Income Taxation of Trusts and Estates

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INCOME TAXATION OF TRUSTS AND ESTATES

Most types of trusts and decedent's estates generally must file Form 1041, U.S. Income Tax Return for Estates and Trusts:

TRUST BASICS

By far the most widely used type of trust in estate planning is the revocable living trust. Normally the grantor (person funding the trust) is generally the trustee of the trust while they are alive, and reserve the right to revoke or amend the trust at any time up until thier death. The grantor is typically the primary beneficiary during his or her lifetime. At the grantor's death, the trust becomes irrevocable, and, after payment of taxes, expenses, and debts, the corpus is distributed to designated beneficiaries or allocated among new trusts created on the grantor's death under the trust agreement usually in order to minimize estate taxes (i.e. the typical A / B split).

During the grantor's lifetime the trust is usually considered a grantor trust. On the grantor's death, the trust becomes a complex trust until distributed or allocated. (more on this latter…)

Examples of other trusts that file form 1041 are as follows:

Joint revocable trust

A joint revocable trust established by married couples is similar in purpose and function to the individual living trust. Many estate plans that utilize Jointy Revocable Trusts provide for separate marital trusts to be created upon the death of the first spouse for benefit of the surviving spouse and direct that all the income be distributed to the surviving spouse along with discretionary principal distributions to the surviving spouse out of the deceased spouses share of the estate.

Irrevocable Insurance Trusts

Irrevocable insurance trusts are established primarily to own life insurance with periodic grantor contributions to pay the insurance policy premiums.

Gift Trusts

Gift trusts are typically used in making gifts for children, grandchildren, nieces, nephews, grandnieces, and grandnephews)

Grantor Retained Annuity Trusts (GRATs)

Grantor retained annuity trusts (GRATs) last for a term of years and provide a periodic payment to the grantor of the trust during the term. At the end of the term, the trust is allocated and distributed among designated beneficiaries, possibly including trusts.

Qualified Personal Residencence Trusts (QPRTs)

In a qualified personal residence trust (QPRT), the grantor generally transfers a personal residence into the trust and retains the right to use the residence rent free for a period of years while gifting the remainder interest to his or her children.

GRANTOR VS. NON-GRANTOR TRUSTS

Grantor trusts are defined under Code sections 671 through 679, and as grantor trusts, they are taxed as part of the grantor's estate. Typically, grantor trusts are those in which the grantor retains specified trust powers or interests to revoke or amend the trust, or gives those powers/interests to individual who remain under the control of the grantor. These powers and interests are enumerated under Code sections 673 through 677.

In general, the grantor of a trust is treated as the owner of the trust if the grantor:

(1) retains a reversionary interest in either the corpus or the income that exceeds 5 percent of the value (Code Sec. 673(a));

(2) retains the power to control the beneficial enjoyment of the trust corpus or trust income without the consent of an adverse party (Code Sec. 674(a));

(3) retains certain administrative powers over the trust (Code Sec. 675);

(4) retains the power to revoke the trust (Code Sec. 676); or

(5) can use the income of the trust for his or her benefit (Code Sec. 677).

Grantor trusts are generally disregarded for income tax purposes during the life of the grantor and the IRS will accordingly treat the grantor as the owner of all assets tilted in the name of the trust. A grantor trust is ignored for tax purposes and all of the income, deductions, etc., are treated as belonging directly to the grantor. Thus, the income from assets titled in the name of the Grantor trusts is reportable on the Grantor's personal income tax return.

Usually, grantor trusts are set up so that they become irrevocable upon the grantor's death and the trust assets are then administered according to the terms of the trust instrument. When the trust becomes irrevocable it becomes a non-grantor trust. Non-grantor trusts are all other trusts that are not grantor trusts.

Complex vs. Simple Trusts

Annually nongrantor trusts must be analyzed to determine whether it is complex or simple. All trusts that do not qualify as simple trusts are classified as complex trusts. This determination affects the allocation of taxable income between income taxed at the trust level and income taxable at the beneficiary level and the exemption available to the trust.

A trust is a simple trust if it meets three requirements:

(1) the terms of the trust agreement must provide that all of the fiduciary accounting income is distributed currently;

(2) the trust must not actually distribute any amounts during the year other than the fiduciary accounting income required to be distributed currently; and

(3) the terms of the trust agreement must not provide for any amounts to be paid, permanently set aside, or used for charitable purposes (Code Sec. 651(a)).

COMPLEX TRUSTS AND ESTATES

Complex trusts and estates are subject to different distribution rules (discussed later) than simple trusts. Estates are subject to the same distribution deduction rules as complex trusts. Unlike a simple trust a complex trust or estate is not required to distribute all of its income currently, can distribute principal, and can make charitable contributions.

CALCULATING TAXABLE INCOME

There are actually four separate calculations of income that must be made when preparing a Form 1041:

(1) fiduciary accounting income (FAI);

(2) distributable net income (DNI);

(3) taxable income; and

(4) distributable net alternative minimum taxable income (DNAMTI).

FIDUCIARY ACCCOUNTING INCOME

The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the tax year determined under the terms of the governing instrument and applicable local law. This is also known as fiduciary accounting income (FAI) (Code Sec. 643(b); Reg. §1.643(b)-1).

The concept of fiduciary accounting income is used to determine the economic interests of the income and remainder beneficiaries of an estate or trust by providing a means of allocating receipts and disbursements between the estate or trust's income, which may be either accumulated or distributed to the income beneficiaries, and its principal, which will eventually be distributed to the remainder beneficiaries. Most states have adopted some form of the Uniform Principal and Income Act (UPIA) as their guideline. Federal income tax law defers to the trust instrument and state law for the determination of the amount of FAI.

TAXABLE INCOME

The calculation of the taxable income of a trust or estate is generally determined in the same manner as that of an individual.[1] Taxable income of an estate or trust requires the understanding of what exclusions from gross income are allowed under the code, calculating gross income with these exclusions in mind, and then determining the allowable deductions. The

[1] IRC §641(b).

allowable deductions will either be above-the- line deductions and/or itemized deductions. After the deductions are taken, the remainder is the taxable income of the estate or trust.

There are various sources of taxable income attributable to trusts and estates which are referred to in Code section 641. For Estates, income includes "income received by estates of deceased people during the period of administration or settlement of the estate," "income accumulated or held for future distribution under the terms of the will," and income which may be distributed to the beneficiaries or accumulated at the discretion of the fiduciary.[2] As for income for trusts, §641 suggests "income which is to be distributed to the beneficiaries or accumulated," and "income accumulated in trust for the benefit of unborn or unascertained persons with contingent interests, and income accumulated or held for future distribution under the terms of the…trust."[3]

As mentioned above, the income of an estate or non-grantor trust is calculated in the same manner as for individuals. Thus, income as listed in §61 also applies to trusts and/or estates. Sections 642-685 list many exceptions for the computation of income for trusts and estates because of the way they differ from the individual, and also the estate or trust may be allowed to pass the income or deductions through to the beneficiaries.

Schedule K-1 is used to notify the beneficiaries of the amounts to be included on their individual income tax returns.

For trusts or estates, income would also include gains derived from dealings in property to the extent of any amount realized in excess of its adjusted basis in property from the sale or disposition on an asset.[4] When the disposition of property is performed to pay off a creditor or beneficiary, it will be taxable to the estate or trust because the fiduciary will have used the property as a means of satisfying an obligation of the trust or estate.[5]

Finally, an estate or trust will have gross income if it collects or disposes of an item of income in respect of a decedent ("IRD").[6] An item of IRD is any item with respect to a decedent which was not properly included in the decedent's final tax return.[7] For a cash basis taxpayer, this could be any item of income he or she was entitled to, but did not actually receive during his or her lifetime. For an accrual basis taxpayer this any income he or she accrued but did not actually receive the rights to receive the income during his or her lifetime.

DISTRIBUTABLE NET INCOME: APPORTIONING INCOME BETWEEN THE TRUSTS AND ITS BENEFICIARIES

A trust or estate generally earns income on the property (i.e., the trust corpus) held by the trust or estate. This income usually takes the form of interest, dividends, rent and similar types of

[2] IRC §§641(a)(1) , (3) and (4).
[3] IRC §§641(a)(2) , (4) and (1).
[4] IRC §61(a)(3); IRC §§ 1001 and 1014.
[5] Rev. Rul. 74-178.
[6] IRC §§ 691(a)(1) and (2).
[7] *Id*.

income. The trust or estate must include these amounts in gross income for tax purposes. However, when the trust or estate distributes (or is required to distribute) the income to a beneficiary, it generally deducts that amount and the beneficiary includes that amount in its gross income. A distribution deduction is utilized to prevent the double taxation of the income of the trust or estate. It offsets the amount that was included in the trust or estate's gross income. As a result, the various beneficiaries pay income tax on the amounts of income distrubted to them and the trust pays income tax on any annual income that remains undistributed.

Distributable net income (DNI) is one of the key elements in calculating taxable income and allows the fiduciary to determine how much income is subject to tax and how much is taxed to the beneficiaries. DNI helps to characterize the income distributed to beneficiaries for the distribution deduction, as well as measuring the amount of income that is distributed to the beneficiaries creating an amount of deductible income for the estate or trust.

The DNI of a trust or estate is equal to the taxable net income of the trust or estate with the removal of the following items:

(1) the income distribution deduction itself;

(2) the personal exemption;

(3) most capital gains and losses (special rules apply).

DNI is calculated much like when computing an individual's taxable income except that capital gains and losses, the personal exemption and the distribution deduction are not used. The reason the distribution deduction is not included in the calculation of DNI is because the distribution to beneficiaries is a function of DNI. Additionally, the personal exemption is not used because it not a component of DNI since it is used to offset income not allocated to the beneficiaries through DNI. Finally, capital gains and losses are generally allocated to the principal and thus not typically included in the DNI calculation.

CAPITAL GAINS (SPECIAL RULES)

Generally, trusts and estates are subject to the same rules as individuals for recognizing and reporting capital gains on the sale of property. However, there are several unique aspects to reporting capital gains and losses of trusts and estates, including the determination of whether the fiduciary or the beneficiary reports any capital gains or losses, whether capital gains are included in the beneficiary's distributable net income, whether distributions of property are in satisfaction of specific bequests, and the effect that these determinations have on the basis of property acquired by a trust or estate and distributed to beneficiaries.

Who Reports Capital Gains and Losses

The proper reporting of capital gains and losses depends on whether they belong to the estate or trust or whether they belong to the beneficiary. Correct reporting turns on whether a particular item of capital income or loss is properly chargeable against principal (i.e., corpus) or against income. As a general rule, the proceeds from the sale of property that are a part of trust corpus, including any profit thereon, remain corpus under the Uniform Principal and Income Act.

Effect of DNI on Reporting Capital Gains and Losses

Generally, capital gains are excluded from DNI and, thus, are taxed to the estate or trust. If the governing instrument allocates capital gains to income they are included in DNI and are taxed to the beneficiary.

Capital gains are excluded from DNI to the extent that such gains are allocated to corpus and are not:

(1) paid, credited, or required to be distributed to any beneficiary during the tax year, or

(2) paid, permanently set aside, or to be used for charitable purposes (Code Sec. 643(a)(3)).

Recognizing Capital Gains on Property Distributions

When an estate or trust distributes appreciated capital assets to a beneficiary, no gain or loss is generally recognized and the beneficiaries receive a carryover basis in the property. However, capital gain on a distribution of property in kind is recognized by a trust or estate if:

(1) the distribution satisfies the beneficiary's right to receive a distribution of a specific dollar amount or a specific asset other than the asset distributed;

(2) the distribution of property is in lieu of income; or

(3) the executor (or trustee) elects to recognize gain or loss

Basis of Property Acquired from an Estate

Generally property acquired from a decedent, the basis of that property in the hands of the person acquiring it, or to whom the property passed, is "stepped-up" (or "stepped-down") to:

(1) the property's fair market value at the decedent's date of death;

(2) the property's fair market value six months after the decedent's date of death, if the executor elects alternate valuation

DISTRIBUTION DEDUCTION

The distribution deduction is unique to trusts and estates and it is not available to individuals. Trusts and estates receive this deduction because of the distributions from their distributable net income ("DNI") to their beneficiaries. Distributions occur either by requirements of the fiduciary, amounts that were paid, or amounts that were credited to the beneficiaries. A trust or estate is not allowed a deduction for the distribution of principal to beneficiaries. A deduction against a trust or estate's taxable income is only allowed for the distribution of trust or estate income to beneficiaries.

Generally, an income distribution deduction is allowed if a trust or estate is required to distribute income to beneficiaries. In order to determine this deduction, it is necessary to calculate the DNI, as well as the fiduciary accounting income ("FAI") and the distributions that are required to be made to the beneficiaries. Typically, this distribution is equal to the lesser of the total amount of income distributions (required to be) made to the beneficiaries or the DNI of the trust or estate.[8]

Computing DNI Limitation

The amount of the income distribution deduction is subject to a DNI limitation. The amount of the DNI limitation is equal to the DNI of the trust or estate less certain tax-exempt interest of the trust or estate.

MISCELLANEOUS ITEMIZED DEDUCTIONS

Trusts and estates are generally allowed to take miscellaneous itemized deductions in the same manner as individual taxpayers. Trusts and estates are also generally subject to the same 2 percent of AGI limitation that applies to the miscellaneous itemized deductions of individual taxpayers. However, there are certain miscellaneous itemized deductions of trusts and estates that are not subject to that limitation.

Miscellaneous itemized deductions are itemized deductions other than interest, taxes, medical expenses, casualty or theft losses, charitable contributions, and certain other specified items. Miscellaneous itemized deductions include ordinary and necessary expenses paid or incurred during the tax year:

(1) for the production and collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; and

(3) in connection with the determination, collection, or refund of any tax (Code Sec. 212).

Examples of miscellaneous itemized deductions include investment advisory fees, certain legal and accounting fees, clerical help, office rent, subscriptions to investment publications, safe deposit box rental fees, and similar expenses paid or incurred in connection with investments. For trusts and estates, miscellaneous itemized deductions also include expenses paid or incurred by the fiduciary on account of administration expenses, including fiduciary fees and expenses of litigation.

Exception to 2% Limitation for Trusts and Estates

The 2 percent of AGI limitation on miscellaneous itemized deductions does not apply to the following types of miscellaneous itemized deduction of trusts and estates:

(1) the deduction of the personal exemption;

(2) the income distributions deduction; and

[8] IRC §§651 and 652

(3) any deductions for costs that are paid or incurred in connection with the administration of the trust or estate and that would not have been incurred if the property were not held in the trust or estate.

The most common types of administration expenses paid or incurred by trusts and estates are fiduciary fees, legal fees, accounting fees, tax return preparation fees, and investment advisory fees. If such administration expenses would not have been incurred if the property were not held in the trust or estate, they are fully deductible by the trust or estate and not subject to the 2 percent of AGI limitation.

Investment Advisory Fees

Investment advisory fees are subjects to the 2% floor and therefore are only deductible to the extent they exceed 2% of AGI. This is because the investment advisory fees would be the same type of fee that an individual with the same investment objectives would incur.[9] These investment advisory fees include any fees or services that would also be provided to any individual investor.[10]

Deductions in Respect of a Decedent (DRD)

Expenses otherwise deductible do not cease to be deductible because of a person's death. Thus, deductions in respect of a decedent (DRD) must be identified when preparing a Form 1041. Deductions relating to interest, taxes, depletion, and expenses relating to business property or property used for the production of income may be items of DRD, as well as the foreign tax credit. There is no definition of DRD and thus it is not always clear when a deduction within one of these deduction categories is an item of DRD (Code Sec. 691(b)). In order for an item to be DRD, the decedent, or a prior decedent, must have been liable for such expenses.

Examples of deductions attributable to a decedent include unreimbursed employee expenses, hobby losses and expenses attributable to the decedent's business. These types of deductions would likely qualify under section 691(b). Finally, if the estate paid an expense relating to an income-producing activity of the decedent, it would receive the same or similar treatment – as an itemized deduction for the estate.

OTHER DEDUCTIONS

Typically, an estate or trust is allowed to take the same deductions as an individual but with certain exceptions, additions and modifications. In order to determine which deductions are allowed to an estate or trust, it is necessary to examine the statutory provisions granting, limiting and modifying the deductions. Code section 642 includes many of these provisions special to estate and trusts. Other allowable deductions are located throughout the code.

Most of the deductions allowed to trusts and estates typically arise out of investment or business contexts, while other deductions arise out of income-producing property. Deductions

[9] *Knight v. Commissioner*, 128 S. Ct. 782 (2008).
[10] Prop. Regs. §1.6704(b)(4).

allowed to an estate or trust include expenses and losses for its activities if the activity is engaged in for profit or if the Code allows it regardless of whether the activity is for profit;[11] deductions for ordinary or necessary business expenses;[12] for expenses for the production of income;[13] interest;[14] taxes;[15] losses;[16] bad debts;[17] depreciation;[18] charitable contributions;[19] and net operating losses.[20]

Deductions for Trade or Business

If a trust or estate is involved or engaging in a trade or business, it may be entitled to various deductions relating to the trade or business, including ordinary and necessary expenses to carry on the trade or business.[21] Like individuals, trusts or estates may take a deduction for ordinary or necessary expenses paid or incurred in carrying on the trade or business, which includes salaries or other compensation for personal services, travelling expenses while away and other expense related to the property for the trade or business.[22] Other business deductions allowed under the Code include interest from indebtedness allocable to the trade or business, taxes necessary to carrying on the trade or business (e.g., state property tax), unreimbursed business losses, reasonable depreciation for property, and depletion of resources used in the trade or business.[23]

Deductions for Income-Producing Activities--Investments

Various deductions are allowed if an estate or trust holds property for income-producing purposes. These included deductions for the following expenses: (i) ordinary and necessary expenses paid or incurred for the production of income or for the management or maintenance of property held for the production of income;[24] (ii) interest related to the indebtedness allocable to property held for investment (with some restrictions);[25] (iii) taxes paid of incurred in relation to income producing activity or property held for production of income;[26] (iv) losses resulting from income-producing activities, not connected with a trade or business (with limitations on capital losses);[27] (v) depreciation when the property is held for income production;[28] and (vi) a

[11] IRC § 183.
[12] IRC § 162.
[13] IRC § 212.
[14] IRC § 163.
[15] IRC § 164.
[16] IRC § 165.
[17] IRC § 166.
[18] IRC § 167. See also IRC §§ 168,611 and 642(e).
[19] IRC § 642(c).
[20] IRC §§ 172 and 642(d).
[21] IRC §162(a).
[22] IRC §§ 162(a)(1)-(3).
[23] IRC §§ 163(a), 163(d)(5)(A), 469, 164, 165(c)(1), 167(a)(1), 167(d), 168, 642(e), 611(a), 611(b)(3)-(4), and 642(a).
[24] IRC §§ 212(1)-(3).
[25] IRC §§ 163(d) and 469.
[26] IRC §164.
[27] IRC §§165(c)(2), 166, and 1211(b).
[28] IRC §§167(a)(2), (d), 168, and 642(e).

reasonable allowance for depletion with regards to mines, oil and gas wells, other natural deposits, and timber.[29]

General Other Deductions

There are certain other deductions that are allowed and not dependent upon the trust or estate engaging in the activity for business or income-production purposes. These include expenses for tax advice or representation;[30] personal casualty or theft losses (subject to a deductible and AGI limitation);[31] taxes relating to real or personal property, state income taxes or GST;[32] amounts paid for charitable contributions;[33] and the personal exemption ($600 for an estate and $300 or $100 depending upon the type of trust—other than qualified disability trusts).[34]

Net Operating Losses

Trusts and estates generally can claim a net operating loss deduction under the same rules that apply to individuals. However, there are a few special rules that apply to trusts and estates. A trust or estate treats an NOL deduction as a miscellaneous itemized deduction not subject to the 2 percent floor.

While operating or engaging in a trade or business, a trust or estate may have net operating losses (NOL), and the trust or estate may be able to deduct those losses by following the guidelines established in Code section 642(d). The NOL deduction is available to trusts and estates with two exceptions: (i) the trust or estate should not take the charitable contribution deduction, and (ii) the trust or estate should exclude portions of income attributable to the grantor when calculating gross income.[35]

If the NOL is carried back to prior years of an estate or trust, is will reduce the DNI for that year and may potentially reduce income a beneficiary was required to report. This would result in the need to recalculate the beneficiary's tax liability for that year, as well as the DNI of the estate after the deduction.

Administration and Tax Advice Costs for Income Producing Activities

Reasonable amounts paid or incurred, which are ordinary and necessary, for the administration of an estate or trust are deductible under §212.[36] Section 212 allows for the deduction of expenses for the management and conservation or property held for the production of income, as well as for any ordinary or necessary expense the trust or estate pays in connection

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[29] IRC §§611(a), (b)(3)-(4), and 642(e).
[30] IRC §212(3).
[31] IRC §165(h).
[32] IRC §164.
[33] IRC §642(c); Treas. Regs. §1.642(c)-2.
[34] IRC §642(b).
[35] Treas, Reg. §§1.642(d)-1(a)-(b)
[36] Treas. Reg. §1.212-1(i).

with the determination, collection, or refund of any tax.[37] The deductions for the administration costs of an estate or trust are the most common deductions allowable.

It is important to understand that these expenses are deductible under §212 as administrative expenses rather than necessary and ordinary business expenses which would be deductible under §162. This is crucial for the proper tax planning of a trust and any after-death planning of an estate. However, if the expenses exceed the income for the year, the beneficiary will not be allowed to deduct them unless they fall under §642(h), which creates a deduction when the expenses are incurred in the final year of the estate or trust.

Depreciation and Depletion Deductions

A deduction is allowable for an estate or trust for the exhaustion, wear, tear and obsolescence of certain property so long as it is reasonable.[38] Further, if the asset is a mine, oil and gas well, other natural deposits, or timber, a deduction will be allowed equal to a reasonable allowance for depletion. The amounts are calculated in a manner similar to that of an individual.

The deduction for depreciation or depletion are only allowed to the extent not allowable to the beneficiaries (under §§167(d) and 611(b).[39] The deduction will be apportioned between the beneficiaries entitled to the income and the fiduciary.[40] The apportionment will be based upon the share allocable to each beneficiary of the estate,[41] or according to the provisions of the trust instrument.[42]

Deductions for Theft of Casualty Losses

Subject to certain limitations, an estate or trust may deduct losses incurred from casualty or from theft which were not compensated for by insurance.[43] If these losses are not incurred either as a result of a trade or business transaction, or from a transaction entered into for profit, they will be considered personal casualty losses.

If the loss is considered personal, there are two limitations. First, the first $100 is not deductible (from each casualty or theft). Second, the excess from casualty gains is deductible only to the extent it exceeds 10% of AGI of the estate or trust.[44]

However, if the loss is incurred as a result of a transaction between related parties, the loss will be disallowed under §267. For purposes of trust and estates, §267 defines related parties to include: (i) a grantor and fiduciary of any trust; (ii) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (iii) a fiduciary of a trust and a beneficiary of such trust; (iv) a fiduciary of a trust and a beneficiary of another trust, if the same

[37] IRC §§ 212(2)-(3).
[38] IRC §§ 167 and 168.
[39] IRC § 642(e).
[40] IRC §642(f).
[41] IRC §§ 167(d) and 611(b)(4).
[42] IRC §§ 167(d) and 611(b)(3).
[43] IRC § 165(c).
[44] IRC §165.

person is a grantor of both trusts; (v) a fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; and (vi) except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.[45]

Losses from Disposition of Capital Assets

Generously, §1211(b) allows for a deduction for losses from the sale or exchange of a capital asset up to the amount of the trust or estates capital gains plus $3000 in excess of those gains. These losses may be carried forward if they are not allowed to be deductible in the tax year they are incurred.[46] However, similarly to casualty losses, §267 disallows these capital losses if they occur between related parties.

Bad Debts

Section 166 may allow for the deduction of bad debts. If the debt is acquired in connection to a trade or business, the trust or estate will be allowed to take the deduction when it becomes wholly or partially worthless.[47] If the bad debt was not incurred by a trade or business and is not considered a business debt, it will be considered a nonbusiness bad debt and treated as a capital loss.[48] Section 166 will tread the nonbusiness bad debt as if it were the sale or exchange of a short-term capital asset creating short-term capital loss.[49]

Interest Paid or Accrued

An estate or trust may have the ability to deduct the interest expense it pays or accrues on indebtedness, subject to the limitations relating to personal and investment interest. Similarly to individuals, §163(h) – which disallows a deduction for personal interest – also applies to estates and trusts. Personal interest means any interest allowable as a deduction, other than interest paid on indebtness allocable to a trade or business, investment interest, §469 interest, qualified residence interest, or any interest payable under §6601, and any interest allowable as a deduction under §221.[50]

State Local and Foreign Taxes

State and local tax on real or personal property, or state income tax that is paid by the trust or estate may be deductible.[51] If a trust or estate is carrying on a trade or business and incurs any state, local or foreign taxes, it may be able to deduct those taxes.[52]

Deduction for Charitable Contributions

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[45] IRC §§ 267(b)(4)-(9).
[46] IRC §1212(b).
[47] IRC §§166(a) and (d)(2)(A).
[48] IRC § 166(d)(1).
[49] *Id*.
[50] IRC §§ 163(h)(2)(A)-(F).
[51] IRC §169.
[52] IRC §§164(a)(1)-(3).

Much like the §170 charitable contribution deduction allowed for individuals, §642(c) allows a trust or estate to take a charitable contribution deduction. This deduction is available for "any amount of gross income without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c)."[53] The amount must be paid by the estate or trust to a charitable organization,[54] or permanently set aside for the exclusive use of charitable purposes.[55]

The amount of the charitable deduction is computed as follows:

(1) Amounts paid out of or permanently set aside from gross income for a charitable purpose under the terms of the governing instrument;

(2) Minus: Any tax-exempt income allocable to the charitable contributions;

(3) Plus: Any capital gains allocated to corpus and paid or permanently set aside for charitable purposes;

The charitable deduction for amounts paid or permanently set aside from gross income for a charitable purpose must be reduced by the portion, if any, that is allocable to tax-exempt income. Capital gains that are paid or permanently set aside for charitable purposes qualify for the charitable deduction whether allocable to income or corpus for fiduciary income accounting purposes.

Deductions for Estate Taxes Paid

A trust or estate may be able to take a deduction for estate taxes attributable to the collection of an item of IRD.[56] However, the deduction is calculated based on the portion of income that was not distributed to the beneficiaries.[57] The portion that is paid or distributed to the beneficiaries is based on the allocation of DNI to the beneficiaries under §§652 and 662.

Income in respect of a decedent (IRD) items are subject to both estate taxes (or generation-skipping transfer taxes) and income taxes. To reduce, but not eliminate, the effect of double taxation, the recipient of IRD is entitled to an income tax deduction for estate taxes (and generation skipping taxes, if any) attributable to an item of IRD under Code Sec. 691(c)(1). Accordingly decedent's beneficiaries are entitled to a miscellaneous itemized deduction for an amount that approximates the estate tax paid on the income. The miscellaneous itemized deduction for estate taxes paid on items of IRD is not subject to the 2 percent floor. However, like other itemized deductions, it may be subject to reduction for taxpayers with adjusted gross income exceeding a threshold amount.

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53 IRC §642(c)(1).
54 *Id*.
55 IRC §642(c)(2).
56 IRC §691(c).
57 IRC §691(c)(1)(B); Treas. Reg. §1.691(c)-2(a)(2).

The deduction is computed based on the following procedure:

(1) Determine the net value of all items of IRD and DRD for the decedent's estate.

(2) Determine the federal estate tax that would have been imposed on the decedent's estate had the gross estate been reduced by the net value of all items of IRD and DRD.

(3) Reduce the actual estate tax liability of the decedent's estate by the hypothetical liability determined under Step (2). This is the most that can be deducted.

(4) Multiply the result in Step (3) by a fraction: the numerator of which is the *lesser* of (a) the estate tax value of the items of IRD included in the recipient's income, or (b) the amount included in the recipient's income; the denominator of which is the total value of all items included in the estate that represent IRD (Reg. §1.691(c)-1(a)).

The Personal Exemption

Estates and trusts (other than qualified disability trusts) are not granted the benefit of the personal exemption. However, the IRS has allowed for estates and trusts to take certain deductions. Estates are allowed a deduction of $600. A trust required to distribute all of its income is allowed a $300 deduction while trusts other than qualified disability trusts are allowed a $100 deduction. [58] Although this is an allowable deduction for trusts and estates, it is typically referred to as an exemption.

ELECTIONS:

SECTION 645(a) ELECTION

Treating a Qualified Revocable Trust as Part of the Estate

A Decedent with an estate plan usually leaves property in a lifetime revocable trust that becomes irrevocable at death. Normally such a trust’s income tax return is filed on a calendar-year basis but a fiscal year is possible if certain conditions are met. A Decedent’s trust and estate are related in that the trust may distribute property to the estate, or vice versa. The estate and trust fiduciaries may also be the same person or institution, such as a bank. Ordinarilty the estate and the trust will be required to file separate Form 1041s, even though the entities are closely related.

A qualified revocable trust (QRT) can make a 645(a) election to be treated as part of a decedent's estate for income tax purposes. A QRT is any trust (or portion thereof) that on the date of the decedent's death was treated as owned by the decedent under Code Sec. 676 by reason of a power held by the decedent. (discussed ealier) To make a 645(a) election, the executor of the estate and the trustee of the trust must both consent if not the same person. This election may be made soley by the Trustee of the QRT if an executor is not appointed for the decedent's related estate.

Advantages and disadvantages of the QRT election

[58] IRC §642(b).

Making an election to treat a QRT as part of the decedent's estate allows the trust does not have to pay estimated taxes for the first two years after the decedent's death. Because the election results in a combining of the incomes of the estate and trust, the combined income may be taxed at a higher marginal tax rate than if left with the separate entities if the combined income is not required to be currently distributed.

Duration of the Section 645 Election

As mentioned above, the election needs to be made with both the trustee and the executor of the decedent's estate. The election is made on a Form 8855 and must be signed by both the executor and the trustee. If there is more than one executor or more than trustee, only one must sign the Form.[59] The election must be filed no later than the time for filing a Form 1041 is prescribed under §6072 for the first taxable year of the related estate. However, if the estate is granted an election for the filing of the 1041, the Form 8855 will still be timely if it is filed within time allowed for the 1041, including the extension period.[60] If, under Treasury Regulation §1.671-4(b)(2)(i)(A) or (B), the trust was not required to file a return because the grantor was allowed to report the income on his or her individual return the Form 8855 is not required. Finally, the election is considered made on the day the 1041 is received, and the election is effective until the trust and related estate distributes all the property or the day before the applicable date, whichever comes first.[61]

If an estate tax return is "not required to be filed as a result of decedent's death, the applicable date is…two years after the date of the decedent's death."[62] If the estate tax return is required to be filed as a result of decedent's death, the applicable date is "the later of the day that is 2 years after the date of the decedent's death, or the day that is 6 months after the date of final determination of liability for estate tax."[63]

ADMINISTRATIVE EXPENSES

An estate or trust is entitled to a deduction for the expenses incurred in the administration of an estate or trust so long as they are ordinary and necessary.[64] "Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary or necessary in connection with the performance of the duties of administration, are deductible under §212."[65] Additionally, most administration expenses of an estate or trust will qualify under §212 since the property held by a trust or estate is typically held for the production of income. However, regardless of whether an estate has assets that are not held for the production of income, the administration expenses are still deductible under §212.

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[59] *See* Form 8855: How to Treat a Qualified Revocable Trust as Part of an Estate, Instructions.
[60] Treas. Reg. §1.645-1(c)(1)(i).
[61] Treas. Reg. §1.645-1(f)(1).
[62] Treas. Reg. §1.645-1(f)(2)(i).
[63] Treas. Reg. §1.645-1(f)(2)(ii).
[64] IRC §212. *See also Trust of Bingham v. Comr.*, 325 U.S. 365, 375 (1945).
[65] Treas. Reg. §1.212-1(i)

Administration expenses typically include expenses for personal representatives' fees, trustees' fees, attorneys' fees, accountants' fees, custodial fees, investment advisors' fees, and similar expenses. The deduction for these administration fees is the most common deduction allowable for trusts or estates.

65-DAY ELECTION

The 65-day election allows a trust or estate to treat the distributions made to beneficiaries during the first 65 days of the taxable year as having been made on the last day of the preceding tax year.[66] The election can be made on the back of the 1041, or if no return is required to be filed, a statement making the election must be filed with the IRS at the office the return would have been filed.[67] A trustee can designate particular distributions made during the first 65 days rather than make the election for all the distributions that occur within the first 65 days.[68] The amount of the distributions which may be elected under the 65 day rule cannot exceed the greater of the accounting income or the DNI, reduced by payments made during the prior year.[69]

FILING THE ESTATE TAX RETURN

When the decedent's gross estate exceeds the effective exemption amount for estate and gift taxes for the year of death, the estate must file an estate tax return. The administrator or trustee of the estate or trust must file the return, or if there is no administrator, the person who is in possession of decedent's property must file the return. If both the decedent's spouse and the executor file the return, only the return filed by the executor will be valid.[70] If the executor fails to file a return, the IRS may prepare a return based on information it can obtain.[71]

Filing Thresholds and Requirements

Generally, for decedent's dying after 2011, the basic exclusion amount is $5 million, which is adjusted for inflation for 2012.[72] This adjustment for inflation creates the threshold for a decedent's estate in 2012 as $5,120,000, and $5,250,000 for 2013.[73]

For decedents who made lifetime gifts, the threshold for filing estate tax returns is reduced by the adjusted taxable gifts made by the decedent which are not included in his or her gross estate.

Determining the Size of the Estate

The value of the gross estate is determined at the date of death even if the estate elects to use an alternate valuation date. The size of the estate is the only factor that determines if the

[66] IRC §663(b)
[67] Treas. Reg. §1.663(b)-2(a)(2).
[68] Treas. Reg. §1.663(b)-1(a).
[69] Treas. Reg. §1.663(b)-1(a)(2).
[70] *Est. of M.M Fairbanks v. Commr.*, 128 F.2d 537 (1942).
[71] IRC §6020.
[72] IRC §2010(c).
[73] IRC §6018(a); Rev. Proc. 2012-41, and Rev. Proc. 2013-15.

estate tax return must be filed. It is possible to undervalue property or inadvertently excluded it from the gross estate, therefore if the size of the estate is close to the filing requirement, it might be beneficial to file the return anyway.

Time for Filing of the Return

The return is due within nine months after the decedent's death.[74] This typically falls on the same numerical day (nine months later) that corresponds with the decedent's death. If the ninth month does not have a corresponding numerical day, the return should be filed on the last day of the ninth month.[75] Extensions for the estate tax return can be made in several circumstances: (i) the IRS can grant extension at its discretion based upon a showing of good cause;[76] (ii) the executor may obtain an automatic 6-month extension of the filing deadline by filing a Form 4768;[77] (iii) deadlines may be extended for persons serving in the armed forces;[78] (iv) extensions may be granted for military and non-military personnel serving in presidentially designated combat zones;[79] and (v) deadlines may be extended for taxpayers affected by a presidentially declared disaster or terror/military action. [80]

The return is generally treated as filed when the IRS receives it. However, it if is not received by the date it is due, the date it is postmarked will be considered the date of delivery and filing.[81] For this rule to apply, the postmark date must fall within nine months of the decedent's death, and the return must be deposited in the envelope with prepaid postage, properly addressed. Registered mail provides the best evidence that the return was filed and delivered to the IRS.[82]

Timing of Estate Tax Payments

The estate tax is due and payable at the time fixed for the filing of the estate tax return. This date is the same numbered day as the ninth month as the date of the month the decedent died. A one-year extension is available upon a showing of good cause, and long extensions are available for reasonable cause for gross estates that include a reversionary or remainder interest in property. The extensions granted for payment are separate and distinct from the extensions for the date of filing the return. Generally, the executor or administrator of an estate is liable for payment of the tax.

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[74] IRC §6075(a).
[75] Treas. Reg. §20.6075-1. An example of this rule: if the date of death is November 2, the return would be due on July 2. If the date of death is July 31, the return would be due on April 30.
[76] IRS letter Ruling 8526997, March 14, 1985.
[77] Treas. Reg. §20.6081-1(b).
[78] IRC §§7508A and 7508; Rev. Proc. 2004-26.
[79] *Id*.
[80] IRC §7508A.
[81] IRC §7502(a)(1).
[82] IRC §7502(c).