries.

If a charitable contribution deduction is allowed for capital gains paid, permanently set aside, or to be used for charitable purposes so that a charitable deduction is allowed for such gains, the gains must be included in determining DNI.[73] The inclusion will be offset by a corresponding charitable contribution deduction.

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71. Treas. Reg §1.643(a)-3(b).

72. Ltr. Rul. 9811036 (Dec. 10, 1997).

73. Treas. Reg. §1.643(a)-3(c). The set-aside charitable contribution deduction is discussed in a separate section, Charitable Contribution Deduction.

CAPITAL LOSSES

If capital gains are required to be included in DNI, they are generally reduced at the trust level by any capital losses. If, however, a capital gain that is allocated to principal but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount distributed or required to be distributed to a beneficiary ("distributed" exception), there is no netting of capital losses against that capital gain. Instead, the gross amount of that capital gain is allocated to the beneficiary. No current deduction is ever allowed to remainder beneficiaries (those taking the principal after termination of the estate or trust) for capital losses attributable to principal except as capital loss carryovers to beneficiaries on termination of the estate or trust.[74]

Example 17. Use the same facts as **Example 2.** The trusts established through the estate of Jack and Diane give Hud, the trustee, discretion to allocate net capital gains to principal or to income. In 2021, one of the trusts has two transactions, one of which results in $10,000 of LTCG, the other in $5,000 of long-term capital loss. Hud properly elects to allocate capital gain to income.

In preparing Schedule D, *Capital Gains and Losses,* each transaction is listed separately at part II, for long-term capital gains and losses. They are netted, resulting in a net long-term capital gain of $5,000. The trustee completes column (1) in part III of Schedule D to show the beneficiaries are allocated the entire $5,000 net capital gain. Because the $5,000 of capital gain is allocated to the beneficiaries, it must also be included in DNI.

Example 18. Use the same facts as **Example 17,** except there was $10,000 of capital loss and $5,000 of capital gain, resulting in a net long-term capital loss of $5,000. Capital gains are required under the instrument to be allocated to income and distributed to beneficiaries. Because there are no net capital gains, nothing is allocable to the beneficiaries from the Form 1041. Instead, the $5,000 capital loss is deductible only on the fiduciary return by the trustee. The only exception would be in the case of a terminating distribution made during the same tax year (discussed later).

EXCEPTION 1: GAINS ALLOCATED TO INCOME

Section 404(2) of the 1997 UPIA allocates gains and losses from the disposition of principal to principal. This rule is commonly applicable even in states that have not adopted the Act. Subchapter J, (taxation of estates and trusts) generally follows this approach, meaning capital gains and losses are, for income tax purposes, allocable to principal and therefore taxable to the fiduciary in the absence of an exception.[75] The statutes are the default rules in the absence of an express direction in the governing instrument. The trust instrument can, however, alter this default rule, either by an express allocation or by giving the trustee discretion over whether capital gains and losses should be allocated to principal or to income. In fact, most trust agreements have boilerplate language permitting the trustee to allocate capital gains between principal and income at the trustee's discretion. The IRS stated in a technical advice memorandum (TAM) that, if the trustee has discretion under the instrument and state law to allocate capital gains to income, any gains allocated under such discretion is taken into account in determining DNI.[76]

The trustee's ability to choose whether capital gains are allocated to principal or income is not unlimited, however. As stated previously, regulations require that the exercise of the trustee's discretion must be "reasonable and impartial."[77] Furthermore, regulations defining trust income — while acknowledging capital gain allocations to income pursuant to a trustee's reasonable and impartial discretion is recognized — also say that trust provisions departing fundamentally from traditional principles of income and principal generally is not recognized. An example is a trust provision defining ordinary dividends and interest as principal when the trust requires all income to be distributed currently.[78]

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74. Treas. Reg. §1.643(a)-3(d).
75. Treas. Reg. §1.643(a)-3(a).
76. TAM 8728001 (Nov. 21, 1986).
77. Treas. Reg. §1.643(a)-3(b).
78. Treas. Reg. §1.643(b)-(1).

It may be possible for a trust or local law to make specific allocations of different classes of trust income to different beneficiaries.[79]

> **Example 19.** A trust is established with language that beneficiaries are to receive all income generated by the trust at least annually. The trustee has discretion to allocate receipts to principal or income. In 2021, the trust has $50 of ordinary interest income and $50 of LTCG that the trustee allocates to income. One of the beneficiaries is in a low marginal income tax bracket and the other in a high bracket. The trustee distributes $50 to the high-bracket beneficiary and designates that as being the LTCG portion. The $50 of ordinary interest income is similarly allocated to the low-bracket beneficiary.

The allocation described in **Example 19** is not permitted. First, the default rules of subchapter J base the character of income distributions to beneficiaries on DNI. DNI includes a proportionate share of every class of income the fiduciary has and any distribution of income to a beneficiary is deemed to consist of those proportionate classes.[80] Second, regulations addressing allocations of different classes of income to different beneficiaries require that the allocation be required in the trust instrument and that the allocation has economic effect independent of the income tax consequences. The regulations provide the following examples.[81]

1. An allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.
2. An allocation pursuant to a provision directing the trustee to pay all of one type of income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.
3. An allocation pursuant to a provision directing the trustee to pay half of the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

The Tax Court said that a specific disproportionate allocation of classes of income to a beneficiary lacks economic effect when the result affects only the beneficiary's income tax liability, but that neither increases nor decreases the dollar amount to which the beneficiary is entitled.[82]

EXCEPTION 2: GAINS UTILIZED CONSISTENTLY IN DETERMINING DISTRIBUTIONS

If a fiduciary adopts a practice of using capital gains in the determination of the amount to be distributed to beneficiaries, capital gains are treated as part of DNI. Based on examples from the regulations at the end of this section, it appears a trustee can adopt this practice the first time it has capital gains.

From what guidance there is, it appears that two requirements are necessary for capital gains to be treated as DNI. First, the trustee must follow a regular practice of distributing the exact net proceeds of the sale of trust property.[83] Second, even if the fiduciary distributes the exact net capital gains, the fiduciary is not treated as having established a practice until after the first tax year of the trust or estate.[84]

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79. Treas. Regs. §§1.652(b)-2(a) and 1.662(b)-(1).
80. Ibid.
81. Treas. Reg. §1.652(b)-2(b).
82. *Van Buren v. Comm'r,* 89 TC 1101 (1987) (citing Treas. Reg. §1.652(b)-2(b).)
83. Treas. Reg. §1.643(a)-3(e), Example 5.
84. Rev. Rul. 68-392, 1968-2 CB 284.

EXCEPTION 3: ACTUALLY DISTRIBUTED OR USED TO DETERMINE DISTRIBUTION

Assuming the governing instrument and state law require capital gains to be allocated to principal, they may, nevertheless, actually be distributed to beneficiaries during the tax year. If they are actually distributed, they enter into the calculation of DNI, even though allocable to principal. It might appear under this rule that a fiduciary could distribute to beneficiaries an amount equal to the capital gain of the trust or estate (in addition to its other income) and thereby effectively cause the capital gain to enter into DNI even in the absence of authority under the governing instrument or state law. This is not the case.

In Rev. Rul. 68-392,[85] the income beneficiary of a testamentary trust was to be paid a fixed annuity for her lifetime, with the annuity to be paid first out of income and then, if necessary, out of principal. For its first tax year, the trust had sufficient income to pay only part of the annuity. The trustee therefore distributed securities in satisfaction of the trustee's obligation to pay the balance of the annuity, with the securities having an FMV equal to the balance. The trustee was required to recognize capital gain because appreciated property was distributed to satisfy a pecuniary obligation. The governing instrument was silent as to the allocation of capital gains, and local law required it to be allocated to principal.

The IRS analyzed the regulations to determine who should be taxed on the capital gain, the trustee or the beneficiary. It concluded that neither the governing instrument nor local law made the capital gain taxable to the beneficiary. Thus, the first exception under which capital gain is taxable to the beneficiary was not satisfied.

The IRS then analyzed whether the capital gain was allocable to principal but was actually distributed to the beneficiary. The IRS stated that this particular provision applies only if the terms of the governing instrument require a distribution upon the happening of a specified event, such as a terminating distribution. The IRS determined that such a condition did not exist in this case.

Finally, the IRS discussed whether the capital gains were utilized under the governing instrument or a practice followed by the trustee in determining the amount distributed or required to be distributed. The IRS determined that the capital gains were not being utilized pursuant to the terms of the governing instrument in determining the amount distributed or required to be distributed. The IRS then went on to say that, because this was the first tax year of the trust, capital gains were not utilized pursuant to the practice followed by the trustee in determining the amount that was distributed or required to be distributed.

EXAMPLES

The following examples, generally based on examples in the regulations, illustrate allocations to income.[86]

> **Caution.** The fact that a trustee has discretion to allocate capital gains to income should not be taken as carte blanche to do so. The trustee is always subject to a fiduciary duty owed to both the current income beneficiaries and the remainder beneficiaries. Allocating capital gains to income will reduce the amount going to the remainder beneficiaries when the trust terminates. A trustee's discretion must not violate their duty to current income beneficiaries and remaindermen or the trustee may be liable for damages for breach of their fiduciary duty.

85. Ibid.

86. Treas. Reg. §1.643(a)-3(e), Examples 1–10.

Example 20. Allocated. Under the terms of the trust's governing instrument, all income is paid to Alma for life. The trustee has discretionary powers to invade principal for Alma's benefit and to deem discretionary distributions made from capital gains realized during the year. During the trust's first tax year, it has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, the trustee allocates the $10,000 capital gain to principal. During the year, the trustee distributes to Alma $5,000, representing her right to trust income. In addition, the trustee distributes to Alma $12,000, pursuant to the discretionary power to distribute principal. The trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in DNI and the $10,000 of capital gain is taxed to the trust. In future years, the trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 21. Consistent use. The facts are the same as in **Example 20,** except the trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by the trust during the year. The trustee documents this treatment by including the $10,000 capital gain in DNI on the trust's federal income tax return so it is taxed to Alma. This treatment of the capital gains is a reasonable exercise of the trustee's discretion. In future years, the trustee must treat all discretionary distributions as being made first from any realized capital gains.

Note. Consistent treatment may be declared by the trustee or evidenced by the trustee's actions the first time such situation arises, but the decision must be made when the fiduciary has capital gains and makes a discretionary distribution of principal. However, once an approach is chosen, it **must** be followed. In effect, it constitutes a method of accounting.

Example 22. Consistent use. Use the same facts as **Example 20,** except the trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by the trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of the trustee's discretion.

Example 23. Allocated. Use the same facts as **Example 20,** except pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in the trust's DNI for the tax year.

Example 24. Distributed. Use the same facts as **Example 20,** except the trustee decides that discretionary distributions are made only to the extent the trust has realized capital gains during the year. Thus, the discretionary distribution to Alma is $10,000, rather than $12,000. Because the trustee uses the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in the trust's DNI for the tax year.

Example 25. Distributed. Use the same facts as **Example 20,** except the trust's assets consist of BilboCo and other property. Under the terms of the trust's governing instrument, the trustee is directed to hold BilboCo for 10 years and then sell it and distribute all the sales proceeds to Alma. Because the trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to Alma, any capital gain realized from the sale of BilboCo is included in the trust's DNI for the tax year.

Note. In **Example 25,** the governing instrument directs distribution to the beneficiary of the proceeds of a disposition of principal. Because there is a specific allocation of the proceeds, the capital gain from the disposition is also allocated to the beneficiary and is includable in DNI. In cases such as this, the beneficiary is effectively entitled to the receipt of capital gains from the trust independently of any trustee discretion.

Example 26. Distributed. The facts are the same as in **Example 20.** Under the terms of the trust's governing instrument, all income is paid to Alma during the trust's term. When Alma reaches age 35, the trust terminates and all the principal is distributed to Alma. Because all the assets of the trust, including all capital gains, are actually distributed to the beneficiary at the termination of trust, all capital gains realized in the year of termination are included in DNI.

Note. Example 26 illustrates the logical rule that, in the year a trust terminates, all capital gain for that year must necessarily be distributed to the beneficiaries. In a tax year when a trust makes final terminating distributions, therefore, the trust will never be taxed on capital gain.

Note the distinction between a **terminating event** and a **terminating distribution.** A terminating event, such as the death of the grantor, is not the same thing as actual termination of the trust. Instead, a reasonable period of administration is generally required to settle the affairs of the trust before it can actually distribute its assets and terminate. The final distribution of assets to the beneficiaries that concludes the existence of the trust is a terminating distribution. It is important to remember that it is the terminating distribution, not the terminating event, that causes capital gain to actually be distributed to the beneficiaries.[87]

Example 27. Distributed. The grantor of a trust dies June 30, 2021. The terms of the trust require the trust to terminate upon the death of the grantor and to distribute all assets. Final distribution of assets does not occur until October 22, 2022. There are capital gains in both 2021 and 2022. The trust instrument is silent as to the allocation of capital gains but requires all income to be distributed currently to the beneficiaries. No actual distributions are made, however, until the terminating distributions in 2022. Because there is no requirement in either the governing instrument or local law for capital gains to be distributed currently to the beneficiaries, the capital gains in 2021 are taxable to the trust. The ordinary income, however, is taxed to the beneficiaries notwithstanding the failure of the trustee to make a distribution until 2022. Because a terminating distribution is made in 2022, all capital gains for 2022 are treated as actually distributed to the beneficiaries and are therefore taxed to the beneficiaries along with any ordinary income for 2022.

Example 28. Distributed. Use the same facts as **Example 26,** except the trustee is directed to pay Breanna $10,000 before distributing the remainder of the trust assets to Alma. Because the distribution to Breanna is a gift of a specific sum of money, none of the trust's DNI that includes all the capital gains realized during the year of termination is allocated to Breanna's distribution.

Example 29. Distributed. The facts are the same as **Example 26,** except the trustee is directed to distribute to Alma half of the principal when she reaches age 35 and the balance when she reaches age 45. The trust assets consist entirely of stock in the Mungo Corporation with an FMV of $1 million and an adjusted basis of $300,000. When Alma reaches age 35, the trustee sells half of the stock and distributes the sales proceeds to Alma. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to Alma. All the capital gain is included in DNI.

Example 30. Distributed. The facts are the same as **Example 29,** except when Alma reaches age 35, the trustee sells all the stock and distributes half of the sales proceeds to her. If authorized by the governing instrument and applicable state statute, the trustee may determine to what extent the capital gain is distributed to Alma. The $500,000 distribution to Alma may be treated as including a minimum of $200,000 of capital gain (and all the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). The trustee evidences the treatment by including the appropriate amount of capital gain in DNI on the trust's federal income tax return. If the trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to Alma, half of the capital gain attributable to the sale is included in DNI.

87. Treas. Reg. §1.641(b)-3(b). Note that an earlier revenue ruling (Rev. Rul. 54-503, 1954-2 CB 237), which would have treated the capital gains for both years as being taxable to the beneficiaries, was apparently overruled by the regulations.

OTHER CAPITAL GAIN/LOSS ISSUES

IRC §643(E) ELECTION

Until June 1, 1984, a distribution of appreciated property to a beneficiary that was not within the specific bequest exception would attract DNI to the extent of the property's FMV. The beneficiary was required to pay income tax to the extent the DNI represented taxable income. The beneficiary also received a basis in the asset equal to its FMV. However, the trustee was not required to recognize any gain with respect to the distribution. The enactment of IRC §643(e) changed this treatment.

Under §643(e)(2), the distribution of property by a fiduciary will attract DNI only to the extent of the lesser of the property's basis or its FMV. This rule does not apply, however, if the fiduciary makes an election to recognize gain or loss on the distribution as if the property were sold to the beneficiary at its FMV.[88] The election is made by checking the election box on Form 1041, page 3, under Other Information on line 7, and attaching Schedule D reporting the gain. Any election is binding and is applicable to all distributions made during the tax year. It cannot be revoked without the consent of the IRS, but it is an annual election rather than a method of accounting.

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	Other Information	**Yes**	**No**
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends . . . ▶ $		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		
3	At any time during calendar year 2020, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? . . . . See the instructions for exceptions and filing requirements for FinCEN Form 114. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for the required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here. See instructions . . ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here. See instructions . . ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here . . . . ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See instructions		
	... trust a specified domestic entity required to file Form 8938 for the tax year (see the ...		

If a fiduciary makes the election to recognize gain or loss on a distribution, the beneficiaries have a basis in the property equal to the basis in the hands of the fiduciary adjusted for any gain or loss recognized to the fiduciary on the distribution.

Example 31. Use the same facts as **Example 4.** When Hud distributed the vintage Porsche to Michelle, it had an FMV of $300,000 and an adjusted basis of $250,000. The trust has DNI for the year of $275,000. When Hud distributes the property to Michelle, $250,000 of the DNI is allocated to Michelle, the distribution beneficiary, leaving the trustee with $25,000 of DNI. Michelle has a basis in the vintage Porsche of $250,000. If, on the other hand, Hud elects to recognize gain on the distribution, the trust still has $275,000 of DNI (because capital gain is not allocated to DNI) and Michelle's basis in the property is $300,000.

Hud recognized $50,000 of gain on the distribution, but DNI remains at $275,000. This happens because the disposition is probably considered a disposition of principal, with the gain allocable to the trustee and therefore excluded from DNI.

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88. IRC §643(e)(3).

Observation. If the fiduciary has unused capital losses that might otherwise pass through to beneficiaries on termination, it might be beneficial under §643 to recognize gain on distribution of appreciated assets to increase the beneficiaries' basis. This should be coordinated with beneficiaries, however, to determine whether it is more valuable to step up basis or to pass through excess capital losses. In deciding whether to make the election, the fiduciary should be aware of a potential trap. Although §643(e) permits the fiduciary to recognize gain or loss on the distribution, any loss is unlikely to be recognized. That is due to the §267 limitation on recognition of losses in transactions between related parties. Any beneficiary of a trust is considered a related party to the fiduciary.[89] The same rule applies to sales and exchanges between an executor of an estate and a beneficiary unless the executor is distributing property in satisfaction of a pecuniary bequest.[90] As discussed below, substituting property for a pecuniary bequest is treated as a sale or exchange by the executor.

If the adjusted basis of the property in **Example 31** had been $250,000 and its FMV $200,000, there would have been a $50,000 loss realized in making the election. However, recognition of that loss is prohibited by §267. The loss, instead, inures to the beneficiary receiving the distribution and serves to reduce any gain the beneficiary may have on a subsequent taxable disposition of the asset.[91] In addition, IRC §1239 may apply to any gain on distributions of property by a trust to the beneficiaries if the property is depreciable in the hands of the beneficiaries. This recharacterizes the gain to the fiduciary as ordinary income. Finally, if gain to the fiduciary is included in net investment income, it may result in an additional tax at the fiduciary level.[92]

DISTRIBUTIONS IN SATISFACTION OF SPECIFIC BEQUEST

If a fiduciary is under an obligation to distribute a specific sum of money as a bequest to a particular beneficiary, the distribution does not attract DNI.[93] For example, if a fiduciary must distribute a $100,000 bequest to a named beneficiary, the $100,000 payment to that beneficiary does not attract DNI. Suppose, however, that the fiduciary distributes $50,000 of cash and $50,000 of securities which, in the hands of the fiduciary, have a basis of $30,000. Because the fiduciary was obligated to pay a specific dollar amount of $100,000 to the beneficiary, the fiduciary in substance has a $100,000 indebtedness to the beneficiary. Under general income tax principles, the use of appreciated property to satisfy repayment of debt is treated as having sold the property at its FMV and must recognize $20,000 of gain.

For income tax purposes, it is not always easy to recognize situations that are considered pecuniary bequests. It is very important to do so correctly because costly mistakes may otherwise result. Consider the following examples in which gain was recognized due to satisfying pecuniary bequests with appreciated property.

Example 32. While still alive, Dad gave Son 100,000 shares of stock in Dad's company. He gave none to Daughter. Dad's will contained an equalization clause which directed that Daughter receive all of Dad's estate up to the value, determined at Dad's date of death, of the 100,000 shares of stock. Because Dad's estate was not large enough, Daughter received distribution of the entire estate, including some appreciated securities. The IRS ruled that the distribution to Daughter was in satisfaction of a pecuniary bequest because she was entitled to **an amount** equal to a certain value, not to specific property.[94]

The total discretion to give assets, in cash or in kind or partly in each, is a pecuniary bequest. Using appreciated property triggers gain to the estate.[95]

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89. IRC §267(b)(5).
90. IRC §267(b)(13).
91. IRC §267(d)(1).
92. IRC §1411.
93. IRC §663(a)(1).
94. Rev. Rul. 82-4, 1982-1 CB 99.
95. Rev. Rul. 86-105, 1986-2 CB 82.

A trust realized a gain when the trustees distributed appreciated stock to pay net income due the beneficiary. The rationale for realizing the gain was because the beneficiary had a right to all the net income, the specific amount of which was fixed at the time of each distribution. However, using appreciated stock to make a distribution to the beneficiary at age 25 of an amount equal to one-fourth of the principal of the trust did not. Although called "an amount," it was similar in the nature to a residuary distribution of one-fourth because the amount the beneficiary would receive fluctuates in value until actually distributed at age 25.[96]

Where a trustee had total discretion to distribute income and principal to a beneficiary and was not required to make any distributions, distributions of appreciated assets caused no recognition of gain. This was because the beneficiary had no rights to either a sum of money or specific property.[97]

Distribution of an amount equal to a stated percentage of corpus required to be distributed to a beneficiary prior to termination of a trust was not a distribution of a definite amount of cash or equivalent value in property. The payment represented a partial distribution of a share of the trust principal.[98]

Example 33. A direction in a will said to distribute $8x worth of a specific stock to a beneficiary, but no more than all of it. At the time of distribution, the estate had 300 shares. Only 64 shares were used to satisfy the requirement. Because the number of shares were determined based on a particular dollar amount, the beneficiary had a claim against the estate for stock in that dollar amount. The distribution was therefore in satisfaction of a pecuniary bequest and triggered recognition of gain.[99]

An executor's final distribution of appreciated property that was insufficient to satisfy a pecuniary legacy did not transform the bequest of a specific sum of money into a bequest of the residue of the estate. The bequest was merely abated by the shortfall. The estate realized a gain measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property distributed. The effect was the same as if the executor had sold the appreciated property and distributed the proceeds to the trustee in trust.[100]

MISCELLANEOUS ITEMIZED DEDUCTIONS

IRC §67(e) provides that an estate or trust computes its adjusted gross income (AGI) in the same manner as that of an individual, except that the following additional deductions are allowable in arriving at AGI.

- Costs paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such estate or trust;[101]
- Deductions allowable under §642(b) (concerning the personal exemption of an estate or nongrantor trust);[102]
- Distribution deduction under IRC §651 (the deduction for simple trusts required to distribute current income);[103] and
- Distribution deduction under §661 (the deduction for complex trusts).[104]

96. Ltr. Rul. 8447003 (Jun. 8, 1984).
97. TAM 7605170360A (May 17, 1976).
98. Rev. Rul. 55-117, 1955-1 CB 233.
99. Rev. Rul. 72-295, 1972-1 CB 197.
100. Rev. Rul. 66-207, 1966-2 CB 243.
101. IRC §67(e)(1).
102. IRC §67(e)(2).
103. Ibid.
104. Ibid.

Because these are deducted in determining AGI, they are not miscellaneous deductions. Consequently, they are not subject to the pre-Tax Cuts and Jobs Act (TCJA) (which took effect December 22, 2017) 2% miscellaneous itemized deduction limitation. The regulations confirm that these listed expenses are not affected by the repeal of miscellaneous itemized deductions and remain fully deductible on fiduciary returns.[105]

A cost is subject to the 2% floor on itemized deductions if **all the following apply.**

1. It is included in the definition of miscellaneous itemized deductions under §67(b).
2. It is incurred by an estate or nongrantor trust.
3. It is commonly or customarily would be incurred by a hypothetical individual holding the same property.[106]

Whether a cost is commonly or customarily incurred by a hypothetical individual holding the same property as the estate or trust depends upon the type of product or service rendered to the estate or trust. Described next are types of costs commonly or customarily incurred by individuals and thus subject to the 2% floor: ownership, tax preparation, investment advisory, appraisal, and certain fiduciary fees. In addition to these other costs include, costs incurred in defense of a claim against the estate, the decedent, or the nongrantor trust that are unrelated to the existence, validity, or administration of the estate or trust.[107]

OWNERSHIP COSTS[108]

Ownership costs are costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property. For purposes of §67(e), ownership costs are considered commonly or customarily incurred by a hypothetical individual owner of a property. Such ownership costs include, but are not limited to, the following.

- Partnership costs deemed to be passed through to and reportable by a partner if these costs are defined as miscellaneous itemized deductions pursuant to §67(b)
- Condominium fees
- Insurance premiums
- Maintenance and lawn services
- Automobile registration and insurance costs

Other expenses incurred merely by reason of the ownership of property may be fully deductible under other provisions of the Code and therefore not miscellaneous itemized deductions. These include §62(a)(4) (adjustments for rents and royalties), §162 (trade or business expenses), or §164(a) (state and local income, property, and other taxes).

TAX PREPARATION FEES[109]

Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2% floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and are subject to the 2% floor.

105. Treas. Reg. §1.67-4(a)(1).
106. Treas. Reg. §1.67-4(a)(2).
107. Treas. Reg. §1.67-4(b)(1).
108. Treas. Reg. §1.67-4(b)(2).
109. Treas. Reg. §1.67-4(b)(3).

INVESTMENT ADVISORY FEES[110]

Fees for investment advice (including any related services that would be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and are subject to the 2% floor. However, certain incremental costs of investment advice beyond a normally charged amount are not subject to the 2% floor. For this purpose, an incremental cost is a special, additional charge added solely because the investment advice is rendered to a trust or estate rather than to an individual. An incremental cost could also be a cost attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remainder beneficiaries). The portion of the investment advisory fees not subject to the 2% floor is limited to the amount of those fees, if any, that exceeds the fees normally charged to an individual investor.

APPRAISAL FEES[111]

Appraisal fees an estate or nongrantor trust incurs to determine the FMV of assets for making distributions as of the decedent's date of death (or the alternate valuation date) are not incurred commonly or customarily by an individual and thus are not subject to the 2% floor. Additionally, appraisal fees otherwise required to properly prepare the estate's or trust's tax returns, or a generation-skipping transfer tax return are not subject to the 2% floor. The cost of appraisals for other purposes (for example, insurance) is commonly or customarily incurred by individuals and is subject to the 2% floor.

CERTAIN FIDUCIARY EXPENSES[112]

Certain other fiduciary expenses are not commonly or customarily incurred by individuals, and thus are not subject to the 2% floor. Such expenses include, without limitation, the following.

- Probate court fees and costs
- Fiduciary bond premiums
- Legal publication costs of notices to creditors or heirs
- Cost of certified copies of the decedent's death certificate
- Costs related to fiduciary accounts.

BUNDLED FEES[113]

If an estate or trust pays a fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's fee) that is subject to the 2% floor and other costs that are not subject to the 2% floor, (bundled fee), then the bundled fee must be allocated between the costs that are subject to the 2% floor and those that are not, to compute the AGI of the estate or trust. If a bundled fee is not computed on an hourly basis, however, only the portion of the fee attributable to investment advice is subject to the 2% floor; the remaining portion is not subject to that floor.

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110. Treas. Reg. §1.67-4(b)(4).

111. Treas. Reg. §1.67-4(b)(5).

112. Treas. Reg. §1.67-4(b)(6).

113. Treas. Reg. §1.67-4(c).

Out-of-pocket expenses billed to the estate or trust are treated as separate from the bundled fee. In addition, payments made from the bundled fee to third parties that would have been subject to the 2% floor if paid directly by the estate or nongrantor trust, are subject to the 2% floor. This is also the case for any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the estate or trust that are commonly or customarily incurred by an individual. Any reasonable method may be used to allocate a bundled fee between costs subject to the 2% floor and those costs that are not. This includes, without limitation, the allocation of a portion of a fiduciary commission that is a bundled fee to investment advice. Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the following.

- Percentage of the value of the principal subject to investment advice,
- Whether a third-party advisor would have charged a comparable fee for similar advisory services, and
- Amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2% floor. This includes fees paid to financial advisors, or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.

> **Observation.** As a practical matter, bundled fees are primarily a feature of commercial trustees who perform both trustee and investment functions.

EXCESS DEDUCTIONS ON TERMINATION

Deductions other than depreciation and depletion[114] always remain currently with the fiduciary and do not pass through directly to the beneficiaries. However, §642(h) provides a special rule that permits excess net operating losses (NOL), capital loss carryovers, and other excess deductions (except the personal exemption and charitable deductions) that arise in or are carried to the termination year of the trust or estate to be passed through to beneficiaries succeeding to its property. **Beneficiaries succeeding to the property** of a trust or estate are beneficiaries who bear the burden of any loss for which a carryover is allowed or any excess of deductions over gross income for which a deduction is allowed upon the termination of the estate or trust.[115]

NOL and capital loss deductions and carryovers passed through to beneficiaries under §642(h)(1) are used to compute beneficiaries' AGI.[116] The other excess deductions under §642(h)(2) are **not** used to compute AGI on beneficiaries' returns. Prior to 2018 (pre-TCJA), the regulations provided that the §642(h)(2) excess deductions were "allowed only in computing taxable income and must be taken into account in computing the items of tax preference of beneficiaries; it is not allowed in computing adjusted gross income."[117] Under those regulations, therefore, excess deductions on termination of an estate or trust were treated as a single miscellaneous itemized deduction of the beneficiary.

114. Depreciation and depletion are apportioned on a current basis between the fiduciary and beneficiaries in accordance with IRC §167(d).

115. Treas. Reg, §1.642(h)-3.

116. Treas. Reg. §1.642(h)-1(b).

117. Former Treas. Reg. §1.642(h)-2(a).

The TCJA enacted §67(g), which suspended for years 2018–2025 the deduction for 2% miscellaneous itemized deductions. The treatment of other excess deductions as a single 2% miscellaneous itemized deduction by beneficiaries results in disparate treatment between beneficiaries and fiduciaries of some of those expenses. IRC §67(e) provides that an estate or trust computes its AGI in the same manner as an individual except that the following additional deductions are allowable in arriving at the AGI of an estate or trust.

- Costs paid or incurred in connection with the administration of the estate or trust and that would not have been incurred if the property were not held in such estate or trust
- Deductions allowable under §642(b) (concerning the personal exemption of an estate or nongrantor trust)
- Distribution deduction under §651 (the deduction for simple trusts required to distribute current income)
- Distribution deduction under §661 (the deduction for complex trusts)

Because these are deducted in determining fiduciary AGI, they are not miscellaneous deductions and therefore are not subject to the pre-TCJA 2% miscellaneous itemized deduction limitation. New regulations confirm that they are not miscellaneous itemized deductions and are not subject to disallowance under §67(g).[118]

The approach adopted in the regulations is to "unbundle" the §642(h)(2) excess deductions so that each deduction retains the same character in the hands of the beneficiary as it had to the fiduciary. In accordance with this, each is assigned to one of three categories.[119]

1. An amount allowed in arriving at AGI (such as trustee's fee)
2. A non-miscellaneous itemized deduction (such as personal property taxes)
3. A miscellaneous itemized deduction (such as investment advisory fees)

Observation. The third category, miscellaneous itemized deductions, should not currently pass through to beneficiaries because §67(g) disallows them at the fiduciary level through 2025. Consequently, the current (2020) instructions for Schedule K-1 (1041) do not require reporting this category to beneficiaries.

As a result of passing through the character of each excess deduction, the regulations require the fiduciary to separately state deductions that may be limited when claimed by the beneficiary as provided in the Form 1041 and Schedule K-1 instructions.[120]

To determine the character and amount of the excess deductions under §642(h)(2), the regulations adopt an approach based on the rules for allocating items of deduction among classes of income in a termination year for Schedule K-1 (Form 1041) reporting of DNI to beneficiaries of a simple trust.[121] They require that deductions attributable directly to one class of income ("direct expenses") be allocated to that income. Any remaining deductions that are not directly attributable to a specific class of income, as well as any deductions that exceed the amount of directly attributable income ("indirect expenses"), may be allocated to any item of income (including capital gains to the extent included in DNI). A proportionate amount must be allocated to tax-exempt income, if any.[122] The character and amount of each deduction remaining after application of these allocation rules constitute the excess deductions available to the beneficiaries succeeding to the property as provided under §642(h)(2).[123]

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118. Treas. Reg. §1.67-4(a)(1)(ii). The effective date for these regulations is for tax years beginning after Oct. 19, 2020, but taxpayers may choose to apply the regulations to tax years beginning after Dec. 31, 2017, and on or before Oct. 19, 2020.

119. Treas. Reg. §1.642(h)-2(b)(1).

120. Ibid. See 2020 Schedule K-1 instructions for box 11.

121. Treas. Reg. §1.652(b)-3

122. See Treas. Regs. §§1.652(b)-3(b) and (d).

123. Treas. Reg. §1.642(h)-2(b).

In summary, the regulations provide the following steps for determining excess deductions on termination.

Step 1. Each deduction directly attributable to a class of income is allocated to that class.

Step 2. To the extent of any remaining income after applying Step 1, deductions (including directly attributable deductions from Step 1 that are in excess of the related income) are allocated to any item of income (including capital gains to the extent included in DNI and including tax-exempt income).

Step 3. These deductions are then allocated among the beneficiaries succeeding to the property of the estate or trust in accordance with existing regulations.[124]

The following examples are taken directly from the regulations.[125]

Example 34. Computations under §642(h) when an estate has an NOL. On January 31, 2020, Adam dies leaving a will that provides for the distribution of all his estate equally to Barbara and to an existing nongrantor trust for Carlotta. The period of administration of the estate terminates on December 31, 2020, at which time all the property of the estate is distributed to Barbara and to Carlotta's trust. For tax purposes, Barbara and the trust report income on a calendar-year basis. During the period of administration, the estate has the following items of income and deductions.

Income		
Taxable interest	$2,500	
Business income	3,000	
Gross income	$5,500	$5,500
Deductions		
Business expenses (including administrative expenses allocable to business income)	$ 5,000	
Administrative expenses not allocable to business income that would not have been incurred if property had not been held in a trust or estate (§67(e) deductions)	9,800	
Total deductions	$14,800	
Less adjustment under IRC §172(d)(4) ($9,800 allowable nonbusiness expenses reduced by $2,500 nonbusiness income)	(7,300)	
Deductions as adjusted	$ 7,500	(7,500)
NOL		($2,000)

Allocation to beneficiaries. Under §642(h)(1), Barbara and Carlotta's trust are each allocated $1,000 of the $2,000 unused NOL carryover of the terminated estate in the tax year, with the allowance of any NOL and loss carryover to Barbara and the trust determined under §172.

Neither Barbara nor the trust can carry back any of Adam's estate NOL made available to them under §642(h)(1).

IRC §642(h)(2) excess deductions. The $7,300 of nonbusiness deductions not taken into account in determining the NOL of the estate are excess AGI deductions on the termination of the estate under §642(h)(2). Such deductions retain their character as §67(e) AGI deductions. Under Treas. Reg. §1.642(h)-4, Barbara and the trust each are allocated $3,650 of excess deductions based on Barbara's and the trust's respective 50% shares of the burden of each cost.

Consequences for beneficiaries. Barbara can deduct the NOL carryover and the excess AGI deductions on her Form 1040, *U.S. Individual Income Tax Return*. None of these are allowable directly to Carlotta because the trust is the beneficiary. To the extent the trust's DNI is reduced by the carryovers and excess deductions, Carlotta may receive an indirect benefit from the carryovers and excess deductions.[126]

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124. See Treas. Reg. §1.642(h)-3.

125. Treas. Regs. §§1.642(h)-5 and -6.

126. Treas. Reg. §1.642(h)-21(b).

> **Observation.** The Form 1040 instructions tell individual beneficiaries to report the NOL on line 8 of Form 1040 Schedule 1, *Additional Income and Adjustments to Income,* as an adjustment to gross income. The first tax year of the beneficiary to which the loss can be carried over is the tax year that the estate or trust terminates. However, for purposes of determining the number of years for which an NOL (or a capital loss) may be carried over by a beneficiary, the last tax year of the estate or trust (whether or not a short tax year) and the first tax year of the beneficiary to which a loss is carried over are each considered a separate tax year. Thus, in **Example 34,** with the trust terminating in 2020 and passing the NOL through to the beneficiaries also in 2020, two years of carryover are used.

Example 35. Computations under §642(h)(2) (deductions other than NOL and capital losses). Doris dies in 2019 leaving an estate of which the residuary legatees are Eduardo (75%) and Fern (25%). The estate's income and deductions in its final year are as follows.

Income		
Dividends		$ 3,000
Taxable interest		500
Rent		2,000
Capital gains		1,000
Total income		$ 6,500
Deductions		
IRC §62(a)(4) deductions (rental real estate expenses)		$ 2,000
IRC §67(e) expenses (AGI expenses of estates and trusts)		
Probate fees	$ 1,500	
Estate tax preparation fees	8,000	
Legal fees	2,500	
Total §67(e) deductions	$12,000	12,000
Nonmiscellaneous itemized deductions (personal property taxes)		3,500
Total deductions		$17,500

Determination of character. The character and amount of the excess deductions are determined by allocating the deductions among the estate's items of income as provided under Treas. Reg. §1.652(b)-3. Under Treas. Reg. §1.652(b)-3(a), $2,000 of real estate tax is a direct expense of and therefore allocated to the $2,000 of rental income. The remaining expense items are indirect expenses and can be allocated among income items at the fiduciary's discretion in accordance with Treas. Reg. §1.652(b)–3(b). Doris' executor therefore exercises their discretion to allocate $3,500 of personal property taxes and $1,000 of §67(e) deductions to the remaining income. As a result, the excess deductions on the estate's termination are $11,000, all consisting of §67(e) deductions as adjustments to gross income.

Allocations among beneficiaries. The excess deductions are allocated in proportion to Eduardo's 75% and Fern's 25% interests in the residuary estate. Eduardo's share of the excess deductions is $8,250, all consisting of §67(e) deductions. Fern's share of the excess deductions is $2,750, all consisting of §67(e).

Alternative allocations requiring separate statement. If the executor instead allocated $4,500 of §67(e) deductions to the remaining income of the estate, the excess deductions on termination would be $11,000, consisting of $7,500 of §67(e) deductions and $3,500 of personal property taxes. The nonmiscellaneous itemized deduction for personal property taxes may be subject to the $10,000 SALT (state and local taxes) limitation on the beneficiaries' returns under §164(b)(6)(B). The executor must separately state the personal property taxes as provided in Treas. Reg. §1.642(h)-2(b)(1).

BENEFICIARIES SUCCEEDING TO PROPERTY

As mentioned previously, beneficiaries entitled to the excess deductions on termination of an estate or trust are those who, upon termination of the estate or trust, bear the burden of any loss for which a carryover is allowed or the burden of any excess deductions over gross income for which a deduction is allowed.[127] Generally, this means the remainder beneficiaries.[128] Beneficiaries entitled to specific bequests are generally not considered beneficiaries bearing the burden of a loss unless the assets of the estate or trust are insufficient to satisfy the bequest as illustrated by the following example from the regulations. In most cases, however, it is the remainder beneficiaries who are entitled to excess deductions on termination.

Example 36. Property is transferred in trust to pay income to Penny for life and then to pay $10,000 to Max, with the remainder to Quinn. Quinn is considered the succeeding beneficiary except to the extent the trust principal is insufficient to pay Max $10,000.[129]

Observation. Judging from the lack of cases and rulings in this area, determining the beneficiaries succeeding to the property of the estate or trust for purposes of excess deductions on termination does not appear to be an issue.

The carryovers and excess deductions are allocated among remainder beneficiaries in proportion to their share of the loss or deductions. A person who qualifies as a beneficiary succeeding to the property with respect to one amount, but does not qualify with respect to another amount, is considered a beneficiary succeeding to the property of the trust only as to the amount with respect to which such person qualifies.

Example 37. Margo bequeaths $100,000 to Nigel in her will. The remainder of the estate is to be split equally between Wanda and Les. The estate has sufficient funds to pay only $90,000 to Nigel, and nothing to Wanda and Les. There are $5,000 of excess deductions over the estate's gross income for the termination year and a $15,000 capital loss carryover. Nigel is a beneficiary succeeding to the estate's property to the extent of $10,000 ($100,000 stated inheritance - $90,000 actually distributed). Because the total of excess deductions and loss carryover is $20,000, Nigel is entitled to the benefit of half of each item, and the remaining half is divided equally between Wanda and Les.[130]

IRC §645 ELECTION

IRC §645 allows executors of probate estates and trustees of qualified revocable trusts to elect to treat the trust as part of the estate for fiduciary income tax purposes for up to two years from the decedent's date of death. Pros and cons for making this election are discussed later. As long as the election is in effect, the trust is not treated for income tax purposes as a separate taxable entity, but as part of the decedent's probate estate. A single fiduciary income tax return is filed that is a combined return of the two entities. The election can also be made by the trust alone if there is no probate estate, in which case the trust, during the election period, is treated for federal income tax purposes as if it were an estate.

Note. Except as otherwise indicated, the following materials are based on the regulations governing §645 elections found in Treas. Reg. §1.645-1. Individual footnotes to that section are therefore generally omitted.

127. Treas. Reg. §1.642(h)-3(a).

128. Those to whom the "remainder" of the assets are distributed after distribution or payment of all specific bequests and payment of all costs of administration and taxes.

129. Treas. Reg. §1.642(h)-(3)(d).

130. Treas. Reg. §1.642(h)-(4).

DEFINITIONS

Qualified Revocable Trust (QRT). A QRT is any trust or portion of a trust which, on the decedent's date of death, was treated as owned by the decedent under IRC §676 by virtue of a right retained by the decedent to revoke the trust.[131] This is commonly referred to as a **grantor trust**, meaning all trust income and expenses (or portion subject to revocation) are taxable directly on the decedent's Form 1040. If the right to revoke was exercisable by the decedent only with the approval or consent of a nonadverse party or the decedent's spouse, it is a QRT. If, however, the trust was treated as owned by the decedent under §676 solely because it could be revoked by the nonadverse party or the decedent's spouse without the requirement that the decedent also have a right of revocation, it is not a QRT. Classic revocable living trusts should therefore be QRTs.

Related Estate.A related estate is the probate estate of the decedent who is the owner of the QRT on the decedent's date of death. The executor of the related estate is the one charged with filing the combined fiduciary income tax return for the trust and the estate pursuant to a §645 election.[132]

Executor. The executor for purposes of the §645 election is an executor, personal representative, or administrator who has obtained letters of appointment to administer the decedent's probate estate through formal or informal appointment procedures. Treas. Reg. §1.645-1(b)(4) states: "Solely for purposes of this paragraph (b)(4), an executor does not include a person that has actual or constructive possession of property of the decedent unless that person is also appointed or qualified as an executor, administrator, or personal representative of the decedent's estate."[133] This means the ancillary executor (appointed by the court(s) in any other state(s) where the decedent held property besides the state where the decedent was domiciled at death) should not be required to join in the election. This only makes sense, because, while both the domiciliary (personal representative in the state where the decedent was domiciled at death) and ancillary executors must each file fiduciary returns, that of the ancillary executor is more in the nature of an information return. All income, deductions, and distributions of both the domiciliary and ancillary administration's must be reported on the domiciliary return.[134]

Electing Trust. This is a QRT for which a valid §645 election was made. It is treated as an electing trust throughout the entire election period.[135]

Election Period. This is the period of time during which an electing trust is treated and taxed as part of its related estate (if any) or is taxed itself as an estate if there is no related estate.[136]

Applicable Date. The applicable date is the end of the longest period of time a §645 election can be in effect.[137] The election period ends on the **day before** the applicable date. Determining the applicable date is discussed next.

MAKING THE ELECTION

The §645 election is made on Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*. Although the Form 8855 has two pages of instructions, the instructions are not always clear. Form 8855 must be completed by the fiduciaries of the related estate (if any) and the electing trust or trusts. How it is filled out depends on whether there is a related estate or just the QRT. Special rules are also provided in the event there are multiple QRTs. By signing the Form 8855, fiduciaries agree under penalties of perjury to comply with conditions contained on the form.[138]

> **Note.** The appendix at the end of the chapter contains two checklists for tasks that enable a QRT to make the §645 election.

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131. Treas. Reg. §1.645-1(b)(1).

132. Treas. Reg. §1.645-1(b)(5).

133. Treas. Reg. §1.645-1(b)(4).

134. Treas. Reg. §1.6012-3(a)(3).

135. Treas. Reg. §1.645-1(b)(2).

136. Treas. Reg. §1.645-1(b)(6).

137. Treas. Reg. §1.645-1(f)(1).

138. These conditions are also in the regulations. See Treas. Regs. §1.645-1(c)(1)(ii)(A) (trustee) and §1.645-1(c)(1)(ii)(B) (executor).

Form **8855**
(Rev. December 2020)
Department of the Treasury
Internal Revenue Service

Election To Treat a Qualified Revocable Trust as Part of an Estate

▶ Go to *www.irs.gov/Form8855* for the latest information.

OMB No. 1545-1881

Part I Estate (or Filing Trust) Information

Name of estate (or the filing trust, if applicable (see instructions))	**Employer identification number** (see instructions)
Name of executor (or the filing trustee, if applicable)	Type of entity prior to the election: ☐ Domestic estate ☐ Foreign estate ☐ Domestic trust ☐ Foreign trust
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	Date of executor's appointment

Under penalties of perjury, I, as executor (or filing trustee):

- Confirm that under applicable local law or the governing document, I have the authority to make this election for the estate (if executor) or trust (if filing trustee) and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for the above-named estate (or filing trust, if applicable);
- Confirm that an agreement has been reached with the trustees of each qualified revocable trust (QRT) joining in the election to allocate the tax burden of the combined electing trusts and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that the related estate's (or filing trust's, if applicable) share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Agree to accept responsibility for filing a complete, accurate, and timely income tax return, when required by law, for the combined electing trust(s) and related estate, if any, for each tax year during the election period;
- (If I am the filing trustee) confirm that if there is more than one QRT making this election, that I have been appointed by the trustees of each QRT making this election to be the filing trustee and I agree to accept the responsibility of filing the appropriate income tax return for the combined electing trust(s) for each tax year during the election period and all other responsibilities of the filing trustee;
- (If I am the filing trustee) represent that no executor has been appointed for a related estate and to the best of my knowledge and belief, one will not be appointed;
- (If I am the filing trustee) agree that, if an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the late appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of executor (or filing trustee)	Date

Part II Decedent Information

Name of decedent	SSN of the decedent	Date of death

For Paperwork Reduction Act Notice, see page 4. Cat. No. 24542R Form **8855** (Rev. 12-2020)

Part III **Qualified Revocable Trust Information**

Name of trust	**Employer identification number** (see instructions)
Name of trustee	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Name of trust	**Employer identification number** (see instructions)
Name of trustee	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Related Estate. The executor of the related estate completes and signs Form 8855, Part I using the related estate's employer identification number (EIN). The trustee of the electing QRT completes and signs the relevant portion of Part III.

No Related Estate. The trustee of the **filing trust** completes and signs Form 8855, Part I. If there is only one QRT, the filing trustee is simply the trustee of that QRT.

More than One Electing QRT. If there is more than one QRT joining in the election, the trustees of the electing QRTs must select one of them as the trustee who will be responsible for preparing and filing the Form 1041 for the collective QRTs.[139] The trustee who completes and signs Part I is considered the **filing trustee.** The trustees of the remaining trusts that join in the election complete their information and sign Part III. Part III has space for the trustees of two electing trusts. If there are more than two electing trusts, additional forms should be attached. In addition, the executor or filing trustee must indicate at the top of the first page of the Form 8855 how many additional pages are attached and the total number of QRTs joining in the election. If there are co-executors or co-trustees, only one is required to sign. If there is more than one QRT, the election may be made for some or all of them.[140]

> **Observation.** It is uncommon for there to be more than one QRT in typical client situations because the definition of QRT requires it to be a trust which, at the time of the decedent's death, is treated as a grantor trust by virtue of the decedent's right of revocation. If, under the QRT terms, a successor trust is subsequently to be established — such as a credit shelter or bypass trust — the §645 election does not apply to the successor trust.[141]

Although not clearly stated, the Form 8855 should be filed separately from the Form 1041. This is based on the fact that the instructions for the Form 8855 give specific mailing addresses for filing and do not request Form 1041 to be attached. Furthermore, the Form 8855 must be timely filed even if a Form 1041 is not required to be filed. An example of when a Form 1041 would not be required is when gross income is less than the filing threshold.[142]

If there is a related estate, the election must be filed by the filing deadline for the Form 1041(including extension) of the estate's first tax year.[143] If there is no related estate, it must be filed by the filing deadline for the Form 1041, including extension, of the electing trust's first tax year. This can be a fiscal year if the election is ultimately timely made, because the QRT will be taxed as an estate beginning with its first tax year.[144] For purposes of the election, the first tax year is measured from the decedent's date of death.[145] It does not matter that the estate or trust does not otherwise have sufficient gross income to require filing a return. Form 8855 must still be filed by the deadline of the Form 1041. Once made, the election is irrevocable.[146]

139. Treas. Reg. §1.645-1(c)(3).

140. Ibid.

141. Treas. Reg. §1.645-1(f)(i).

142. See Treas. Reg. §1.645-1(c)(2).

143. Treas. Reg. §1.645-1(c)(1).

144. Treas. Reg. §1.645-1(c)(2).

145. Treas. Reg. §1.645-1(d)(2); Instructions to Form 8855.

146. IRC §645(c).

Example 38. The grantor of a QRT dies September 16, 2021. There is no related estate. Without a §645 election, the trust must use a calendar year. It will have a short first tax year from September 16, 2021, to December 31, 2021.

If the trustee intends to make a §645 election, the trust can be taxed as an estate and is entitled to a fiscal year. The longest fiscal year it can have is one ending August 31, 2022. The normal due date for a Form 1041 with the year ending on that date is December 15, 2022. However, if an extension is filed on or before that date, the extended due date is May 31, 2023. A Form 8855 filed on or before May 31, 2023, would be retroactively effective to the grantor's date of death permitting the trust to be taxed as an estate.

Caution. If a §645 election is not timely filed, the QRT must file as a trust and not as an estate. It must use the short tax year ending December 31, 2021 as its initial tax year. This could result in late-filed return penalties.[147]

Executor Appointed After QRT's Election. If an executor is appointed after a §645 election was made by a QRT, the executor must agree to the trustee's election. The IRS must be notified of that agreement by filing a revised Form 8855 within 90 days of the executor's appointment. Otherwise, the election period terminates the day before the executor's appointment.[148] If the election terminates, the executor must file separate estate Forms 1041 from the decedent's date of death. However, the regulations do not require filing amended trust returns for periods prior to such termination (assuming no estate income or expenses were included in the trust's prior returns).[149]

It is important to remember that the name, social security number (SSN), and date of death of the deceased grantor is required on Form 8855, Part II at the bottom of the first page.

Caution. When a §645 election is made, Form 1041 item G must be checked. This indicates the existence of the election. This checkbox is **not** used to make the election. Form 8855 must be completed.

Practitioner Planning Tip

If it is uncertain whether a §645 election will be filed or related estate opened, it is advisable to file an extension for a short-year return for the trust ending December 31. That can provide sufficient time to make the §645 decision and generally protects against a possible late-filed calendar-year return if no §645 election is made. A §645 election can be made even if a short-year return was filed if the election is otherwise timely, and an amended return is filed zeroing out the prior return and showing all those items on the estate return filed as a result of the election. Filing the short-year return has no effect on the ability to choose a fiscal year on the first return filed after the §645 election.

147. Treas. Reg. §1.645-1(d)(2).

148. Treas. Reg. §1.645-1(g)(1).

149. Treas. Reg. §1.645-1(g)(3).

EMPLOYER IDENTIFICATION NUMBERS

The rules governing EINs for related estates, in the case of a §645 election, are simple. The rules for electing trusts are not. They are as follows.

Estate After Death of Decedent. The estate of a decedent is required to obtain its own EIN and to furnish that to payors to the estate.[150]

> **Observation.** The EIN of the related estate never changes.

Electing Trust After Death of Grantor. The electing trust must obtain an EIN following the death of the decedent regardless of whether there is an executor for a related estate and regardless of whether a §645 election will be made after the decedent's death. This EIN must be furnished to payors of the electing trust.[151]

Electing Trust Returns Filed Prior to §645 Election. If an electing trust files any returns prior to making the §645 election, those returns must be filed under the EIN of the trust.[152]

Electing Trust EIN During Election Period. Once a §645 election is made, if there is a **related estate**, all returns are filed under the related estate's EIN.[153] If there is **no related estate**, returns are filed under the electing trust's original EIN obtained following the death of the grantor.[154] If there is more than one QRT included in the election and no related estate, the EIN of the filing trustee is used.

> **Observation.** If there is a related estate, the regulations do not indicate whether the EIN of the estate should now be provided to third-party payors of the electing trust or to continue using the EIN of the electing trust. However, the clear implication of the regulations is that the electing trust EIN should continue to be used for payors. Any Forms 1099 with a trust EIN are presumably pointed to the EIN of combined return as part of the IRS match process.

Electing Trust Continues After End of Election Period. If an electing trust is still in existence when the election ends, whether it is required to obtain a new EIN depends on if there was an executor of a related estate. If there was no executor, the filing trust **must** obtain a new EIN if it continues after termination of the election. It must provide the new EIN to third-party payors.[155] If there was an executor of a related estate and all returns were filed under the EIN of the related estate, the regulations refer to the Form 1041 instructions to determine whether a new EIN is required for the electing trust.[156] The 2020 instructions are silent in this respect, meaning the electing trust continues to use its original EIN.

> **Observation.** As long as the first return filed by an electing trust is a combined return with a related estate, the electing trust is not required to obtain a new EIN if it continues beyond the end of the election period. In all other cases it will. However, a "tentative" calendar year return filed prior to a §645 election does not require a new EIN.

Estate Continues After End of Election. If the estate continues as a taxpayer after termination of the election, the estate continues to use its original EIN.

150. IRC §6109; Treas. Reg. §301.6901-1(a)(1)(ii)(C).
151. Treas. Regs. §§1.645-1(d)(1), and 301.6109-1(a)(3).
152. Treas. Reg. §1.645-1(e)(3)(ii).
153. Treas. Reg. §1.645-1(e)(2)(ii).
154. Treas. Reg. §1.645-1(e)(3)(ii).
155. Treas. Reg. §301.6109-1(a)(4)(ii).
156. Treas. Reg. §301.6109-1(a)(4)(i).

FILING REQUIREMENTS

No Related Estate

If a §645 election is made, the electing trust is treated as an electing trust from the decedent's date of death. Tax returns are filed as an estate during the election period. A short-year trust return from the date of death through December 31 is not required even if an election was not made. Instead, the initial return is based on the tax year chosen pursuant to the §645 election, which can be a fiscal year.[157] If a §645 election is not made, or it is uncertain whether the election will be made, the trust must file as a trust and will have an initial short-year return. If the electing trust files an initial short-year return as a trust and subsequently makes a §645 election, the trustee is required to file an amended Form 1041 for the electing trust excluding all items of income and expense. These amounts are then included on the first Form 1041 filed as an estate pursuant to the §645 election.[158]

Once a §645 election is made, the electing trust is treated as an estate for all purposes of subtitle A (income tax provisions) of the Code.[159] It indicates with a checkmark on the Form 1041 that it is filing as a "Decedent's estate" and is entitled to a $600 personal exemption regardless of whether it might otherwise be considered a simple or complex trust. The electing trust is also able to take advantage of other provisions available only to estates, as described more fully later in this section. If there is more than one electing trust, the return is prepared and signed by the filing trustee under its name and EIN. The names and EINs of other electing trusts must be included on a statement attached to the return.[160]

If a QRT has made a §645 election and filed one or more returns as an electing trust before an executor is appointed and the executor does **not** consent to the §645 election, the election period ends the day before appointment of the executor.[161] The executor of the estate is required to file separate Forms 1041 under the name and EIN of the estate under the usual rules for all tax years of the estate ending after the decedent's death. **These are not combined returns.** The trustee of the electing trust is not required to amend any returns filed for the trust during the election period prior to the executor's refusal. The IRS must be notified of the end of the election although there appears to be no guidance on how to proceed. Extrapolating from other requirements, it probably requires the electing trust to file a final return as an estate as of the end of its election, obtain a new EIN as a trust, and begin filing as a trust in the manner described previously for continuation of the trust following termination of the election period.[162]

Observation. No reason is given for not requiring the trust to file amended returns when a subsequently appointed executor refuses to consent to the §645 election. Items reported on the estate's separate return are only those associated with the probate estate and were not reported by the trust. Not amending the trust returns, however, can result in expenses and tax liabilities having been treated improperly through the use of estate income tax rules that are more liberal than trust rules.

157. Treas. Reg. §1.645-1(d)(2)(i).

158. Treas. Reg. §1.645-1(d)(2)(ii)(B)(2).

159. Treas. Reg. §1.645-1(e)(3)(i).

160. Treas. Reg. §1.645-1(e)(3)(ii).

161. Treas. Reg. §1.645-1(g)(1).

162. See Treas. Reg. §1.645-1(g)(3).

Related Estate

If there is a related estate, the executor annually files a single Form 1041 under the related estates' name and EIN for the combined related estate and electing trust. Information concerning the electing trust must be provided on Form 1041 in accordance with its instructions. The 2020 Form 1041 instructions require attaching a separate statement listing the electing trust's name and EIN, and its trustee's name and address. Except for the special separate share rules applicable to the combined return (discussed next), all items are reported on Form 1041. The tax is computed as if there were one single entity — the estate — and a single personal exemption in the amount of $600 is permitted.[163]

The trustee of the electing trust does not file a Form 1041 during the election period (other than a final return if the trust terminates during the election period as described later). Instead, the trustee must timely provide the executor with all trust information necessary for the executor to prepare the combined Form 1041 and pay the electing trust's share of any tax obligations.[164]

There is no specific penalty provided under the Code if the trustee fails to timely provide the executor with the necessary trust information or fails to carry out any other responsibilities under the election. However, the IRS could subject the electing trust to negligence or other appropriate penalties on its share of the combined tax. This is because the administrative and procedural provisions of the subtitle F of the Code are not affected by the §645 election, which applies only for purposes of subtitle A (the income tax provisions of §§1–1563). Instead, each electing trust and related estate is treated as a separate taxpayer for all purposes of subtitle F, which includes tax assessments and penalties.[165] The statute of limitations for assessment of taxes with respect to both entities starts with the filing of the combined return.[166]

RETURN PREPARATION

No Related Estate

When there is no related estate (and assuming only one electing trust), preparing Form 1041 is relatively straightforward. The entity is identified as a trust with a trustee, but on Form 1041, section A "Decedent's estate" is checked during the period of the election. The box should be checked on Form 1041, section G to indicate a §645 election was made and the trust's EIN is included even though it is already listed on section C. The return is prepared as usual, except applying estate income tax rules to the extent they differ from those applicable to trusts. These are discussed later in this section under "Income Tax Effects of §645 Election."

It is important to remember that, although an electing trust is taxed as an estate, it is still a trust under state law, not a probate estate. It is therefore governed by the trust instrument and state laws applicable to trusts. This can create a problem. If a trust is required to distribute all income currently, makes no distributions of principal, and has no charitable contribution income tax deduction, it is a **simple trust**. In computing its taxable income, a simple trust is allowed a deduction under §651 for the amount of income required to be distributed currently to beneficiaries. This is called the **distribution deduction** and serves to prevent double taxation of income. Beneficiaries are required to include this in their gross income regardless of whether it is actually distributed to them.

Because the distribution deduction relates to the amount of **taxable income** being transferred to and reported by the beneficiaries, the distribution deduction is limited to the least of:

- FAI,
- DNI, or
- Taxable income.

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163. Treas. Regs. §§1.645-1(e)(2)(i) and 2(ii)(A).

164. Treas. Reg. §1.645-1(e)(2)(ii)(A).

165. Treas. Reg. §1.645-1(e)(4).

166. Treas. Reg. §1.645-1(e)(2)(ii)(A).

Solely for purposes of determining the deduction, however, neither the amount of income required to be distributed currently nor DNI includes items of trust income, such as tax-exempt interest (with appropriate adjustments for deductions allocable to them), that are not included in the gross income of the trust. This prevents the double benefit of a deduction for an amount not included in gross income in the first place.

Any trust that is not a simple trust is a **complex trust.**

IRC §661 determines the distribution deduction available to a complex trust and to an estate. The complex trust and estate rules differ from those applicable to simple trusts by creating a 2-tiered distribution scheme. IRC §661(a)(1) allows **first-tier deductions** for amounts of income required to be distributed currently, the same rule that applies to simple trusts. However, IRC §661(a)(2) permits further deductions for any other amounts properly paid, credited, or required to be distributed for the taxable year. These are **second-tier distributions.** Second-tier distributions carry income out only to the extent DNI has not already been absorbed by first-tier distributions. Estates are always treated the same as complex trusts in determining their distribution deduction.

First-tier distributions are distributions of income that are required to be made currently. The identification of first-tier deductions is made under the same principles that apply to simple trusts, because both involve required distributions of income. **Second-tier distributions** are any other amounts properly paid, credited, or required to be distributed to the beneficiary for the taxable year that are not payments or distributions of specific bequests.

A beneficiary may be both a first and second-tier beneficiary, such as with a trust that is required to distribute income currently to a beneficiary, but under which the trustee has discretion to make distributions of principal in excess of FAI. For any year in which principal distributions are made, the beneficiary may receive distributions from both tiers. Whether distributions are deemed to come from income versus corpus (principal) can have important tax consequences.

Complex trusts and estates are not limited to distribution deductions only to the extent of FAI but may in fact deduct distributions to the full extent of DNI (as reduced by items not included in gross income) if DNI is greater than FAI. The mechanism that permits distributions in excess of FAI is the tier system. DNI is first allocated to the first-tier distributions, those required to be made. Any remaining DNI is then allocated to second-tier distributions to the full amount of the distribution.

Example 39. Ambition Street Trust is required to distribute all income currently to its beneficiary. Travis, the trustee, has discretion to invade principal under an ascertainable standard. In 2021, Ambition Street Trust has a partnership K-1 with $10,000 of rental income and $10,000 of interest. The partnership makes a $5,000 distribution to the trust. Ambition Street Trust has $20,000 of both taxable income and DNI, but only $5,000 of FAI. This is because only cash distributions from business entities are treated as FAI under the UPIA. Consequently, Travis distributes $5,000 plus an additional $10,000 discretionary distribution of principal.

The trust is a complex trust because there was a distribution of principal. The $5,000 of FAI distributed to the beneficiary is a first-tier distribution and carries out $5,000 of DNI. The $10,000 principal distribution is a second-tier distribution and carries out an additional $10,000 of DNI. The trust has taxable income of $5,000 and the beneficiary has taxable income of $15,000.

If an electing trust is required to distribute income currently and, without the §645 election, would be treated as a simple trust, it is effectively treated as a complex trust during the period it is taxed as an estate. This is because estates are always subject to complex trust rules[167] (but the box on Form 1041, section A for "complex trust" should **not** be checked). The income is treated under §662 as a first-tier distribution from an estate and is includable in the gross income of the income beneficiaries under the normal subchapter J rules. This is regardless of whether it is actually distributed. Any other distributions are treated as second-tier distributions.

167. IRC §661(a).

Consequently, determining the distribution deduction of an electing trust is unaffected by a §645 election. If the trust were otherwise treated as a simple trust required to distribute all income currently, this distribution is the equivalent of a first-tier distribution under the complex trust rules. All income is reportable by the beneficiaries regardless of when it is actually distributed. If DNI exceeds FAI, the beneficiary's share of DNI and the distribution deduction are limited to FAI. If the trustee also distributes principal, such as under a power of invasion, it would be treated as a complex trust even without the §645 election as in **Example 39.**

Related Estate

If there is a combined return with a related estate, the executor of the estate prepares a single return under the related estate's EIN, combining all items of income and deduction of the related estate and electing trust. The return is prepared using the estate income tax rules.[168] The only specific guidance provided by the regulations and forms' instructions on preparing a combined return involves use of the separate share rule.

Separate Share Rule. The **separate share rule** is applicable only to complex trusts and estates. Although a trust may be considered a single trust under state law and for most income tax purposes, if the trust has more than one beneficiary and if the different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts **solely** for purposes of determining the DNI allocable to each of the respective beneficiaries. The fiduciary then determines its distribution deduction under IRC §§661 and 662 based on the DNI allocations among the separate shares.[169] The purpose of the separate share rule is really one of fairness as illustrated by the following example.

> **Example 40.** An irrevocable trust has three beneficiaries, each of whom is entitled to discretionary income and principal distributions from their separate one-third share of the trust. The trust has $30,000 of income for the year and $6,000 of expenses. The DNI is therefore $24,000. The trustee makes a $15,000 distribution to one beneficiary for their share but makes no distributions to the other two.
>
> The distribution rules under §661(a) allow the trustee a distribution deduction for all income required to be or actually distributed to beneficiaries during the year, but not in excess of DNI. Without the separate share rule, the beneficiary receiving the distribution is treated as receiving $15,000 of DNI, all of which is taxable. Yet, the share of trust income that the beneficiary is entitled to is only $8,000. Therefore, the beneficiary pays income tax on $8,000 of trust income that, under the terms of the trust, is credited to the shares of the other two beneficiaries.
>
> The separate share rule requires a separate DNI calculation for each of the three shares. In this case, each is treated solely for purposes of the trust's distribution deduction as having $8,000 of DNI. The $15,000 distribution carries out only $8,000 of DNI that is taxed to the beneficiary. The remaining $7,000 is a nontaxable distribution in excess of DNI.

For purposes of the §645 election, the separate share rule applies in determining allocations of DNI between a related estate and a QRT or to their beneficiaries. The separate shares of the trust and of the estate may also be subdivided further into two or more separate shares to the extent their governing instruments or applicable state law create separate shares.[170] If a distribution is made during the year by either entity to one of its separate third-party beneficiaries, the DNI of the share (electing trust or estate) making the distribution must be determined and the distribution rules applied using its separately determined DNI under the usual rules applicable to separate shares. In that manner, its share of the combined gross income is reduced by the distribution.

168. Treas. Reg. §1.645-1(e)(2)(ii).

169. IRC §663(c).

170. Treas. Reg. §1.645-1(e)(2)(iii)(A).

If the related estate makes a distribution to the electing trust (or vice versa, although uncommon), and if the distribution is treated as one that carries DNI if made to a separate beneficiary, the distribution is treated as shifting DNI from the share making the distribution to the share receiving it. For this purpose, the amount of DNI shifted is the amount determined as if the distribution were made to a separate beneficiary but, for this purpose only, not limiting DNI only to items that are includable in gross income. It will include such things like tax-exempt interest. Solely for purposes of computing its DNI, the share receiving the distribution increases its gross income by the same amount (including tax-exempt interest, although the interest is still not taxable).[171] The distribution has the same character in the hands of the recipient share as it had in the hands of the distributing share. The whole point of the manner in which the separate share rule is applied on these transfers is to ensure that any distribution from one entity to the other reflects all income and deductions — both taxable and nontaxable — of the share from which the distribution is made. This is referred to for purposes of these materials (but not in the regulations themselves) as the **internal transfer rule** and transfers within its scope as **internal transfers.**

To summarize, the following ordering rules are applicable to distributions when there is a §645 election in place.

1. If there is no related estate, the distribution deduction of the distributing entity is determined using the usual rules under §§661 and 662 applicable to allocating DNI to separate shares. The appropriate distribution deduction on the electing trust's Form 1041 (filing as an estate) is taken.
2. If there is a distribution from a related estate to an electing trust (or vice versa), the internal transfer rule is applied first.
3. After application of the internal transfer rule (or if there was no internal transfer), determine the distribution deduction of the entity receiving the internal transfer for distributions it makes to third parties. For this distribution, the usual rules of §§661 and 662 governing allocations of DNI among separate shares as initially described previously (and not the modified §645 rules) are applied. Then, this distribution deduction on the combined return is used.

The following example is the only one provided in the regulations, and has been modified for clarity.[172]

Example 41. Vincent's will provides that after paying debts, expenses, and taxes, the residue of his estate is to be distributed to a testamentary trust, an electing trust. The sole beneficiary of the trust is Zach.

Estate. The estate's separate share has $15,000 of gross income, $5,000 of deductions, $10,000 of taxable income, and $10,000 of DNI for the tax year based on the assets held in the estate. During the tax year, Vincent's estate distributes $15,000 to the trust. The distribution reduces the DNI of the estate share by $10,000 to zero.

Trust. For the same tax year, the trust share separately has $25,000 of gross income, $5,000 of deductions, and $20,000 of DNI prior to considering the distribution from the related estate. In calculating the DNI for the trust share, the gross income of the trust share is increased by $10,000, the amount of the reduction in the DNI of the estate share as a result of the distribution to the trust. Thus, solely for purposes of calculating its DNI, the trust share has gross income of $35,000 ($25,000 of gross income + $10,000 of DNI distributed to it by the related estate). Its taxable income is $30,000 ($35,000 gross income – $5,000 of deductions). Consequently, the trust share has $30,000 of DNI for the tax year.

Combined Return. During the same tax year, the trust distributes $35,000 to Zach. The distribution deduction reported on the **combined** Form 1041 filed for Vincent's estate and trust is $30,000 because all the trust's DNI was distributed. The gross income reported on the combined Form 1041 filed for Vincent's estate and trust is $40,000. However, the taxable income is zero ($40,000 – $10,000 expenses – $30,000 distribution deduction = $0).

171. Treas. Reg. §1.645-1(e)(2)(iii)(B).

172. Ibid.

Zach. As a result of the distribution by the trust to Zach, he must include only $30,000 in his gross income for the tax year because the distribution exceeds DNI by $5,000.

The following tables clarify the example.

Allocations from Estate to Trust

Item	Estate	Estate's Adjustments for DNI Distribution	Trust Before Distribution	Trust's Adjustments for Estate's DNI Distribution	Trust as Adjusted
Gross income	$15,000		$25,000	$10,000	$35,000
Deduction	(5,000)		(5,000)	(0)	(5,000)
DNI	10,000	(10,000)	20,000	10,000	30,000
Distribution	15,000		0		35,000

Combined Return

Item	Estate	Trust	Combined
Gross income	$5,000	$35,000	$40,000
Deduction	(5,000)	(5,000)	(10,000)
Distribution	0	35,000	35,000
Maximum distribution deduction	0	30,000	(30,000)
Taxable income	0		0

Observation. There is no distribution shown on the combined return for the related estate because its distribution was to the electing trust. The separate share rule is simply a matter of internal record keeping. Only distributions made to third parties by the related estate, the electing trust, or both are taken into account in determining taxable income on the combined return.

The following example is **not** taken from the regulations.

Example 42. The separate share rule can quickly become complicated. Use the same facts as in **Example 41,** except the estate share also has $15,000 of tax-exempt interest income. Tax-exempt income is normally excluded from DNI for purposes of determining the distribution deduction.[173] It is included in DNI for distribution purposes for determining which classes of income was distributed to beneficiaries. It is also mandatory that tax-exempt income be reduced by a proportionate share of fiduciary expenses.[174]

Estate. The estate's separate share has $15,000 of gross income, $15,000 of tax-exempt income, and $5,000 of deductions. The $5,000 of deductions must be allocated proportionately between gross income and tax-exempt income (50%) for determining **both** the estate's distribution deduction and the classes of income distributed to the trust. The estate has a total DNI of $25,000 ($12,500 of taxable income + $12,500 of tax-exempt income).

Internal Transfer. During the tax year, Vincent's estate distributes $15,000 to the trust. This consists of $7,500 of gross income and $7,500 of tax-exempt income. The distribution reduces the DNI of the estate share by $15,000 to $10,000 ($5,000 of gross income + $5,000 of tax-exempt income). In calculating the DNI for the trust share, the income of the trust share is increased by the $15,000 distribution from the estate to the trust ($7,500 of gross income + $7,500 of tax-exempt income included in the DNI from the estate share).

Trust. For the same tax year, the trust share separately has $25,000 of gross income, $5,000 of deductions, and $20,000 of DNI before calculating the distribution from the related estate. After applying the internal transfer rule, the trust share has gross income of $32,500 ($25,000 of its separate gross income + $7,500 of gross income DNI distributed to it by the related estate). It also has $7,500 of tax-exempt income. Its combined gross and tax-exempt incomes are therefore $40,000 ($32,500 + $7,500). Its separate taxable income is $30,000 ($32,500 of gross income – $2,500 (50% × $5,000 of deductions allocable to tax-exempt income)). Its separate tax-exempt income is $5,000 ($7,500 - $2,500 (50% × $5,000 of deductions allocable to tax-exempt income)).

The trust share has $30,000 of DNI ($32,500 of gross income – $2,500 of expenses) for the tax year for purposes of determining its **separate distribution deduction** for the distribution to Zach. This is because under the usual separate share rules, DNI must be reduced by the tax-exempt income and its $2,500 of allocated expense. In determining the **classes of income** distributed to Zach, DNI consists of both gross and tax-exempt income, each reduced by their proportionate share of expenses. Total DNI is $35,000 ($30,000 of gross income + $5,000 of tax-exempt income).

Combined Return. The gross income reported on the combined Form 1041 filed for Vincent's estate and trust is $40,000 ($15,000 of estate gross income + $25,000 of trust gross income). The distribution deduction reported on the **combined** Form 1041 filed for Vincent's estate and trust is $30,000 because all of the trust's DNI was distributed.

Zach. During the same tax year, the trust distributes $35,000 to Zach. As a result of the distribution by the trust to Zach, he must include only $30,000 in his gross income for the tax year because the distribution exceeds DNI by $5,000.

Allocations from Estate to Trust

Item	Estate	Estate's Adjustments for DNI Distribution	Trust Before Distribution	Trust's Adjustments for Estate's DNI Distribution	Trust as Adjusted
Gross income	$15,000	($7,500)	$25,000	$ 7,500	$32,500
Tax-exempt income	15,000	(7,500)		7,500	7,500
Deduction	(5,000)		(5,000)		(5,000)
DNI	25,000		20,000	15,000	35,000
Distribution	15,000				35,000

173. IRC §661(b) and Treas. Reg. §1.661(c)-(1).

174. IRC §643(a)(5).

Combined Return

Item	Estate	Trust	Combined
Gross income	$7,500	$32,500	$40,000
Tax-exempt income	7,500	7,500	15,000
Expense deductions	(5,000)	(5,000)	(7,273) [a]
Distribution			35,000
Maximum distribution deduction			(32,727) [b]
Taxable income			0

[a] The $10,000 combined deduction is reduced by tax-exempt income's $2,727 ratable share (($15,000 ÷ $55,000) × $10,000), resulting in $7,273.

[b] The $45,000 maximum distribution deduction is reduced by $12,273 tax-exempt income ($15,000 − $2,727 allocated expenses), resulting in $32,727.

DNI Calculation for Distribution to Beneficiary

Gross income	$40,000
Tax-exempt net of expense	12,273
Subtotal	$52,273
Less: deductible expense	(7,273)
DNI	$45,000

Beneficiary Share

	Gross Income	Tax-Exempt Income	Total
Combined income	$40,000	$15,000	$55,000
Less: share of expense	(7,273)	(2,727)	(10,000)
Amounts distributable	$32,727	$12,273	$45,000

Gross income: $35,000 × ($32,727 ÷ $45,000) = $25,454

Tax-exempt income: $35,000 × ($12,273 ÷ $45,000) = $9,546

Observation. Although the regulations do not discuss this, it is important to note that in determining the amount of DNI that is shifted from the related estate to the electing trust, the gross amount is not reduced by any expenses. That is because the expense reduction occurs on the combined return with respect to the distribution to the beneficiary.

Observation. Allocation of capital gain between the estate and trust or the trust and Zach is subject to the subchapter J rules when capital gains are included in DNI. This is discussed in the "Capital Gains and Losses" section earlier in this chapter.

Combined Charitable Contribution Deduction. As discussed in the section under "Charitable Contribution Deduction," estates and trusts that elect to be taxed as estates under §645 are entitled under §642(c) to charitable contribution deductions for amounts paid to or permanently set aside for charitable purposes. There are several requirements that must be satisfied in order for a fiduciary to take an income tax charitable contribution deduction. For example, the contribution must be expressly authorized under the terms of the governing instrument for a charitable purpose and payable out of gross income. The §642(c) requirements are applied separately to the related estate and the electing trust, but if either entity separately satisfies those requirements, the contribution deduction is taken in determining the taxable income on the combined return.[175] The deduction should be allocated to the entity actually making the contribution, however, in determining its share of the combined taxable income and tax liability.

Subsequently Appointed Executor.[176] An electing trust may make a §645 election by itself under the assumption that no probate administration will be opened. The trust then files a Form 1041 under its own EIN and identifies itself as an estate. If a related estate is subsequently opened (such as when assets are discovered after death), the executor consents to the §645 election. If the electing trust already filed returns, amended returns must be filed by the trust and the estate reflecting the prior income and deductions of **both** the trust and the estate that should have been reported on a combined return.

The amended returns must be filed under the name and EIN of the **electing trust.** The amended return includes the items of income, deduction, and credit for the related estate for the periods covered by the returns. The name and EIN of the related estate must be included on a statement with the amended returns as required by the Form 1041 instructions. The amended trust return for the tax year ending immediately before the executor was appointed must indicate it is a final return.

If the statute of limitations for making income tax assessments has expired with respect to the electing trust for any of the Forms 1041 filed by the trustee, the executor must file Forms 1041 for any items of income, deduction, and credit of the related estate that cannot be properly included on amended forms for the electing trust (and no personal exemption can be taken on these returns).[177] Thereafter, the estate files combined returns under its own EIN.[178] Because it filed a final return, the electing trust must obtain a new EIN and presumably supply that new EIN to third-party payors. If no returns were filed by the electing trust before the related estate consents to the election, no amended returns are required, and the trust retains its EIN.

Electing Trust Terminates Prior to End of Election. If the electing trust terminates during the election period and there is a related estate, the trustee must file a Form 1041 under the name and EIN of the electing trust indicating it is a final return. This notifies the IRS that the electing trust is no longer in existence. **No items** of income and expense are reported on the final return. They are instead reported on the combined return of the related estate and electing trust. There is no requirement for the electing trust to obtain a new EIN for any purpose. The related estate does not pay tax on the trust income reported on its return if the trust terminates because the trust distributes all its income to its beneficiaries. This gives the combined return a distribution deduction for that amount. This eliminates any tax attributable to the trust's share of the combined income.[179]

175. Treas. Reg. §1.645-1(e)(2)(iv).
176. Treas. Reg. §1.645-1(g).
177. Treas. Reg. §1.645-1(g)(2)(i).
178. Treas. Reg. §1.645-1(g)(2)(ii).
179. Treas. Reg. §1.645-1(h)(2).

END OF ELECTION PERIOD

Regardless of whether a related estate exists, on the close of the last day of the election period, if the electing trust continues beyond the election period, it is deemed to receive a distribution of its separate share as if it were a new trust receiving a funding distribution from a complex trust. All items of income attributable to the separate share — including net capital gains — are included in the calculation of the DNI of the electing trust's separate share and are treated as distributed to the new trust (or to the remainder beneficiaries if the trust terminated). The combined electing trust and related estate (or electing trust if no estate) is entitled to a distribution deduction under the rules governing complex trusts. The new trust must include the distribution in gross income under the usual rules.[180] Although the regulations do not specify, the amount that is deemed distributed also includes tax-exempt income.

If there is a related estate, the executor files a Form 1041 for the year of termination which includes all the following.[181]

- Items of income and deduction of the electing trust for the period from the first day of the tax year to the last day of the election period
- Items of income and deduction of the estate for the entire tax year
- A deduction for the deemed distribution of the electing trust's share as of the end of the election period

The return filed by the related estate for the tax year that includes termination of the §645 election includes activity for the full year of the estate without regard to the termination (unless the estate also terminates on the same date). The regulations do not address how income and expenses are apportioned between the related estate and electing trust for the estate's full year and the trust's partial year.

Note. The most accurate method is to use a books and records allocation in which items of income and expense are taken into account when actually paid or incurred under the entity's method of accounting.

If there is no related estate, the tax year of the electing trust closes on the last day of the election period. The trustee files a final Form 1041 reporting all income and deductions for the period from the first day of the tax year through the last day of the election period and taking a distribution deduction for the deemed distribution to the new trust. The new trust then files its first return (most likely a short-year return).[182]

PERIOD OF THE ELECTION

The election period begins on the decedent's date of death and ends on the earlier of the day on which both the electing trust and the related estate, if any, have distributed all their assets, or the day before the **applicable date** (defined later). The election does not apply to any successor trusts. Successor trusts are those created under or are distributees under the trust instrument or are testamentary trusts created under the will.[183]

180. Treas. Reg. §1.645-1(h)(1).

181. Treas. Reg. §1.645-1(h)(2)(i)(A).

182. Treas. Reg. §1.645-1(h)(2)(ii).

183. Treas. Reg. §1.645-1(f)(1).

Example 43. Jake dies. His existing QRT contains a marital deduction formula clause. This clause creates a separate bypass trust funded up to the lifetime exclusion amount available to his estate and which Jake's spouse, Carly, can access, subject to ascertainable standards. Carly is the beneficiary of the marital trust under IRC §2056 from which she will receive all income at least quarterly and can invade principal. Although Jake's trust directs the creation of a separate bypass trust, a trust generally is not treated as coming into existence until it is funded, meaning assets are transferred to it.[184] There is no probate estate.

There will eventually be two separate trusts following Jake's death, but until the actual funding of the bypass trust occurs, there is only a single trust that came into existence at his death when his living trust became irrevocable. The QRT is eligible to make a §645 election. All income and expenses are reported on the single Form 1041 filed by the trustee of the QRT.

One year after Jake's death, the bypass trust is funded with assets remaining as part of the marital trust. The bypass trust is a new trust created by distribution of assets from the QRT. Because the bypass trust is a succeeding trust, it is not a QRT itself and is therefore not eligible to make a §645 election. There is no grandfathering of Jake's QRT. The bypass trust begins filing Form 1041 as a trust and not as an estate.

The rest of the assets continue to be held in the marital trust. Because the marital trust is a continuation of the original QRT, the §645 election should remain in effect until the earlier of termination of the marital trust or the applicable date.

The **applicable date** is the day that is two years after the decedent's date of death if no Form 706 is required to be filed.[185] If a Form 706 is required to be filed, the applicable date is the later of the day that is two years after the decedent's date of death or that is six months after the date of final determination of the estate tax liability.[186] Solely for this purpose, the date of a final determination is the earliest of one of the following.

1. The date that is six months after the issuance by the IRS of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 12 months after the issuance of the letter
2. The date of a final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim
3. The date of execution of a settlement agreement with the IRS that determines the liability for the estate tax
4. The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court
5. The date of expiration of the statute of limitations for assessment of the estate tax[187]

The regulations contain the following examples illustrating the final determination rules.[188]

Example 44. Stephanie died on October 20, 2020. The executor of her estate and the trustee of the Stephanie Trust, an electing trust, made a §645 election. A Form 706 is not required to be filed as a result of her death. The **applicable date** is October 20, 2022, the day that is two years after Stephanie's date of death. The last day of the election period is October 19, 2022. Beginning October 20, 2022, the Stephanie Trust will no longer be treated and taxed as part of her estate.

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184. See UTC §401(1) (amended 2010).
185. Treas. Reg. §1.645-1(f)(1).
186. Treas. Reg. §1.645-1(f)(2).
187. Treas. Regs. §§1.645-1(f)(2)(ii)(A)–(E).
188. Treas. Reg. §1.645-1(f)(2)(iv).

Example 45. Use the same facts as **Example 44,** except a Form 706 is required to be filed as the result of Stephanie's death. The IRS issues an estate tax closing letter, accepting the Form 706 as filed on March 15, 2021. The estate does not file a claim for refund by March 15, 2022, the day that is 12 months after the date of issuance of the estate tax closing letter. The date of final determination of liability is September 15, 2021, and the applicable date is March 15, 2022. The last day of the election period is March 14, 2022. Beginning March 15, 2022, the Stephanie Trust will no longer be treated and taxed as part of Stephanie's estate.

Example 46. Use the same facts as **Example 44,** except a Form 706 is required to be filed as the result of Stephanie's death. The Form 706 is audited, and the IRS mails the executor of the estate a notice of deficiency authorized under IRC §6212 because of the audit. The executor files a petition in Tax Court. The Tax Court issues a decision resolving the liability for estate tax on December 14, 2021, and neither party appeals within 90 days after the issuance of the decision. The date of final determination of liability is December 14, 2021. The applicable date is June 14, 2022, the day that is six months after the date of final determination of liability. The last day of the election period is June 13, 2022. Beginning June 14, 2022, the Stephanie Trust will no longer be treated and taxed as part of Stephanie's estate.

The filing threshold for a Form 706 is based on the gross estate, not whether there is a taxable estate or a tax liability.[189] The filing threshold for a decedent dying in 2021 is $11.7 million.[190]

For a decedent's surviving spouse to take into account the decedent's deceased spouse unused exemption amount (DSUE), the executor of the decedent's estate must make a portability election of the DSUE on a timely-filed Form 706. The regulations state that, for filing purposes, the portability election is treated under IRC §6018 as being a return required to be filed. The due date of an estate tax return filed for purposes of a portability election is therefore nine months after the decedent's date of death or 15 months if extended. This applies regardless of whether the value of the decedent's gross estate is less than the filing threshold and an estate tax return otherwise would not be required to be filed.[191]

Filing a Form 706 to make a portability election should have no effect on determining the applicable date for a §645 election. There is no requirement under §6018 (governing the filing of estate tax returns) that requires filing an estate tax return for purposes of making a portability election. It is the regulations under IRC §2010 that require a Form 706 to be filed in accordance with the time limits of §6018 to make a portability election. Thus, filing a Form 706 solely to make a portability election if the decedent's gross estate is below the filing threshold is merely the making of an election, which does not constitute a filing requirement under the Code. The term of the election in such cases should therefore be two years unless the estate actually has a filing requirement as defined in §6018.

> **Note.** Rev. Proc. 2017-34 was created for an executor to use if they missed the original election date and was not otherwise required to file Form 706 under §6018(a) for any other reason than to exercise the DSUE portability election. For persons dying after December 31, 2010, the executor may file a Form 706 by the second anniversary of the decedent's death to elect portability. The return must state at the top that it is "filed pursuant to Rev. Proc. 2017-34 to elect portability under §2010(c)(5)(a)."

189. IRC §6018.

190. Rev. Proc. 2020-45, 2020-46 IRB 1016.

191. Treas. Reg. §20.2010-2(a)(1).

INCOME TAX EFFECTS OF §645 ELECTION

What is the effect of the §645 election and why is it important for tax practitioners to understand its benefits? The following discussion highlights some of the income tax benefits resulting from a §645 election. As a practical matter, most §645 elections do not involve a related estate. If they do, the executor of the related estate and the trustee of the QRT are the same person, and the will being probated often involves a pour-over to the trust. Even if it is not a pour-over will, the residuary beneficiaries of the estate are usually the same as those under the trust. **Especially in cases where there is no related estate, a §645 election should be considered as a standard part of preparing a trust return.** When there is a related estate, however, the §645 election has a tendency to benefit the trust, while adding no benefit to the estate or even resulting in a slight detriment through loss of lower brackets and increased administrative costs. The following are some income tax considerations associated with a §645 election.

Practitioner Planning Tip

If there is a related estate, it is important to evaluate the relationship between the trust and the related estate. If both entities have the same fiduciary and beneficiaries, a §645 election should be considered, especially if it is a pour-over will with the same return preparer for both entities. If there are different fiduciaries or beneficiaries, it may be better to avoid a §645 election because there may be issues or conflicting tax benefits.

Tax Year

Although the Taxpayer Relief Act of 1997[192] eliminated some of the income tax differences between estates and trusts, several remain. One of the most important, is that estates are permitted to adopt a fiscal tax year, while trusts are required to use a calendar year. By making a §645 election, a trust can choose a fiscal year.

Note. Choosing a fiscal year is likely the most common reason why practitioners consider making a §645 election. If the trust is still in existence when the §645 election period ends, it becomes taxable as a trust and is required to switch to a calendar year as discussed previously.

Charitable Set-Aside Deduction

Estates are permitted a charitable deduction for income actually paid to or permanently set aside for charity. Trusts are permitted a deduction only with respect to amounts actually paid to a charity out of current or accumulated income.[193] Making the §645 election enables the trust to use the charitable set-aside deduction to currently deduct amounts to be paid in the future.[194] It also means that a later payment to the charity of the amount set aside by the trust will not be deductible in that year.

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192. *Taxpayer Relief Act of 1997,* PL 105-34.

193. Treas. Reg. §1.642(c)-1.

194. Treas. Reg. §1.642(c)-1(a)(1).

Practitioner Planning Tip

Availability of the set-aside deduction can be especially important for avoiding malpractice in the case of trusts with charitable remainder beneficiaries that are entitled to distribution of assets of the trust when the trust terminates. This is discussed in detail in the section on charitable deductions.

Exemption Amount

An estate is entitled to a $600 exemption. Trusts are permitted exemptions of only $300 (simple trusts) or $100 (complex trusts). If there is no actual probate estate, the election gives the trust the benefit of the $600 exemption. If there is a probate estate, the election somewhat reduces the total exemptions that are available if the estate and trust filing separately ($600 with the §645 election versus $700 or $900 with no election). There is also the problem of how the benefit of the single $600 exemption is allocated between the estate and the trust in determining each entity's share of the combined income tax liability.

Depreciation

For trusts, depreciation is allocable to the trustee to the extent the trustee is required or chooses to maintain a reserve for depreciation.[195] Any depreciation in excess of the reserve is allocated between the trustee and the beneficiaries on the basis of the FAI allocable to each.[196] In an estate, depreciation is allocated entirely on the basis of FAI because estates — being temporary administrative entities — do not maintain reserves for depreciation. Because the estate income tax rules apply, a trustee maintaining a reserve for depreciation is not allocated any of the depreciation deduction against the reserve. Instead, all depreciation of the trust is allocated between the fiduciary and the beneficiaries in accordance with income. Because "income" for this purpose means FAI, beneficiaries of the related estate — if they are different from beneficiaries of the trust — probably are not allocated any of the trust depreciation.[197]

Observation. Because it is uncommon for trusts to maintain a reserve for depreciation, it is unlikely that this will actually be an issue.

S Corporations

One of the requirements for a corporation to be an S corporation is that it have only **permitted shareholders.** Permitted shareholders means individuals, estates, and certain trusts.[198] These rules can be confusing in the case of trusts, especially when there is a §645 election. The following are the applicable rules for determining whether estates and trusts are permitted shareholders.

Grantor Trust. A grantor trust is a permitted shareholder as long as an individual who is a citizen or resident of the United States is treated under the grantor trust rules as being the owner of the S corporation stock for income tax purposes.[199] Revocable living trusts are classic examples of grantor trusts.

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195. Treas. Reg §1.167(h)-1(b).
196. IRC §167(d); Treas. Reg. §1.167(h)-1.
197. Treas. Reg. §1.167(h)-(1)(b)(2).
198. IRC §§1361(b)(1)(B) and 1361(c)(2).
199. Treas. Regs. §§1.1361-1(h)(1)(I) and 1.1361-1(h)(3)(i)(A).

Estate. Generally, an estate can be an S corporation shareholder indefinitely as long as the estate is not treated as terminated because administration has been unduly prolonged.[200] For example, stock remained held in the names of the estate executors after all the routine tasks of estate administration were completed, even though the stock was distributable to a trust. A subsequent S election for the corporation years later was held invalid because the estate was treated as having terminated for income tax purposes and the trust — an ineligible shareholder — was considered for income tax purposes to be the owner of the corporation's stock.[201]

Grantor Trust Becomes Irrevocable. A grantor trust that becomes irrevocable (usually by the death of the grantor) can be an S corporation shareholder for only two years after the death of the grantor shareholder.[202] During that period of time and solely for subchapter S eligibility purposes, the regulations treat the stock as held by the decedent's estate, even if there is none.[203] However, for purposes of IRC §1366 (relating to the pass through of items of income, loss, deduction, or credit), IRC §1367 (relating to adjustments to basis of shareholder's stock), and IRC §1368 (relating to distributions), the trust is treated as the shareholder and reports those items on the trust return.[204] Prior to the end of the 2-year period, the stock must be distributed to eligible shareholders; a QSST election must be made;[205] or the trust must become an ESBT.[206] **If the trust fails to do one of these, the corporation's S election terminates after the expiration of the 2-year period.[207]**

Testamentary Trust (no §645 Election). If S corporation stock held by an estate is distributable to a testamentary trust, the estate is treated as the shareholder prior to the time shares are actually or deemed distributed to the trust. This means the estate can hold the stock indefinitely (assuming administration of the estate is not unduly prolonged).[208] The two years begins running when the stock is distributed to the trust.

IRC §645 Election. Whether there is a related estate and regardless of whether subchapter S stock is held by the related estate or the QRT, the stock is treated as held by an estate until the earlier of its distribution or the end of the §645 election period.[209] During this time, subchapter S items are reportable under the income tax rules applicable to estates rather than trusts (such as the differences in allocating depreciation between the fiduciary and the beneficiaries). If the trust continues in existence beyond the election period, the S corporation stock is treated as distributed from an estate to a trust. This is treated as a distribution from an estate to a testamentary trust.[210] The "new" trust has a 2-year grace period during which it is permitted to continue holding the S corporation stock, pending disposition to qualified shareholders or the making of a QSST or ESBT election that permits the trust to continue holding the stock.[211]

The following example from the regulations illustrates the 2-year period and the §645 deemed testamentary trust rules.

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200. IRC §1361(b)(1)(B); Treas. Regs. §§1.1361-1(f) and 1.641(b)-3(a).

201. *Old Virginia Brick Company, Inc. v. Comm'r,* 367 F.2d 276 (4th Cir. 1966), *aff'g* 44 TC 724 (1965).

202. Treas. Reg. §1.1361-1(h)(1)(ii).

203. Treas. Reg. §1.1361-1(h)(3)(i)(B).

204. Treas. Reg. §1.1361-1(h)(3)(i). See also, Treas. Reg. §1.1361-1(k), Example 2(ii).

205. Treas. Reg. §1.1361-1(h)(1)(i).

206. Treas. Reg. §1.1361-1(h)(1)(iii).

207. Treas. Reg. §1.1361-1(h)(3)(ii)(A).

208. For example, see Treas. Regs. §§1.645-1(e)(2)(i) (related estate) and 1.645-1(e)(3)(i) (no related estate); Ltr. Rul. 202004002 (Jan. 1, 2020).

209. Treas. Reg. §1.1361-1(h)(3)(i)(D).

210. Treas. Reg. §1.1361-1(h)(1)(iv)(B).

211. Ibid. See, also Ltr. Rul. 200529006 (Apr. 11, 2005).

Example 47. 2-Year Rule. Gretta owns stock of Pretty Stuff, Inc., an S corporation. In addition, Gretta is the owner of a grantor trust that holds stock in Ordinary Retail, an S corporation. Gretta dies on July 1, 2021. The trust continues in existence after her death but is no longer a grantor trust. On August 1, 2021, Gretta's stock in Pretty Stuff is transferred to the trust pursuant to the terms of her will.

Because the stock of Pretty Stuff was not held by the trust when Gretta died, the 2-year period during which the trust can hold the stock does not begin until August 1, 2021, the date the shares are distributed to the trust from the estate. The last day on which the trust can be treated as a permitted shareholder of Pretty Stuff is July 31, 2023, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust.

With respect to the shares of stock in Ordinary Retail held by the trust at the time of Gretta's death, the last day on which the trust can be treated as a permitted shareholder of Ordinary Retail is June 30, 2023, the last day of the 2-year period that begins on July 1, 2021, the date of Gretta's death.

Example 48. IRC §645 Electing Trust and Successor Trust. Use the same facts as **Example 47,** except Gretta's trust is a QRT for which a valid §645 election is made on October 1, 2021. Under §645, the electing trust is treated for income tax purposes as part of Gretta's estate, and the trust may continue to hold the Ordinary Retail stock for the duration of the §645 election period. However, on January 1, 2022, during the election period, the shares of stock in Ordinary Retail are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust is treated as a testamentary trust under the regulations (discussed previously), the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2022, or the effective date of a QSST or ESBT election for the successor trust.[212]

Elections

Various elections may be available, such as whether to accrue Series EE bond interest[213] and how to depreciate assets.[214] A few elections, such as whether to deduct administration expenses on the fiduciary return or the estate tax return, can be done on a selective basis.[215] If there is a related estate, it is prudent for the trustee and the executor to enter into an agreement regarding how decisions on elections will be made.

Accounting and Allocations[216]

It is necessary to keep track of the separate attributes of the trust and the estate, such as passive activity losses, NOLs, and capital losses. Although the trust and estate are subject to the separate share rule for purposes of determining the distribution deduction, that rule does not otherwise require the shares to be treated separately in determining the entity's taxable income.

212. Treas. Reg. §1.1361-1(k), Example 3.

213. Rev. Rul. 58-435, 1958-2 CB 370. The election to report the interest accruals on the estate's return is available only if the estate becomes the successor owner of the bonds; the election is unavailable if the bonds were owned by joint tenants or payable on death to a named person.

214. IRC §§167(d) and 642(e).

215. Treas. Reg. §20.2053-1(e).

216. Treas. Reg. §1.663(c)-4(a).

Loss of Lower Rates[217]

If the trust and estate file separate returns, as compressed as they are, each has its own progressive tax rates. If a §645 election is made, it is possible that the overall tax might be somewhat higher because the combined entities are entitled only to a single use of the progressive tax rates. This would probably not be a concern in the case of a trust required to distribute all income currently, or one that actually does so. Related to this is the issue of apportionment of any actual tax liability between the two fiduciaries. This probably must be done based on what their individual liabilities would have been if they filed separately (similar to the approach for apportioning separate tax liabilities between spouses on a joint return).

Passive Activity Limitations

There is a special $25,000 small taxpayer exception for rental real estate passive activity losses in which an individual actively participates. The estate of a decedent may also be eligible for the exception for rental real estate activities in which the decedent actively participated. This is limited to the first two years after the decedent's death, except to the extent it is used by a surviving spouse.[218] Trusts are not eligible for this exception.[219] A §645 election makes a QRT eligible under the estate rule.

Estimated Tax Payments

The 2-year exemption from estimated tax payments is available to the electing trust even if there is no related estate.[220]

THE SECURE ACT

The SECURE Act[221] made major changes in the tax treatment of IRAs and more limited changes to qualified plans and other benefits for tax years beginning after December 31, 2019. The primary focus of this section is the IRA and distribution changes.

Probably the two most significant changes to defined contribution plans and to IRA distributions are the following.

1. The maximum age for contributions to traditional IRAs is repealed.[222]
2. The "stretch," or the ability of most beneficiaries of a deceased participant to take distributions over their actuarial life expectancies is eliminated except for a new category of **eligible designated beneficiaries** (EDBs) (defined in detail later).[223]

It is important to review beneficiary designations and estate plans for retirement benefits.

> **Note.** In the following section, the term "participant" is used to refer to both an employee with a defined contribution plan, such as a 401(k) plan, and the owner of an IRA.

217. Treas. Reg. §1.645-1(e)(ii)(A) references that the election results in only the $600 exemption for estates being permitted. The income and expenses of the trust are reported once and tax is calculated on the resulting net income as opposed to being reported separately and taxed accordingly had the §645 election not been made.

218. IRC §469(i)(4).

219. See IRC §469(i)(1) (limited to "natural persons").

220. Treas. Reg. §1.645-1(e)(4).

221. *Further Consolidated Appropriations Act of 2020,* PL 116-94, Div. O.

222. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §107(a), repealing IRC §219(d).

223. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §401(a)(2)(E)(ii), amending IRC §401(a)(9)(E).

PRE-2020 REQUIRED MINIMUM DISTRIBUTION (RMD) RULES

The following is a summary of the pre-2020 RMD rules. These rules are found in the regulations at §§1.401(a)(9)-1 through 1.401(a)(9)-9. A **designated beneficiary (DB)** is a human being who is designated as a beneficiary.[224] A beneficiary that is not a human being, such as a charity, is not a DB. These types of beneficiaries are referred to in this section as a **nondesignated beneficiary** (**NDB**). A surviving spouse is also a DB. However, they are eligible for special treatment not afforded nonspousal DBs. These definitions **were not changed** by the SECURE Act.

Participant's RMD

Upon reaching their **required beginning date (RBD),**[225] participants are required to begin taking RMDs**.** Each year's RMD is determined based on actuarial life expectancies from the IRS Uniform Lifetime Table.[226] For participants, the table is based on joint-life expectancies of the individual and a hypothetical beneficiary 10 years younger than the individual. For an individual with a spouse as DB who is more than 10 years younger (and thus the number of years in the couple's joint-life expectancy is greater than the uniform lifetime table), the joint-life expectancy of the couple is used. Actuarial life expectancy is recalculated each year.[227]

Participant Dies Before the RBD

Nonspousal Beneficiaries. If a participant dies before the RBD, mandatory distributions have not commenced. No actuarial life expectancies were established for distribution purposes. Distributions must be made under **one** of the following rules.

Rule 1. The distribution is made in annual amounts over the life expectancy of the DB, beginning no later than December 31 of the year following the participant's death **(the annuity rule).**[228]

Rule 2. The distribution is made by December 31 of the fifth year following the year of the participant's death **(the 5-year rule).**[229]

The annuity rule is the default for nonspousal DBs, although the beneficiary of an IRA is always free to accelerate distributions. The 5-year rule must be followed if the participant is treated as dying without a DB (other than a qualified trust), such as when benefits are payable to a probate estate.[230]

224. Treas. Reg. §1.401(a)(9)-4, Q&A 1.

225. Prior to the SECURE Act, the RBD for traditional IRAs was April 1 following the calendar year in which the IRA owner attained age 70½. For employer-sponsored retirement plans, the RBD is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. The employee exception does not apply to an employee who is a 5% owner. For years after 2019, the RBD is the year in which an individual attains age 72. The change applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after that date. IRC §401(a)(9)(C).

226. Treas. Reg. §1.401(a)(9)-5, Q&A 4.

227. IRC §401(a)(9)(D); Treas. Reg. §1.401(a)(9)-5, Q&A 4.

228. Treas. Reg. §1.401(a)(9)-5, Q&A 5(c)(1).

229. Treas. Reg. §1.401(a)(9)-3, Q&A 1.

230. Treas. Regs. §§1.401(a)(9)-3, Q&A 4 and 1.401(a)(9)-8, Q&A 11.

Surviving Spouse is Beneficiary. If the surviving spouse is the sole beneficiary of an account, different rules apply. The surviving spouse has two choices. First, the surviving spouse can simply wait until the year the participant would have been 70½ to begin taking distributions.[231] In this case, the deceased spouse's IRA is treated as an inherited IRA for the surviving spouse. Alternatively, the surviving spouse can do a rollover conversion of the IRA to the surviving spouse's own IRA,[232] and take distributions in the year in which the surviving spouse attains age 70½. Thereafter, the surviving spouse is treated in the same manner as the participant for purposes of distributions to DBs of the surviving spouse.[233] There is no time limit within which the surviving spouse must elect to convert. For example, the survivor could wait until the deceased spouse would have been 70½ and then convert.

Qualified Trust is Beneficiary. If a trust is a beneficiary of an IRA, it is not a DB and is not entitled to distributions over an actuarial life expectancy because it has none.[234] If the trust satisfies the requirements for a qualified trust,[235] distributions are made to the trust over the actuarial life expectancy of the oldest human beneficiary.[236] Because of this, one of the requirements for a qualified trust is that under the terms of the trust, no IRA or qualified plan distributions to the trust can be made to a beneficiary who is not an individual. If a trust has a beneficiary that is not an individual, distributions would be made under the 5-year rule.[237]

Participant Dies On or After RBD

When the participant dies on or after the RBD, remaining distributions are determined based on who the beneficiaries are. The rules are as follows.

No Designated Beneficiary. If a participant dies and there is no DB, an RMD for the year of death must be calculated using the participant's life expectancy for that year.[238] For distributions after that year, RMDs are based on the participant's fixed single-life expectancy determined based on the participant's age in the year of death and reduced by one full year thereafter.[239]

Nonspousal Designated Beneficiary. If the participant has one or more designated beneficiaries other than a spouse, RMDs are based on the longer of the DB's age in the year after the participant's death.[240] This is then reduced by one full year for each year of the subsequent distribution period. If there are multiple designated beneficiaries, the age of the oldest DB is used,[241] but this rule is easily avoided by dividing the single IRA with multiple beneficiaries into separate IRAs for each beneficiary so that each DB can use their own life expectancy.[242]

231. Treas. Reg. §1.401(a)(9)-3, Q&A 3(b).
232. IRC §408(d)(3)(C).
233. Treas. Reg. §1.401(a)(9)-4, Q&A 4(b).
234. For example, see Treas. Reg. §1.401(a)(9)-4, Q&A 3 ("only individuals may be designated beneficiaries").
235. See Treas. Reg. §1.401(a)(9)-4, Q&A 5 and 6 for requirements.
236. Treas. Reg. §1.401(a)(9)-5, Q&A 7.
237. Treas. Reg. §1.401(a)(9)-4, Q&A 5-6.
238. Treas. Reg. §1.401(a)(9)-5, Q&A 4(a).
239. Treas. Reg. §1.401(a)(9)-5, Q&A 5(a)(2).
240. Treas. Reg. §1.401(a)(9)-5, Q&A 5.
241. Treas. Reg. §1.401(a)(9)-5, Q&A 7.
242. Treas. Reg. §1.401(a)(9)-8, Q&A 2.

Spouse is Designated Beneficiary. If the surviving spouse of the participant is the participant's **sole** beneficiary, two options are available.

1. The surviving spouse can convert the decedent's IRA to the surviving spouse's own IRA. A converted account is treated as the survivor's for all purposes of the Code. Thus, the distribution rules for the converted account are based on the surviving spouse's RBD and age using annual recalculation of life expectancy. DBs of the surviving spouse are determined and treated as if the converted IRA had always belonged to the survivor. If the deceased spouse was taking RMDs, the survivor must take the RMD for the decedent's year of death before converting. If the surviving spouse has not reached their RBD, no further RMDs (other than that for the decedent's year of death) will have to be taken from the converted IRA until the survivor reaches their RBD.

2. If the surviving spouse is already beyond their own RBD and does not convert the IRA, an RMD for the deceased participant's year of death must be taken for the year of death. For the distribution year following the participant's death, the surviving spouse calculates their RMD based on the survivor's single-life expectancy for that year. The survivor's life expectancy is recalculated each year during the distribution period until the year after the surviving spouse's death. At that time, the distribution period becomes a fixed period based on the single-life expectancy of the surviving spouse in the year of the survivor's death, reduced by one year for each year thereafter.[243] It is generally better for the surviving spouse to convert the IRA to their own, however, as the actuarial tables for a converted IRA are based on the life of the surviving spouse and a joint life up to and including 10 years younger, which would require smaller RMDs than the single life of the surviving spouse.

POST-2019 RMD RULES

The SECURE Act changes the after-death RMD rules applicable to defined contribution plan distributions to DBs but leaves other distribution rules unchanged. A defined contribution plan is a qualified retirement plan (QRP), which includes §401(k) plans, §403(b) plans, governmental §457(b) plans, and IRAs. Defined benefit plans are not included. The Act also applies to annuity contracts purchased from insurance companies under defined contribution plans or IRAs.

Note. For convenience, the term **QRP** in these materials includes all types of qualified retirement plans, as listed previously.

Prior to the SECURE Act, the following categories of beneficiaries were defined as follows.

1. **Designated beneficiaries (DBs)** — individuals other than surviving spouses
2. **Nondesignated beneficiaries (NDBs)** — any entity other than an individual
3. **Surviving spouse** designated beneficiaries

Under the SECURE Act, the categories of beneficiaries are as follows.

1. **Designated beneficiaries (DBs)** — individuals designated as beneficiaries[244]
2. **Nondesignated beneficiaries (NDBs)** — any entity other than an individual
3. **Eligible designated beneficiaries (EDBs)** — individuals, including surviving spouses, who fall into one of five categories of beneficiaries and who receive special treatment (discussed later).

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243. Treas. Reg. §1.401(a)(9)-5, Q&A 5(c)(2).

244. IRC §401(a)(9)(E)(i).

Distributions to Designated Beneficiaries

Under the SECURE Act, **the 5-year rule** is expanded to become a 10-year period instead of five years **("10-year rule")** for distributions to DBs. More significantly, the 10-year rule is now the general rule for distributions to DBs after the death of the participant regardless of whether the participant dies before, on, or after the RBD unless the DB is an EDB.[245] In the case of a DB who is not an EDB (defined later), distribution of the participant's entire benefit is required to be made by the end of the tenth calendar year following the year of the participant's death. As with the former 5-year rule, there is no requirement to take any distribution prior to expiration of the 10 years.

Distributions to Nondesignated Beneficiaries

The rules governing distributions to NDBs have not changed. If a participant dies prior to their RBD, distributions to an NDB (such as the probate estate) must be made under the 5-year rule.[246] If a participant dies after their RBD, distributions to an NDB will be made over the single-fixed actuarial life expectancy of the participant as of the year of death without recalculation.[247]

Eligible Designated Beneficiaries

There is an exception to the 10-year rule for EDBs that generally allows distributions over the life expectancy of the EDB beginning in the year following the participant's year of death, regardless of whether the participant dies before, on, or after their required beginning date. An EDB is one who, as of the date of the participant's death, is **one** of the following.[248]

- The surviving spouse of the participant
- A disabled individual
- A chronically ill individual
- An individual who is not more than 10 years younger than the participant
- A child of the participant who has not reached the age of majority

Surviving Spouse. As under pre-2020 law, if the surviving spouse is the sole DB, a special rule allows RMDs to the surviving spouse to be delayed until the end of the year that the participant would have attained age 72 (the new RBD under the SECURE Act). Alternatively, the surviving spouse can convert the deceased spouse's QRP to the survivor's own and then begin RMDs at the survivor's RBD. If the surviving spouse dies before RMDs are required to begin, the surviving spouse is treated as the participant in determining the required distributions to their DBs. Any DBs of the surviving spouse are subject to the new rules, however.[249]

> **Observation.** Basically, nothing has changed in respect to what a surviving spouse can do. What has changed is the 10-year distribution rule for DBs of the surviving spouse who are not EDBs.

245. IRC §401(a)(9)(H)(i)
246. IRC §401(a)(9)(B)(ii).
247. IRC §401(a)(9)(B)(i).
248. IRC §§401(a)(9)(E)(ii)(I)–(V).
249. IRC §401(a)(9)(B)(iv).

Disabled and Chronically Ill Individuals. The status of an individual as disabled or chronically ill is determined on the participant's date of death.[250] An individual who becomes chronically ill or disabled after that date cannot be an EDB. Both disabled and chronically ill individuals who are EDBs are entitled to receive distributions over their actuarial life expectancies. When a disabled or chronically ill EDB dies or is no longer within that category, the 10-year rule applies.[251]

Disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to end in death or to be for a long-continued and indefinite duration.[252] An individual is not considered disabled unless proof of the disability is furnished in such form and manner as the Secretary may require. Substantial gainful activity for this purpose is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability or prior to retirement if the individual was retired at the time the disability arose.[253] An individual who is entitled to social security disability benefits is generally considered disabled under this test.

The definition of a **chronically ill** individual incorporates by reference (with modification) the requirements for qualified long-term care insurance.[254] Under this definition, a chronically ill individual is any individual who:

- Is unable to perform (without substantial assistance from another individual) at least two activities of daily living (ADLs) for an indefinite period (expected to be lengthy in nature) due to a loss of functional capacity;
- Has a level of disability similar to the level of disability described above requiring assistance with daily living based on loss of functional capacity; or
- Requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.[255]

The ADLs for which assistance is needed for purposes of determining loss of functional capacity are eating, toileting, transferring, bathing, dressing, and continence.

Less Than 10 Years Younger DB. The legislative history notes that the intent of the retirement savings and distribution rules are to provide retirement income for the participant and their surviving spouse, but that DBs were able under prior law to receive distribution of a deceased participant's retirement savings over their life expectancies that were "in excess" of the amount required for retirement.[256] Apparently, allowing DBs who are not more than 10 years younger than the participant to use their life expectancies rather than the 10-year rule was seen to be less revenue draining. In fact, as long as the younger DB is younger than 82, under the new uniform lifetime actuarial tables effective in 2022, their actuarial life will be more than 10 years.[257] The interesting question is whether the IRS will issue regulations permitting a DB over the age of 81 to use the 10-year rule rather than actuarial life expectancy, which will, beginning at age 82, be less than 10 years.

Example 49. Henrietta dies at age 85 having named her 75-year-old brother, Henry, as the DB of her QRP. Henry's actuarial life expectancy under the 2022 tables for a 75-year-old is 14.8 years.

If Henry is instead 84 years old the year after Henrietta's death, his actuarial life expectancy is only 8.6 years unless the IRS issues guidance permitting him to use the 10-year rule.

If Henry dies before taking distribution of the entire QRP, his DBs will be subject to the 10-year rule even if there is more than 10 years left of Henry's actuarial life on his date of death.

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250. IRC §401(a)(9)(E)(ii) (flush language).

251. IRC §401(a)(9)(H)(iii).

252. The definition of disabled in IRC §72(m)(7) is incorporated by reference into IRC §401(a)(9)(E)(ii)(III).

253. Treas. Reg. §1.72-17(f).

254. IRC §7702B(c)(2).

255. IRC §7702B(c)(2)(A).

256. HR Rep. 116-65, Title IV A (May 16, 2019) (Comm. Rep.).

257. TD 9930, 2020-49 IRB 1400.

Minor Children. In the case of a child who has not reached the age of majority, calculation of the RMD under this exception is allowed only through the earlier of the year that the child reaches the age of majority or dies, at which point the 10-year rule applies to any further distributions.[258] For purposes of this exception, the child must be that of the participant;[259] grandchildren, such as children of a deceased child, are not eligible and are subject to the 10-year rule.

The definition of **age of majority** is unclear. IRC §401(a)(9)(E)(ii)(II) in defining "majority" does so by cross reference to §401(a)(9)(F) for this purpose, which says the following.

> *Under regulations prescribed by the Secretary, for purposes of this paragraph, any amount paid to a child shall be treated as if it had been paid to the surviving spouse if such amount will become payable to the surviving spouse upon such child reaching majority (or other designated event permitted under regulations).*

The regulations then provide the following.

> *[P]ayments under a defined benefit plan or annuity contract that are made to an employee's child until such child reaches the age of majority (or dies, if earlier) may be treated, for purposes of section 401(a)(9), as if such payments were made to the surviving spouse to the extent they become payable to the surviving spouse upon cessation of the payments to the child. For purposes of the preceding sentence, a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26.*[260]

No one seems quite sure what this means in the first place, let alone in the context of defining **majority** for purposes of the SECURE Act, as the SECURE Act is expressly not applicable to defined benefit plans. However, it is probable that the intent is that age of majority for a minor EDB is the greater of the age of majority under state law, or age 26 if the individual is engaged in a **specified course of education.** What constitutes a specified course of education requires IRS guidance. The following example assumes the specified-course-of-education requirement is satisfied.

Example 50. Robert is a single parent of two minor children, Audrey, age 12, and Peter, age 6. Robert dies in 2021. The two children are beneficiaries of his QRP, which is divided into separate accounts for each child after his death. The age of majority in the children's state is 18.

At age 18, Audrey is a full-time college student. She graduates at age 21. Until graduation, Audrey will take RMDs using her actuarial life expectancy as of the year after Robert's death and reduced by one full year for each year thereafter. The year after graduation, Audrey is required to convert to distributions under the 10-year rule. If Audrey enrolls full-time in graduate school following her college graduation, she continues to be an EDB until the year after the earlier of her ceasing to be a student, age 26, or her death.

Peter will similarly take RMDs using his actuarial life expectancy until age 18. Beginning after that year, he must qualify under the student exception to continue life expectancy RMDs or must apply the 10-year rule for distributions.

If Peter takes a year off after high school before enrolling full-time in college, he must take distributions under the 10-year rule. There is nothing that permits a former EDB to regain EDB status once it is lost.

Observation. The definition of a **minor** under the education exception above differs significantly from the definition of **qualifying child** for purposes of dependency status under IRC §152. There, the student exception applies only until age 24 and requires the individual to be a full-time student for at least five calendar months during the year.

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258. IRC §§401(a)(9)(E)(iii) and 401(a)(9)(H)(iii).

259. IRC §401(a)(9)(E)(ii)(II).

260. Treas. Reg. §1.401(a)(9)-6, Q&A 15.

> **Note.** When there are minor children, it is common for parents to name a trust as a beneficiary of an QRP rather than naming the children directly. This worked well under pre-2020 law, as distributions from a qualified trust would be based on the actuarial life expectancy of the oldest of the minor children, which would still be quite lengthy. Unfortunately, the SECURE Act adversely affected this form of planning, as discussed later in the chapter.

EFFECTIVE DATES[261]

The provisions of the SECURE Act are generally effective for RMDs for participants with a date of death **after** December 31, 2019.

In the case of a governmental plan (as defined in IRC §414(d)), in determining RMDs after the death of a participant, the provision applies to distributions for participants who die **after** December 31, 2021.

In determining RMDs after the death of a participant in the case of a collectively bargained plan, the Act applies to distributions for participants who die in calendar years beginning after the **earlier** of:

1. The **later** of:
    a. The date on which the last collective bargaining agreement ratified before date of enactment of the provision terminates, or
    b. December 31, 2019
2. December 31, 2021

The modification to the after-death minimum distribution rules does not apply to a qualified annuity that is a binding annuity contract in effect on the date of enactment of the provision and at all times thereafter. There are several requirements (not covered in these materials) that apply to qualified annuities.

GRANDFATHERED RMDs

In the case of a participant who died before 2020, if the DB of the participant dies on or after January 1, 2020, the SECURE Act applies to any beneficiary of the DB as though the deceased DB were an EDB. Thus, the entire interest of the deceased DB must be distributed by the end of the tenth calendar year after their death. For this purpose, the effective date is the date of death of the participant used to determine when the provision applies to the QRP (such as before January 1, 2020, under the general effective date or January 1, 2022, for a governmental plan).[262]

Example 51. Jack dies on January 25, 2016. His sister, Jill, who is 20 years younger, is the beneficiary of his QRP. Because Jack died before 2020, Jill is treated as an EDB even though she is more than 10 years younger than Jack. Jill can continue taking RMDs over her actuarial life expectancy. However, if Jill dies on or after January 1, 2020, before the balance in the QRP is distributed, the account balance must be paid out to any beneficiary of hers under the 10-year rule.

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261. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §401(b), Div. O.

262. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §401(b)(5), Div. O.

EFFECT ON TRUSTS AS BENEFICIARIES

A trust is not a DB because it is not a human being and therefore has no actuarial life expectancy over which RMDs can be paid. If the trust is a qualified trust, however, the existence of the trust is ignored, and individual beneficiaries of the trust are treated as DBs solely for determining the life over which RMDs will be made.[263] These are referred to as **see-through trusts** because they look through the trust to use a DB as an actuarial measuring life for RMDs. There are two types of see-through trusts, commonly referred to as **accumulation trusts** and **conduit trusts.**

> **Observation.** The SECURE Act has had no effect on the requirements trusts must satisfy to be treated as qualified accumulation or conduit trusts. What has changed is the determination of the period of time over which distributions can be made to qualified trusts.

Accumulation Trusts

The purpose of an accumulation trust is generally to accumulate and add income to principal to the extent it is not distributed to beneficiaries. To be a see-through accumulation trust, the following requirements must be met.[264]

1. The trust must be valid under state law or would be but for the fact that there is no corpus.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the grantor-participant.
3. The beneficiaries of the trust, who are also the beneficiaries of the interest the trust has in the retirement benefit, are identifiable in the trust instrument and the age of the oldest is determinable (which can include a class of beneficiaries, such as grandchildren).
4. Any beneficiary, who could receive trust distributions including any amount from a QRP distribution to the trust, must be an individual. For this purpose, beneficiary status is determined as of September 30 of the year after the participant's death. This permits eliminating an NDB — such as a charity — by making distribution to it by the September 30 determination date, thereby eliminating the charity as a countable beneficiary. Failure to eliminate an NDB means distributions to the trust must be made as if the grantor-participant died without a DB.
5. Certain documentation concerning the trust must be provided to the plan administrator or QRP custodian by October 31 of the year after the participant's death.[265]

Only one DB's life can be used as the measuring life and that must be the life of the oldest beneficiary.[266] The creation of separate accounts does not change this. The classic revocable living trust, for example, is typically a see-through trust for purposes of the first two requirements previously listed. If the beneficiary of the trust is another trust, such as a credit shelter trust, the beneficiaries of the other trust are treated as being beneficiaries of the first trust for purposes of the see-through trust rules as long as the second trust is also a see-through trust.[267]

Although beneficiaries of the trust are treated as DBs for determining the time over which benefits must be paid out, they are not otherwise treated as DBs. For example, the separate account rules, under which the account of each individual beneficiary can be paid out over that beneficiary's own life expectancy is not available. [268] In addition, the beneficiary with the shortest life expectancy is the designated beneficiary for purposes of determining the applicable distribution period even if that individual dies.[269]

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263. Treas. Reg. §1.401(a)(9)-4, Q&A 5.
264. Ibid.
265. See Treas. Reg. §1.401(a)(9)-4, Q&A 6.
266. Treas. Reg. §1.401(a)(9)-5, Q&A 7(a)(1).
267. Treas. Reg. §1.401(a)(9)-4, Q&A 5(d).
268. Treas. Reg. §1.401(a)(9)-4, Q&A 5(c).
269. Treas. Reg. §1.401(a)(9)-5, Q&A 7(a)(1).

The documentation requirement (#5 is the previous list) is satisfied by providing the trustee or plan administrator with one of the following documents that are required by the trustee or administrator.

- The trustee must provide the administrator with a final list of all beneficiaries of the trust, including contingent and remainder beneficiaries, with a description of the conditions of their entitlement as of September 30 of the year after the death of the participant or spouse with certain additional certifications.
- Alternatively, the trustee must provide the plan administrator with a copy of the trust instrument of the trust that is the beneficiary of the benefit as of the participant's date of death. This is generally the easier option.[270]

Bypass Trust Issues. A bypass trust is one that is intended to create a separate trust upon the death of the first spouse and that is generally funded in an amount equal to the maximum available estate tax exemption amount for that spouse. These may also be referred to as **credit shelter trusts** or **A-B trusts.** Generally, the trust then pays income to the surviving spouse for life, with remainder at the survivor's death to their children. There is also usually a power for the trustee to invade principal under an ascertainable standard related to health, education, etc. Even though the $11.7 million exemption amount in 2021 means the combined estates of most couples are not subject to any estate tax, there is no assurance that the higher exemption amounts will remain in place. Furthermore, there are many older estate plans that have not been updated for higher exemption amounts and will therefore result in creating unnecessary bypass trusts that are separate tax entities for income tax purposes.

If an individual makes their trust the beneficiary of their QRP, any portion of the QRP allocable to the bypass trust is subject to generally unfavorable RMD requirements. That is because both the surviving spouse and the remainder beneficiary children are "countable" beneficiaries for purposes of identifying which beneficiary has the shortest life expectancy. This occurs as a result of default FAI rules under state principal and income acts. Although RMDs are treated as income for tax purposes, only a portion are treated as FAI. Instead, the UPIA provides the following default rules for distributions from QRPs.

1. To the extent a payment is characterized as interest or dividends, it is allocated to FAI. Any remaining portion of the payment or any other payments received during the year that are not characterized as interest or dividends, are allocated to principal.
2. If no part of the payment is characterized as interest or dividends and the payment is required to be made, 10% is allocable to FAI and the remainder to principal. If the payment is not required to be made or is the entire amount to which the trustee is entitled, it is allocated entirely to principal.[271]

Example 52. A bypass trust pays all income to the surviving spouse for life and pays the remainder to the couple's children. The RMD for 2021 is $50,000. None of the distribution is designated as interest or dividends. Therefore, $5,000 is allocated to FAI and distributed to the surviving spouse as income and the remaining $45,000 is allocated to principal. Because the children receive the distribution of the trust principal at the surviving spouse's death, that portion of the RMD allocated to principal is a portion of QRP money distributable to them. As a result, both the surviving spouse and the remainder beneficiary children are all countable lives in determining the beneficiary with the shortest actuarial life.

270. Treas. Reg. §1.401(a)(9)-4, Q&A 6(b).

271. UPIA §§409(b) and (c) (Unif. Law Comm'n 2003 as amended 2008).

As shown by **Example 52,** the most commonly used life in a bypass trust is that of the surviving spouse because the surviving spouse will be the oldest beneficiary.[272] That life continues to govern distributions to the children if the surviving spouse dies before the entire QRP is distributed.[273] The surviving spouse is also not eligible for other spousal benefits, such as the ability to defer distributions until the decedent would have been 72 (formerly 70½) or rolling over the QRP as their own.[274] Under current IRS rules, dividing the trust into separate trusts for each beneficiary does not operate to create separate accounts and thereby change the result.[275]

> **Example 53. Pre-2020.** Melissa dies with a trust directing creation of a credit shelter trust to pay the income to husband George for life. The remainder at George's death is divided equally among their three children. The trust is the beneficiary of Melissa's QRP. George is 75 years old, and the children are 50, 40, and 35. The trust is a qualified trust. Because George is the oldest beneficiary, RMDs must be calculated based on the actuarial life of a 76-year-old (George's age the year after Melissa's death). If George dies before the QRP is fully distributed, the children continue taking distributions using his life expectancy.[276]

As a result of the SECURE Act, the situation may be worse — or better — depending on the age of the surviving spouse and future IRS guidance. The surviving spouse is not an EDB because the survivor is not the sole beneficiary of the QRP. This is because a portion of the QRP distribution to the trust passes to the remainder children. Because there is no EDB, distributions are subject to the 10-year rule. Under the new actuarial tables effective in 2022, if the surviving spouse is 81 years old or less (80 or less in 2021), their life expectancy is more than 10 years. Beginning with age 82 (81 in 2021) the 10-year rule is actually more favorable.

> **Example 54. Post-2019.** Use the same facts as in **Example 53.** The actuarial life expectancy of a 76-year-old is 12.7 years (2021 tables). However, because there is no EDB exception, distributions must be made under the 10-year rule. If George is 85, his life expectancy is 7.6 years, the 10-year rule still applies.

> **Observation.** If a surviving spouse is the sole income beneficiary of a conduit trust (discussed later), they are treated as an EDB eligible to use spousal rules even if the remainder beneficiaries are different.

Trusts for Minors. The situation for minors who are beneficiaries of accumulation trusts is less clear. As described previously, if an IRA is payable directly to a DB who is a minor, the minor is treated as an EDB entitled to use an actuarial life expectancy until the earlier of date of death or attaining age of majority. If the benefit is payable to a trust for the benefit of the minor, however, it is uncertain if the minor need to be the sole beneficiary or if that is the same problem as previously discussed for a bypass trust for the benefit of a surviving spouse. There is no statutory provision (as in the case of a trust for disable or chronically ill individuals below) permitting a trust for a minor to be treated as an EDB as long as the minor is the sole income beneficiary until the earlier of death or age of majority. In the absence of future IRS guidance to the contrary, therefore, the minor EDB exception may require the use of conduit trusts.

Disabled or Chronically Ill Individuals

There are two special rules applicable to trusts for disabled or chronically ill individuals that are not available in the case of any other EDB.

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272. Treas. Reg. §1.401(a)(9)-5, Q&A 7(a).

273. Treas. Reg. §1.401(a)(9)-5, Q&A 7(c)(2).

274. Treas. Reg. §1.401(a)(9)-5, Q&A 7(c)(3), Example 1.

275. Treas. Reg. §1.401(a)(9)-4, Q&A 5(c); see, e.g., Ltr. Rul. 201503024 (Oct. 20, 2014).

276. Treas. Reg. §1.401(a)(9)-5, Q&A 7(c)(3), Example 1.

First, an accumulation trust can be divided upon the death of the participant into separate trusts so that any separate trust for the benefit of a disabled or chronically ill individual is eligible for the EDB actuarial distribution rule.[277] This overrides the IRS's normal rule pertaining to bypass trusts that says post-death separation of a single trust into separate trusts does not affect the determination of the distribution requirements.

Second, an accumulation trust is eligible for the actuarial life payout with respect to a disabled or chronically ill individual as long as no other person has any interest in the trust during the life of the EDB. Consequently, a trust that pays all income to the disabled or chronically ill beneficiary for life with remainder to their siblings after their death uses the life expectancy of the disabled or chronically ill beneficiary.[278]

> **Observation.** Under the second exception, when the beneficiary is no longer disabled or chronically ill prior to death, the 10-year rule becomes applicable. The 10-year rule also applies following the beneficiary's death.

Conduit Trusts

The term **conduit trust** applies to a trust with special provisions addressing retirement distributions made to the trust. Normally, part of any QRP distribution to a trust—whether an RMD or lump sum—is allocated under a state's principal and income act to principal and taxed to the trust, while the rest of it is considered FAI that can be distributed to and taxed to the beneficiary.[279] Because principal is ultimately distributable to the remainder beneficiaries, there can be a problem in accumulation trusts (as described previously) of multiple potential beneficiaries of any QRP distribution resulting in limitations on the period over which distributions are made and the options available to beneficiaries. In a conduit trust, there is no accumulation, and the trustee is required by the terms of the trust to distribute immediately to the beneficiary of the trust **any** distribution the trustee receives from the QRP. The trustee has no power to accumulate any QRP distributions made during the lifetime of the primary income beneficiary and no distributions can be made to any other beneficiary during the primary beneficiary's lifetime.[280]

In such cases, the IRS ruled that the conduit beneficiary is treated for distribution purposes as if the beneficiary were named directly as a beneficiary of the QRP rather than as a beneficiary of the trust.[281] As a result, distributions are made over the life expectancy of the beneficiary. If there are multiple beneficiaries and each beneficiary is named as a separate beneficiary of a portion of the QRP distribution, each beneficiary can use their own life expectancy rather than the life expectancy of the oldest beneficiary.[282]

> **Observation.** The conduit trust overrides default state principal and income acts with respect to QRP distributions by redefining FAI in the trust agreement as including all QRP distributions so that none can be allocated to principal. Furthermore, for income tax purposes, FAI is defined as being the trust's income for the tax year "determined under the terms of the governing instrument and applicable local law."[283]

277. IRC §401(9)(H)(iv).

278. IRC §401(9)(H)(iv)(II).

279. See UPIA §§409(b) and (c) (Unif. Law Comm'n 2003 as amended 2008).

280. Treas. Reg. §1.401(a)(9)-5, Q&A-7(c)(3), Example 2.

281. Ibid. See, e.g., Ltr. Rul. 201750004 (Sep. 12, 2017).

282. Ltr. Rul. 200537044 (Mar. 29, 2005).

283. Treas. Reg. §1.643(b)-(1).

If a surviving spouse is the sole beneficiary of a conduit trust, they can generally use most of the rules that would have been applicable if the surviving spouse — instead of the trust — were directly named the beneficiary of the QRP. There is one major exception: the surviving spouse generally is not allowed to convert the deceased spouse's QRP to their own because it is the trust that owns the beneficial interest in the QRP.[284] The survivor can, however, delay distributions until the later of the end of the year after the participant's death or the year the participant would have reached age 72. In addition, the surviving spouse is permitted to determine RMDs using recalculation of life expectancy.

As discussed previously, if a minor is the beneficiary of a conduit trust, they are treated as an EDB entitled to actuarial life expectancy payout. Once the minor reaches age of majority or dies, the 10-year rule applies and the remainder of the QRP — which may be considerable given the actuarial factors for a minor — must be distributed by the end of the 10th year after the minor reaches the age of majority. Staged payouts, such as distributing a portion of the trust as a child reaches various ages such as 25, 35, and 45, are not possible with a conduit trust.

There are many questions commentators and practitioners have about the new distribution rules that must be addressed by IRS guidance, such as the following examples.

- Can a conduit trust have multiple minor EDBs? If so, what triggers the 10-year rule? Is it when the first minor reaches majority?
- If the separate share rule[285] applies to the trust, is it as each reaches the age of majority with respect to their share? Or does a trust have to directed to be divided into separate conduit trusts for each minor at the death of the grantor?
- If a conduit trust has multiple beneficiaries, one or more of whom are not minors, can any minor beneficiaries still be treated as EDBs? Currently, until the IRS issues guidance, the safe approach is to have separate conduit trusts for minor beneficiaries with each trust the beneficiary of its proportionate share of the QRP.

An important difference between an accumulation trust and a conduit trust for minors is the timing of the start of the 10-year distribution rule. Because of the small actuarial RMDs required for a younger child, a conduit trust can continue to accumulate tax-deferred earnings before the 10-year rule applies. The closer a child gets to the age of majority, the less time there is.[286] An accumulation trust pays income tax at trust rates on the portion of RMDs allocated to principal. The conduit trust has no trust-level income tax, because RMDs are taxed to the beneficiary. RMDs are subject to the kiddie tax, however.[287] Once a child is over the age of 18 (or 24 if a full-time student), there is no longer a kiddie tax and distributions from that point on are at the beneficiary's bracket rather than the parents.[288] The choice between an accumulation trust and a conduit trust for minors has therefore become much more complicated today.

284. For example, see Ltr. Rul. 9509028 (Dec. 1, 1994). This letter ruling also illustrates that if the surviving spouse can compel the trustee to distribute all of the IRA to the spouse, they can do so by direct rollover from the IRA custodian to an IRA for the spouse and thereby effect a rollover spousal conversion.

285. See Treas. Reg §1.663(c)-(3).

286. For example, under the actuarial tables for 2021 the life expectancy of a 10-year-old is 74.9 years, of an 18-yer old is 67.0 years, and of a 72-year old is 27.4 years. Thus, the RMD factor for a 10-year old is 1/74.9, decreasing by one year each year thereafter. Treas. Reg. §1.401(a)(9)-9(b), Single Life Table.

287. See Temp. Treas. Reg. §1.1(i)-1T, Q&As 6 and 16 (RMDs are not within the scope of earned income and are trust distributions.)

288. See IRC §1(g).

Example 55. Use the same fact as **Example 7.** When the will of Jack and Diane established trusts for their children, the concern for the financial management of assets for two of the minors, Teddi and Justice, became a quandary for Hud, the trustee. This is because assets that were allocated to the trusts for Teddi and Justice came from Jack and Diane's substantial traditional IRA investments. Hud must balance the needs of the minor children with the concern of the trusts paying tax as accumulation trusts versus treating distributions as conduit to Teddi and Justice and the commensurate risk of them being too immature to handle assets properly.

Observation. This situation presents the problem of trust and estate taxation for trustees and their advisors. Is it more important to minimize trust and estate taxes now by distributing assets, or is it more important to accumulate assets in a trust arrangement but be faced with punitive trust and estate income tax rates? For the trustee, the age-old question becomes, "How long does life go on, long after the thrill of living is gone"?

ACTION ITEMS AND PLANNING

Clients who are known to have QRPs with trusts as beneficiaries should be advised to have their estate plans reviewed with respect to SECURE Act changes.

If a client wants to continue using an accumulation trust even in the face of the 10-year distribution rule, they should consider providing the trustee discretion to make decisions with respect to the timing of QRP distributions and distributions to the beneficiaries to maximize whatever tax benefits may be available in any particular year. That should specifically include the trustee's discretion to demand distributions in any amount and to allocate receipts between trust principal and income. Such discretion is important after the SECURE Act because the only RMD under the 10-year rule is that the entire IRA account must be distributed by the end of the tenth year after the participant's death. Classic trust language requiring the trustee to distribute to beneficiaries the greater of the RMD or trust income (FAI) could literally result in no distributions until a terminating lump-sum distribution.

Roth IRAs are subject to the same distribution rules after the death of the participant as traditional IRAs. Under current law they are still tax-free, however. The more rapid distribution schedule to nonspousal DBs from traditional IRAs may result in higher marginal tax rates for the DBs. Depending on the participant's marginal tax bracket and personal desires, it may be beneficial to make Roth contributions or, if over the threshold for contributions, to do Roth conversions, including "backdoor" conversions.[289]

Note. For more information on backdoor Roths, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Retirement Plan Distributions.

If an individual is inclined to make a significant charitable gift, consideration might be given to using IRA assets instead of nonretirement assets for that purpose. The untaxed earnings of traditional IRAs constitute IRD and is therefore taxed to the trust or beneficiary as received.[290] If, instead, a §501(c)(3) charity is a beneficiary, the charity receives it tax free and other nonIRD assets can be used for other taxable beneficiaries.

Another consideration for a philanthropic client is to make a charitable remainder trust (CRT) the beneficiary of an IRA. Because the CRT is an NDB, the 5-year rule applies. However, the CRT is not taxed on receipt of the IRA distribution. Distributions from the CRT — while generally taxable to the beneficiary — can then be made over the life of the beneficiary, thereby creating an alternative form of stretch. The rules governing CRTs are complicated, and the advice of an expert should be sought.

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289. Backdoor conversions involve making a nondeductible traditional IRA contribution and then converting it to a Roth because there is no AGI phaseout for Roth conversions as there is for Roth contributions.

290. IRC §691(a)(1). See Rev. Rul. 92-47, 1992-1 CB 198.

POST 70½ IRA CONTRIBUTIONS

For years before 2020, individuals could not make contributions to traditional IRAs after age 70½. They were permitted, subject to modified AGI limitations, to make contributions to Roth IRAs. Individuals were also permitted after age 70½ to make contributions to employer-sponsored plans, such as a savings incentive match plan for employees (SIMPLE) and a simplified employee pension (SEP), even though those plans are based on IRAs. For years after 2019, there is no longer an age limit for contributions to traditional IRAs.[291] However, there is no change in the requirement that an individual must have "earned income" to contribute to a traditional IRA; retirement and investment income are not considered earned income. For years after 2019, amounts includable in an individual's income and paid to them to aid the individual in the pursuit of graduate or postdoctoral study or research (such as a fellowship, stipend, or similar amount) is treated as compensation for purposes of IRA contributions.

Qualified Charitable Distributions

There may be a hidden cost associated in making deductible IRA contributions after age 70½, however. With the TCJA increase in the standard deduction, a common means for making charitable contributions by individuals unable to itemize, is through qualified charitable distributions (QCDs) from QRPs. A QCD is a nontaxable distribution made directly by the IRA custodian (other than a SEP or SIMPLE IRA) to an organization eligible to receive tax-deductible contributions.[292] An individual must be at least age 70½ when the distribution is made and this age limit was not changed by the SECURE Act. The contemporaneous written acknowledgment requirements are also applicable to QCDs.[293]

Observation. Although QCDs cannot be made from employer retirement plans, such as 401(k)s, SEP, and SIMPLE,[294] if rollover transfers can be made from such plans to a traditional IRA, a QCD can then be made from that IRA.

The maximum annual exclusion for QCDs is $100,000. In determining the $100,000 limit, the amount treated as a QCD is limited to the amount of the distribution that would otherwise be included in income. If the IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income. Any QCD in excess of the $100,000 exclusion limit is included in income as any other distribution. **QCDs count toward RMDs.[295]** They are reported in full together with any other retirement distributions on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, and must be listed on line 4a Form 1040. However, the 2020 Form 1040 instructions say to report on line 4b the taxable portion only and to write "QCD" next to it.[296]

Note. For more information on QCDs, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

291. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §107, Div. O., repealing former IRC §219(d) setting 70½ as the maximum age for making traditional IRA contributions.

292. See IRC §408(d)(8).

293. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.

294. IRC §408(d)(8)(B).

295. The preceding rules are found at IRC §408(d)(8).

296. *IRA FAQs — Distributions (Withdrawals)*. Mar. 26, 2021. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-distributions-withdrawals] Accessed on May 5, 2021.

The hidden cost of making post-70½ IRA contributions affects individuals making charitable contributions through QCDs. For QCDs made after December 31, 2019, the amount of the QCD excludable from gross income under §408(d)(8)(A) is reduced (but not below zero) by an amount equal to:

1. The aggregate amount of post-70½ deductible IRA contributions made by the individual that did not already reduce QCDs, over
2. The aggregate amount of reductions in QCD exclusions for all post-2019 tax years preceding the current tax year.[297]

Example 56. Warren, age 74, makes a $7,000 IRA contribution in 2021. He must take a $10,000 RMD from his IRA for 2021. Because Warren cannot itemize deductions, he makes a $10,000 QCD to charities, which satisfies his RMD. Unfortunately, Warren discovers that if he deducts the IRA contribution, he must include $7,000 of the QCD in gross income ($7,000 aggregate post-70½ deductible IRA contributions over $0 aggregate post-2019 QCD reductions).

In 2021, Warren includes the $7,000 QCD in gross income. In 2022, he makes no deductible IRA contribution and does another $10,000 QCD. The amount of the QCD includable in gross income is $0 ($7,000 aggregate post-70½ deductible IRA contributions over $7,000 aggregate post-2019 QCD reductions).

In 2022, Warren makes a $5,000 deductible IRA contribution and a $10,000 QCD. He includes $5,000 of the QCD in gross income ($12,000 aggregate post-70½ deductible IRA contributions over $7,000 aggregate post-2019 QCD reductions).

Note. The provision requiring reduction of QCDs appears to have been added at the last minute, as it is mentioned nowhere in the legislative history. Consequently, there is no indication of what Congress intended. It is likely, however, that Congress became concerned that individuals could effectively offset RMDs by converting deductible IRA contributions into tax-free IRA charitable distributions in the form of QCDs.

Example 57. Use the same facts as **Example 56,** except there is no requirement to reduce QCDs by deductible IRA contributions. In 2020, Warren contributes $7,000 to an IRA and deducts it. He also makes a $10,000 QCD that is excludable from gross income. The net reduction in Warren's IRA balance is only $3,000 because he effectively offset $7,000 of his RMD with the $7,000 deductible contribution. Warren has therefore accomplished two things: (1) he has, as a nonitemizer, indirectly deducted a $7,000 charitable contribution in the form of a deductible $7,000 IRA contribution and (2) he has taken a net RMD of only $3,000.

297. IRC §408(d)(8)(A).

APPENDIX — §645 ELECTION CHECKLISTS

QRT With No Related Estate

	Task	Notes
1.	Is the trust a qualified revocable trust (QRT)? If the answer is NO, this checklist does not apply.	
2.	Obtain a trust EIN.	
3.	If unsure whether a §645 election will be made, file a tentative short-year calendar-year return for the grantor's year of death. If a §645 election will be or has already been made, no short-year return is necessary.	
4.	If a §645 election is being made, choose a tax year, calendar or fiscal year.	
5.	Prepare and file Form 8855 no later than the due date, plus extension, for the chosen tax year. Do not file with the Form 1041. Mail it certified. Form 8855 must be filed even if trust has insufficient gross income to require filing Form 1041.	
6.	If a tentative calendar-year return was filed at step 3 above, file an amended return excluding all items of income and expense from that return and including them on the fiscal-year return filed as an estate.	
7.	Determine the applicable date (end of the §645 election period).	
8.	Prepare Forms 1041 filing as an estate.	
9.	If the trust terminates before the applicable date, file a final return as an estate.	
10.	If the trust will continue beyond the applicable date, get an EIN for a "new" trust created as of the day after the end of the §645 election.	
11.	If the trust continues beyond the applicable date, file a final Form 1041 as of the last day of the election period as an estate, using the original EIN. Treat **all** classes of income as having been distributed to a new trust and take a distribution deduction for **all** taxable income.	
12.	Form 1041 will now be filed as a trust and will be required to be filed on a calendar-year basis.	
13.	The first trust Form 1041 will include all taxable and tax-exempt income items from the final estate return.	

QRT With Related Estate

Task	Notes
1. Is the trust a qualified revocable trust (QRT)? If the answer is NO, this checklist does not apply.	
2. The estate must obtain an EIN. This EIN should be provided to estate payors.	
3. Obtain a trust EIN regardless of whether a §645 election will be made. This EIN should be provided to trust payors.	
4. If a §645 election is made, choose a tax year. There is no requirement for the trust to file a short-year calendar-return even if the election has not been made. If, for some reason, it does file a return as a trust, it will have to file an amended return removing all items of income and expense, which will then be reported on the estate's return. Amendments are also required if the trust has filed as an estate and there is a subsequently appointed executor who consents to the election. Also, have an agreement between the executor and the trustee concerning apportionment of any income tax liability between the two.	
5. Prepare and file Form 8855 no later than the due date plus extension for the chosen tax year. Do not file with the Form 1041. Mail it certified. Form 8855 must be filed even if there is insufficient gross income to require filing Form 1041.	
6. Determine the applicable date.	
7. Prepare Forms 1041 filing as an estate. The trustee must provide all items of trust income and expense to the executor for this purpose. All returns are prepared by and signed by the executor.	
8. If the trust terminates before the applicable date, the trustee must file a final Form 1041 (including no items of income and expense) under the trust EIN to notify IRS of its termination. Income and expenses are all reported on the estate's full-year return without regard to the trust termination, allocated using books and records. Remainder beneficiaries receive a Sch. K-1 from the estate.	
9. If the trust continues beyond the applicable date, get an EIN for a "new" trust created as of the day after the applicable date. This EIN should be provided to trust payors. If the estate continues, it continues to use its EIN.	

QRT With Related Estate *(continued.)*

	Task	Notes
10.	If the trust continues beyond the applicable date, file a full-year estate Form 1041 with income and expenses allocated using books and records. Treat **all** the trust's share of taxable and tax-exempt income as having been distributed to a new trust and take a distribution deduction for **all** the taxable income.	
11.	If the trust continues beyond the applicable date, a separate Form 1041 is filed by the trust and is required to be filed on a calendar-year basis.	
12.	The first trust Form 1041 filed after the applicable date includes all income items from the final estate return.	