

# The Ultimate Guide to Probate

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# **The Ultimate Guide to Probate**

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**The Ultimate Guide to Probate**  
**VI. Tax Deadlines and Preparing, Coordinating and Filing Returns**  
*Charles J. Andres, Presenter*

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## VI. Tax Deadlines and Preparing, Coordinating and Filing Returns

*Charles J. Andres and Stephen M. Johnson*<sup>1</sup>

### Introduction

As we continue exploring probate law, we arrive at taxes. Before we delve into tax deadline and return details, we need to survey the tax canvas landscape to understand how the parts fit together. While probate law is the exclusive province of the states, tax law adds federal and sometimes state or local threads to the probate tapestry.<sup>2</sup> Kansas and Missouri do not have state estate, gift, or generation skipping transfer (GST) taxes, but some states and/or localities do, so an attorney should be alert to those lurking issues when working with an out of state client or a client with interests in various states or countries, and should retain local counsel for other jurisdictions.<sup>3</sup> Kansas and Missouri have fiduciary income taxes.<sup>4</sup>

A decedent's estate must file her tax returns on her behalf. These could include (1) her final Form 1040 individual income tax return, (2) her estate's initial Form 1041 fiduciary income tax return, (3) her estate's Form 706 estate tax return, (4) her estate's Form 709 gift tax return, and/or (5) her estate's Form 709 GST return.<sup>5</sup> Let's explore the landscape contours of these various federal taxes in turn.

#### *Fiduciary: To Appoint or Not to Appoint*

A fiduciary acts for someone else's benefit.<sup>6</sup> Fiduciary relationships include a personal representative, executor, administrator, guardian, conservator, or a trustee.<sup>7</sup> When a fiduciary or personal representative is appointed to represent an estate in the decedent's place, the individual or corporate fiduciary will owe duties to the estate: duties of loyalty, of care, of serving the estate's best interest, and so on.<sup>8</sup> As future Supreme Court Justice Benjamin Cardozo memorably wrote, a fiduciary duty is very high indeed: "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is ... the standard of behavior... the level of conduct for fiduciaries [is] .... kept at a level higher than that trodden by the crowd."<sup>9</sup> A Kansas fiduciary has various duties: (1) the duty to administer the estate in good faith, (2)

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<sup>1</sup> Copyright, 2015, Charles J. Andres and Stephen M. Johnson. Andres and Johnson are members of the Kansas, Missouri, Kansas City, and Johnson County bars, and the Kansas City Estate Planning Society, and welcome correspondence at [charlesjandres@cs.com](mailto:charlesjandres@cs.com) and [steve@johnsonlawkc.com](mailto:steve@johnsonlawkc.com).

<sup>2</sup> K.S.A. §59-101 et seq.; V.A.M.S. §473.010 et seq.

<sup>3</sup> Charles J. Andres and D. Michael Dwyer, eds., *Probate and Trust Administration After Death* (7<sup>th</sup> ed. 2008) ("Kansas Probate Handbook"), §§5.2-5.4. K.S.A. §79-15,253; V.A.M.S. §§145.011 – 145.955.

<sup>4</sup> K.S.A. §79-3220(c) et seq. (Kansas Income Tax Act); V.A.M.S. §143.311.

<sup>5</sup> Sample Forms 706,709, 1040, and 1041 and select schedules are in the appendix. Estate and trust income taxes are reported on Form 1041, but we focus on estate income taxes for simplicity.

<sup>6</sup> Bryan A. Garner, *Black's Law Dictionary* (8<sup>th</sup> ed., 2004), 658.

<sup>7</sup> K.S.A. §§59-102(2) (personal representative), 59-102(3) (fiduciary), 59-701 (executor), 59-705 (administrator), 59-3051(d) (conservator), 59-3051(e) (guardian), 58a-103(19) (trustee). Giving bond is a token pledge of the fiduciary's call to duty. K.S.A. §§58a-702 (trustee's bond); 59-1101 ("Every fiduciary ... before entering upon the duties of his ... trust shall execute and file a bond").

<sup>8</sup> *Black's Law Dictionary*, 545.

<sup>9</sup> *Meinhard v. Salmon*, 249 N.Y. 458, 464 (N.Y. 1928) (Cardozo, J.)

the duty of loyalty “solely” to the beneficiaries’ interests, (3) the duty of impartiality, (4) the duty of prudent administration, and (5) the duty to inform and report.<sup>10</sup>

When a fiduciary has been appointed, the best practice is to file a Form 56 with the IRS, alerting the Service of the fiduciary’s existence and role.<sup>11</sup> Once a fiduciary has been appointed and finished its duties, the fiduciary may be relieved of further liability by filing a written notice and evidence of the fiduciary role termination with the IRS.<sup>12</sup>

But appointing a fiduciary may not always be in the estate’s or the proposed fiduciary’s best interest.<sup>13</sup> A fiduciary takes on personal liability in her official role in the estate, so if a tax deadline is missed or a tax lien is imposed, the IRS can sue her and pursue her individually for the taxes, not just her in her fiduciary capacity for the estate.<sup>14</sup> If appointing a fiduciary is deemed unwise or infeasible for an estate, probate law allows an estate to be settled without appointing a fiduciary, including by a determination of descent in Kansas or determination of heirship in Missouri.<sup>15</sup>

### *Fiduciary Tax Filings*

Regardless of whether a fiduciary is appointed, a Form 1041 fiduciary income tax return reflects estate income and may need to be filed with the IRS.<sup>16</sup> The Form 1041 is required if the estate had: (1) gross income of at least \$600 for the tax year or (2) a nonresident alien beneficiary.<sup>17</sup> Schedule K-1 (of Form 1041) is used to report an estate beneficiary’s share of income, deductions, credits, or other items.<sup>18</sup> If the Form 1041 is prepared, each beneficiary’s share would be reflected on their respective Schedule K-1 (of Form 1041), which flows into their Form 1040 income tax returns, regardless of the form of the beneficiary’s share (real property, personal property, intangible or intellectual property, stock, cash, etc). So Form 1041 and the Schedule K-1 exhibit a tax symmetry: the Form 1041 reports the estate’s macro income tax picture, while the Schedule K-1 tells each beneficiary (1) who received a distribution or (2) to whom an allocation was made during the tax year what she needs to report on her income tax return.<sup>19</sup>

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<sup>10</sup> K.S.A. §§58a-801 (administer), 58a-802 (loyalty), 58a-803 (impartiality), 58a-804 (prudent administration), 58a-813 (“reasonably inform” and report to trust beneficiaries). The 58a-801 administration duty is read through 58a-804’s prudent administration lens. Prudent administration requires the trustee to “exercise reasonable care, skill, and caution.” K.S.A. §58a-804. The duty to administer includes taking “reasonable steps to take control of and protect the trust property” and collect trust property from a prior trustee. K.S.A. §§58a-809, 58a-812. The trustee also takes “reasonable steps” to (1) “enforce” the trust’s claims and (2) “defend” the trust against claims. K.S.A. §58a-811.

<sup>11</sup> Code §6903; Treas. Reg. §301.6903-1(b); Jonathan G. Blattmachr and F. Ladson Boyle, *Blattmachr on Income Taxation of Estates & Trusts* (PLI, 16<sup>th</sup> ed. 2014), §2:2. The authors commend Edward Jones’ complementary 2 volume set *2015 U.S. Master Tax Guide* and *2015 U.S. Master Estate & Gift Tax Guide* to the practitioner.

<sup>12</sup> Treas. Reg. §301.6903-1.

<sup>13</sup> Andres, *Kansas Probate Handbook*, §§5.1.2(b), 5.1.6(b)(2), 5.2.11(a), 5.5.2.

<sup>14</sup> Andres, *Kansas Probate Handbook*, §5.1.6(a).

<sup>15</sup> K.S.A. 59-2250; V.A.M.S. 473.663.

<sup>16</sup> Frederick M. Sembler & Michael J. Feinfeld, *Planning an Estate* (4<sup>th</sup> ed., 2014-2015), §§15:3-15:4.

<sup>17</sup> Code §§641, 6012(a)(3), (5); Form 1041 instructions, pg. 4. Alan S. Acker, *Income Taxation of Trusts and Estates*, Bloomberg BNA (852-4<sup>th</sup>, 2014), A-75.

<sup>18</sup> Code §6034A(a); Form 1041 instructions, pp. 36-40.

<sup>19</sup> Code §6034A(a). A symmetry arises between returns for other entity level and individual level taxpayers.

## *Death and Taxes*<sup>20</sup>

When a person dies, all his or her assets (and liabilities) become his or her estate.<sup>21</sup> An estate customarily applies for its own entity identification number (EIN), since it is a separate taxpayer and legal entity from the deceased person.<sup>22</sup> When a person dies, the estate's fiduciary or personal representative will file two tax returns for the tax year: (1) a final Form 1040 for the decedent and (2) a Form 1041 for the decedent's estate.<sup>23</sup> Often both tax returns are short year returns, since they likely cover less than 12 months.<sup>24</sup> The final Form 1040 is filed where the fiduciary or personal representative lives.<sup>25</sup> A final Form 1041 may be filed jointly with the decedent's surviving spouse.<sup>26</sup>

The final Form 1040's due date is the same as if the decedent lived for the whole tax year.<sup>27</sup> For a decedent who filed her Form 1040 on a fiscal year, the final Form 1040 will be due on the 1<sup>st</sup> day of the 4<sup>th</sup> month after the close of her final tax year.<sup>28</sup> The final Form 1040 covers the decedent's income from January 1 through the decedent's date of death, while the Form 1041 captures income from the decedent's date of death through December 31. For future tax years, the estate will only need to file a Form 1041, and the Form 1041 will be marked as "final" for the tax year when the estate is fully distributed to the beneficiaries. Estate expenses will be reported on the applicable lines or schedules of Form 1041. Some excess expenses might carry over to next year for a final year deduction. Form 1041 captures the estate's taxable income and corresponding expenses or deductions.

## *Kansas Fiduciary Income Tax*

The trustee of a trust administered in Kansas must file a K-41 return for Kansas income.<sup>29</sup> The trustee of a trust administered outside of Kansas must file a return for Kansas source income.<sup>30</sup> Kansas follows the IRS' treatment of grantor trusts and trustees of nongrantor trusts can take a distribution deduction.<sup>31</sup> Nongrantor trusts have a Kansas income tax rate of 4.60%.<sup>32</sup>

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<sup>20</sup> "Things as certain as Death and Taxes, can be more firmly believ'd." Daniel Defoe, *The Political History of the Devil* (1726), 269.

<sup>21</sup> A person's death and the simultaneous birth of the estate triggers the probate law, K.S.A. §§59-101 et seq. (Kansas), or V.A.M.S. §§473.010 et seq. (Missouri).

<sup>22</sup> Treas. Regs. §§1.645-1(d)(1), 301.6109-1(a)(3). An estate or trust can obtain an EIN by filing a Form SS-4 or applying online, at [http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-\(EIN\)-Online](http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online).

<sup>23</sup> Code §§443(a)(2), 6012(b)(2). Form IRS Publication 559, pp. 3-15 (final Form 1040), 15-24 (Form 1041); Andres, *Kansas Probate Handbook*, §§5.5.3 (final Form 1040), 5.5.4 (Form 1041).

<sup>24</sup> Code §443; Treas. Reg. §1.443-1.

<sup>25</sup> Code §6091(b)(1)(A); Treas. Reg. §1.6091-2(a)(1).

<sup>26</sup> Code §§6013(a)(2); John R. Price and Samuel A. Donaldson, *Price on Contemporary Estate Planning* (2013), §§12.3.1 – 12.3.3.

<sup>27</sup> Code §6072(a); Treas. Reg. §1.6072-1(b).

<sup>28</sup> Treas. Reg. § 1.6072-1(b).

<sup>29</sup> See Richard W. Nenno, *State Income Taxation of Trusts* (Bloomberg BNA Tax Portfolio 869, 2013), A-58 – A-59. K.S.A. §§79-32, 109(d).

<sup>30</sup> K.S.A. §§79-3220(c); 79-32, 110(d); 79-32, 134; 79-32, 136; 79-32, 1375

<sup>31</sup> K.S.A. §§79-32, 116, 79-32, 117; 79-32, 134.

<sup>32</sup> K.S.A. §§79-32, 110(a)(2)(B)-(G). Andres, *Kansas Probate Handbook*, §5.2.12.

### *Missouri Fiduciary Income Tax*

The trustee of a trust administered in Missouri must file a Missouri MO-1041 return if a federal Form 1041 is due.<sup>33</sup> The trustee of a trust administered outside of Missouri must file a Missouri return for Missouri source taxable or gross income of \$600 or more.<sup>34</sup> Missouri follows the IRS' treatment of grantor trusts and trustees of nongrantor trusts can take a distribution deduction.<sup>35</sup> Nongrantor trusts have a Missouri income tax rate of up to 6% on Missouri source income over \$9,000.<sup>36</sup> Missouri trusts do not owe estate tax payments.<sup>37</sup>

### **Fiduciary Taxes, Estate, Gift, and GST Taxes**

The Form 1041 fiduciary income tax return is distinct from the Form 706 estate tax return and the Form 709 gift tax return. The Form 706 estate tax return only needs to be filed if (1) estate tax is owed or (2) the surviving spouse elects portability (retaining the deceased spouse's unused estate tax exemption for their own use later). And the Form 709 gift tax return only needs to be filed if the decedent made a gift to a family member or friend of more than annual exclusion amount or beyond the lifetime gift tax exemption.<sup>38</sup> And much of a client's generation skipping gifts, reported on Form 709, will also be exempt. Estate, gift, and generation skipping (GST) taxes are paid by the trust/donor, not the recipient.

### **Estate Tax**

Estate taxes are owed when a person dies with a gross estate that exceeds the estate tax's lifetime threshold.<sup>39</sup> For 2014, an estate's first \$5.34 million was exempt from estate tax; and for 2015, the first \$5.43 million is exempt.<sup>40</sup> The estate tax is 40% of the amount the gross estate is over the threshold. The estate tax is computed by subtracting certain deductions from the gross estate and reported on Form 706.<sup>41</sup>

Estate beneficiaries receive a stepped up basis in each asset.<sup>42</sup> A protective special use valuation election is available.<sup>43</sup> No payment extension is available.<sup>44</sup> Estate tax liens may be imposed if the full tax owed is not paid promptly.<sup>45</sup> The marital deduction and

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<sup>33</sup> See Nenno, *State Income Taxation of Trusts*, A-61 – A-62. V.A.M.S. §§143.481(3), (5).

<sup>34</sup> V.A.M.S. §§143.481(3), (5).

<sup>35</sup> V.A.M.S. §§143.011, 143.111, 143.121; 143.431.

<sup>36</sup> V.A.M.S. §§143.011, 143.061.

<sup>37</sup> MO-1041 instructions, pg. 1.

<sup>38</sup> Code §§2503(b) and 2505(a).

<sup>39</sup> Code §§2033-2044; Andres, *Kansas Probate Handbook*, §5.14; Price, *Price on Contemporary Estate Planning* §2.13; Sembler, *Planning an Estate*, §§2:3-2:35.

<sup>40</sup> Rev. Proc. 2013-35 (2014 level); Rev. Proc. 2014-61 (2015 level).

<sup>41</sup> Code §§2001(b) (gross estate), 2051 (taxable estate), 2053-2058 (estate tax deductions). Form 706 instructions; William M. McGovern, Jr and Sheldon F. Kurtz, *Wills, Trusts and Estates* (West, 2004), §15.3. Andres, *Kansas Probate Handbook*, §5.1.5(a).

<sup>42</sup> Code §1014; Price, *Price on Contemporary Estate Planning* §2.15.

<sup>43</sup> Andres, *Kansas Probate Handbook*, §5.1.4(c)(3).

<sup>44</sup> Code §§6151(a), 6311; Treas. Reg. §301.6311-2; Andres, *Kansas Probate Handbook*, §5.1.5(d).

<sup>45</sup> Code §§6321, 6323; Andres, *Kansas Probate Handbook*, §5.1.2.

charitable deduction are powerful tools to reduce estate tax owed.<sup>46</sup> The Form 706 estate tax return is due within 9 months after the decedent's date of death.<sup>47</sup> A sample cover letter and required documents checklist should be consulted.<sup>48</sup>

## **Gift Tax**

A gift occurs when one person transfers an asset to someone in exchange for less than fair market value.<sup>49</sup> Depending on the amount involved and the time frame of the gifts, gift tax could be owed. If gift tax is owed, it is up to a 40% federal gift tax on any gift over the annual exclusion amount (\$14,000 per recipient or \$28,000 per recipient from a married donor) or the lifetime exclusion amount (\$5.34 million in 2014 or \$5.43 million in 2015), along with filing a Form 709 to report the gift's taxable portion.<sup>50</sup> Gift tax is paid by the donor, not the recipient. A gift recipient receives the donor's carryover basis.<sup>51</sup> If the gift donor is married and the donor's spouse co-owns the property, the donor and spouse could elect to gift split and give twice the annual exclusion value, tax free to the recipient.<sup>52</sup> The gift splitting election is made by checking a box on Form 709 and filing Form 709, even where no gift tax is owed.<sup>53</sup>

## **Generation Skipping Transfer (GST) Tax**

The GST tax is complex, but is triggered by a transfer from generation one (a grandparent) to generation three (a grandchild), where generation two (the child - the grandchild's parent) is skipped.<sup>54</sup> GST taxes are reported on Form 709, but the GST "is the only transfer tax" often "assessed many years after the transfer."<sup>55</sup> For 2014, the first \$5.34 million of GST is exempt; and for 2015, the first \$5.43 million of GST is exempt.<sup>56</sup> The GST design is often used in wealthy families to transfer monies from one generation to another when the middle generation (children) is already wealthy and does not want the older generation's (grandparents) inheritance, so the inheritance skips to the younger generation (grandchildren). The child whose generation is skipped over is called a "skip person."<sup>57</sup> In a wealthy family, each spouse's GST exemption should be carefully allocated.<sup>58</sup> The GST tax is triggered by: (1) a taxable termination, (2) a taxable distribution, or (3) a direct skip.<sup>59</sup> A taxable termination happens when a trust interest

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<sup>46</sup> Code §2056, 2055(a); Andres, *Kansas Probate Handbook*, § 5.1.3(b), (d).

<sup>47</sup> Code §6075(a); Treas. Reg. §20.6075-1.

<sup>48</sup> Treas. Reg. §20.6016-4; Andres, *Kansas Probate Handbook*, §5.1.5(b), (c).

<sup>49</sup> Code §§2503(b), 2505(a), 2511(a); Treas. Reg. §§25.2511-1(a), (c); Andres, *Kansas Probate Handbook*, §5.1.7; Price, *Contemporary Estate Planning*, §2.4; Sembler, *Planning an Estate*, §§2:36-2:48.

<sup>50</sup> Rev. Proc. 2013-35 (2014 level); Rev. Proc. 2014-61 (2015 level).

<sup>51</sup> Code §1015; Price, *Contemporary Estate Planning*, §2.4.5.

<sup>52</sup> Code §2513; Price, *Contemporary Estate Planning*, §2.7.

<sup>53</sup> Price, *Contemporary Estate Planning*, §§2.10, 2.10.4.

<sup>54</sup> Code §§2601-2663. See McGovern, *Wills, Trusts and Estates*, §15.4; Carol A. Harrington, *Generation-Skipping Transfer Tax* (Bloomberg BNA Tax, 850-2<sup>nd</sup>, 2014); Andres, *Kansas Probate Handbook*, §5.18; and Sembler, *Planning an Estate*, §§5.27-5.36, for more details about the GST's design. We draw on Thomas W. Abendroth's paper, "Ticking Timebombs of the GST Tax," to the Kansas City Estate Planning Symposium (April 23-24, 2015), on file with the authors.

<sup>55</sup> Thomas W. Abendroth, "Ticking Timebombs of the GST Tax," 127.

<sup>56</sup> Rev. Proc. 2013-35; Rev. Proc. 2014-6; Price, *Contemporary Estate Planning*, §2.27.

<sup>57</sup> Code §2613(a); Andres, *Kansas Probate Handbook*, §5.1.8(c)(4).

<sup>58</sup> Price, *Contemporary Estate Planning*, §§2.29, 2.41.

<sup>59</sup> Price, *Contemporary Estate Planning*, §§2.24 – 2.41.9.

ends (by death, time lapse, or release of power of appointment), causing a skip person to receive the trust interest.<sup>60</sup> A taxable distribution happens when trust income or principal are distributed to a skip person other than by a taxable termination (e.g. a normal trust distribution to a skip person).<sup>61</sup> A direct skip is a property transfer subject to the estate or gift tax which is made to a skip person, such as a grandparent giving a grandchild property taxable by the estate and/or gift taxes.<sup>62</sup> The GST also has exclusions and exemptions.<sup>63</sup> The GST tax rate is the maximum estate tax rate (currently 40%) times the GST inclusion ratio.<sup>64</sup>

The Form 709 GST tax return must be filed by the responsible party.<sup>65</sup> GST tax triggered by a direct skip (not in a trust) is due when the estate or gift tax returns are due.<sup>66</sup> All other GST tax returns are due by the 15<sup>th</sup> day of the 4<sup>th</sup> month of the tax year close for the return year – usually April 15 after the GST triggering event.<sup>67</sup>

#### **A. Tax Selection Year: Calendar Year vis-à-vis Fiscal Year**

Having explored the basic landscape contours of the tax canvas, we focus in on the tax selection issue.<sup>68</sup> Taxable income is calculated for the taxpayer's tax year, that is, the annual accounting period the taxpayer uses to track income for in the books and records.<sup>69</sup> The taxpayer can usually elect to use a calendar or fiscal year, unless certain rules apply.<sup>70</sup> A calendar tax year begins January 1 and ends December 31, while a fiscal tax year is more flexible: any “12 month period ending on the last day of any month other than December.”<sup>71</sup> A small estate, which closes in less than one year, can pass an excess deduction to the beneficiaries.<sup>72</sup>

##### *Estate Tax Year*

An estate can choose a calendar or fiscal year to file its Form 1041.<sup>73</sup> The Form 1041 filing deadline depends on whether the estate is a calendar year or fiscal year taxpayer. This in turn hinges on how the initial fiduciary income tax return was filed. (It is possible, but difficult, to change the estate's tax year with the IRS' consent.) A calendar year estate

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<sup>60</sup> Code §2612(a); Treas. Regs. §§26.2612-1(d), 26.2651-1, 26.2612-1(b); Andres, *Kansas Probate Handbook*, §5.1.8(d); Price, *Contemporary Estate Planning*, §§2.25.2, 2.32.3.

<sup>61</sup> Code §2612(b); Treas. Reg. §26.2612-1(c); Andres, *Kansas Probate Handbook*, §5.1.8(e); Price, *Contemporary Estate Planning*, §§2.25.3, 2.32.2.

<sup>62</sup> Code §2612(c); Treas. Reg. §26.2612-1(a); Andres, *Kansas Probate Handbook*, §5.1.8(f); Price, *Contemporary Estate Planning*, §§2.32.1, 2.38.1.

<sup>63</sup> Code §§2611(b), 2642(c); Andres, *Kansas Probate Handbook*, §5.1.8(g); Price, *Contemporary Estate Planning*, §2.30.

<sup>64</sup> Code §§2641, 2642(a); Andres, *Kansas Probate Handbook*, §5.1.8(c)(5).

<sup>65</sup> Code §2662(a)(1); Treas. Reg. §26.2662-1(c); Price, *Contemporary Estate Planning*, §2.38.

<sup>66</sup> Code §2662(a)(2)(A); Price, *Contemporary Estate Planning*, §2.39.

<sup>67</sup> Code §2662(a)(2)(B).

<sup>68</sup> Sembler, *Planning an Estate*, §§15:13 – 15:15.

<sup>69</sup> Code §441.

<sup>70</sup> Treas. Reg. §1.441-1. Partnerships, S corporations, and personal service corporations can elect another tax year, but estates and trusts are not within Code §444's list of approved taxpayers to make the election.

<sup>71</sup> Code §441(e); Acker, *Income Taxation*, A-31.

<sup>72</sup> Code §642(h).

<sup>73</sup> Code §443, 7701(a)(1), (14); Acker, *Income Taxation*, A-31; Andres, *Kansas Probate Handbook*, §5.5.7(a).

must file its Form 1041 by April 15, while a fiscal year estate must file its Form 1041 by the 15<sup>th</sup> day of the 4<sup>th</sup> month after the tax year closes.<sup>74</sup> An estate can elect a tax year as long as (1) the tax year ends on the last day of the month and (2) the year only has 12 months. An estate's tax year is elected when the initial Form 1041 is filed, by entering the start and end dates at the top of Form 1041 ("For calendar year 2014 .... and ending..."). E-filing a Form 1041 does not appear to be allowed: addresses to mail a paper Form 1041 to the IRS are provided in the 1041 instructions, depending on where the estate is located and whether a check or money order are enclosed.<sup>75</sup>

Most taxpayers, including estates, file on a calendar year basis unless there is some reason to be a fiscal year taxpayer.<sup>76</sup> While most executors want to finish the estate administration and tax reporting process as soon as possible, it may or may not be possible to complete tax reporting in the year final distributions are made, depending on the trust's tax year and how the initial Form 1041 was filed. A short year return may be filed in some cases.<sup>77</sup>

#### *Trust Tax Year*

Most trusts are required to use calendar tax years.<sup>78</sup> If a trust's terms call for its termination upon an event's occurrence, the trust tax year does not end when the event occurs. Instead, the trustee has a reasonable time after the event's occurrence to finish trust administration.<sup>79</sup> While a trust must use a calendar year, a trust beneficiary is not required to use a calendar year for its tax year, so the trust and its beneficiary could each have a distinct tax year.

### **B. When to File Form 1041/Estate Income Tax Return<sup>80</sup>**

When choosing between a calendar tax year and a fiscal tax year for an estate, the calculus will vary based on different variables. The estate could have (1) IRA income,<sup>81</sup> (2) IRD issues, (3) a capital gain, or (4) fiscal year reporting could determine when the money is taxed to the beneficiaries.<sup>82</sup> The tax year choice can be used to: (1) finesse income and defer income taxes, (2) match the estate's and/or trust's best interest with the beneficiary's best interest, (3) sync income reporting so there is only one tax return to file when the probate estate is settled, (4) handle tax losses so losses reflected on the final

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<sup>74</sup> Code §6072(a); Form 1041 instructions, pg. 8; Price, *Contemporary Estate Planning*, §12.7.

<sup>75</sup> Form 1041 instructions, pg. 8

<sup>76</sup> See e.g. Caron Beesley's blog post on the Small Business Administration's website, available at (<https://www.sba.gov/blogs/calendar-or-fiscal-which-tax-year-right-your-small-business>). Calendar year is the default choice for taxpayers. If taxpayer attempts the fiscal year election, but does not have an annual accounting period, does not keep good books or records, or the current tax year does not qualify as a fiscal year, then the IRS will require the taxpayer to use a calendar year. Treas. Reg. §1.441-1.

<sup>77</sup> Code §443; Treas. Reg. §1.443-1.

<sup>78</sup> Code §644(a); Blattmachr, *Income Taxation*, §3:7.3; Price, *Contemporary Estate Planning*, §10.4.15.

<sup>79</sup> Treas. Reg. §1.641(b)-3(b); Blattmachr, *Income Taxation*, §3:7.3.

<sup>80</sup> Form 1041 instructions, pg. 8.

<sup>81</sup> IRA tax issues are complex. The authors commend Natalie Choate's classic IRA tax treatise to the practitioner. Natalie Choate, *Life and Death Planning for Retirement Benefits* (7<sup>th</sup> ed. 2011).

<sup>82</sup> This raises a loyalty issue for the fiduciary, whose duty lies with the estate, but who could face pressure from a beneficiary to make a favorable tax election for that beneficiary vis-à-vis the estate. And what if the fiduciary is also a beneficiary, a soul like Janus whose faces or loyalties are divided?

return flow through to the beneficiaries for items like attorney's fees and itemized deduction items on Schedule A (of Form 1040), and (5) allow the estate and trust to be treated as one taxpayer via the §645 election.<sup>83</sup>

## IRD

Income in respect of a decedent (IRD) is income due and payable, but not yet realized by the decedent at death.<sup>84</sup> IRD money is earned by the taxpayer *before* death, but not actually paid until *after* death. IRD is reported on the Form 1041, not the final Form 1040, if the money was received after the decedent's death. IRD money is taxed the same way in the beneficiary's hands as the income would have been taxed in the decedent's hands while the decedent was alive.

## The §645 Election: Treating a Trust as Part of an Estate

Code §645 is about treating a trust and an estate as one - an estate and trust's income tax returns need not be filed separately, despite having distinct EINs, which is the proper EIN procedure.<sup>85</sup> A qualified revocable trust (QRT) may elect to be treated as part of the decedent's estate using Form 8855.<sup>86</sup> This treatment is desirable if reporting trust income on a fiscal year basis would be beneficial, as estates may file on a fiscal year basis, but trusts cannot. The §645 election is irrevocable and must be made by the filing deadline for the estate's first Form 1041.<sup>87</sup>

The trustee of the trust and the executor of the estate make the §645 election by filing Form 8855.<sup>88</sup> If there's no executor of the client's estate, the trustee can make the §645 election unilaterally.<sup>89</sup> While the §645 election stands, the estate's executor files one Form 1041 for the estate *and* the trust under the estate's name and EIN.<sup>90</sup> But the §645 election doesn't affect the estate's and trust's separate treatment for tax procedure and administration questions, only for income tax purposes. An estate's 2 year estimated tax payment exception (under §6654(1)(2)(A)) applies to a trust making the §645 election.<sup>91</sup>

The §645 election stands until the "applicable date," which is the later of (a) 2 years after the decedent's death or (b) 6 months after estate tax liability is determined.<sup>92</sup> When an estate makes a valid §645 election, the estate doesn't terminate until the earlier of (a) the "applicable date" or (b) the day when the qualified revocable trust and the estate have

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<sup>83</sup> A fiscal year estate can finesse distribution timing: a beneficiary who receives a distribution in one calendar year may not need to report the income until the next calendar year, since a beneficiary's income is deemed distributed on the last day of the estate's fiscal year, regardless of when the distribution was paid. Code §662(c); Acker, *Income Taxation*, A-31; Andres, *Kansas Probate Handbook*, §5.5; Price, *Contemporary Estate Planning*, §§12.7, 12.9 - 12.10.

<sup>84</sup> Code §691.

<sup>85</sup> Andres, *Kansas Probate Handbook*, §5.5.7(d); Price, *Contemporary Estate Planning*, §10.15.

<sup>86</sup> A QRT is a revocable trust created before death. While the decedent was alive, the QRT's income was taxable under the grantor trust rules. The trust agreement will specify QRT status. Code §645(b)(1).

<sup>87</sup> Code §645(c); Treas. Regs. §§1.645-1(c), 1.645-1(1)(e)(1).

<sup>88</sup> Treas. Reg. §1.645-1(c)(1)(i).

<sup>89</sup> Treas. Reg. §1.645-1(c)(1)(i).

<sup>90</sup> Treas. Reg. §1.645-1(e)(2)(ii).

<sup>91</sup> Treas. Reg. §1.645-1(e)(4).

<sup>92</sup> Code §§645(a), 645(b)(2); Treas. Reg. §1.645-1(f)(2)(ii).

distributed all their assets.<sup>93</sup> The final estate tax day is (prong “b” of the “applicable date” above) is the earliest of (a) 6 months after an estate tax closing letter is issued, (b) the final disposition of a refund claim resolving estate tax liability, (c) execution of a settlement agreement resolving estate tax liability, (d) a court decision or order resolving estate tax liability, or (e) the statute of limitation (§6501) expiring for collecting estate taxes.<sup>94</sup>

The §645 election doesn’t relieve the trust from filing an initial Form 1041 for the tax year ending with the client’s death, but the trustee doesn’t need to file Form 1041 for the short year of the trust (from the client’s death until December 31).<sup>95</sup>

#### *§645 Impacts on Form 1041*

The §645 election has five impacts on Form 1041. First, the estate’s and trust’s income, deductions, and credit are combined, and only one personal exemption is allowed.<sup>96</sup> Second, the executor and trustee must reasonably apportion tax liability between the estate and trust.<sup>97</sup> Third (and related), the executor and trustee must timely pay the estate’s and trust’s shares of the tax bill.<sup>98</sup> Fourth, the estate and trust are treated as separate shares for calculating distributable net income (DNI) and certain distributions (under §§661 and 662).<sup>99</sup> But the separate share rule only applies to allocating DNI, not to creating DNI.<sup>100</sup> Fifth, a charitable deduction is granted to the estate and trust.<sup>101</sup>

#### *§645 Advantages and Disadvantages*

Making the §645 election carries a variety of advantages and disadvantages. On the one hand, a §645 election doesn’t allow (a) splitting income with another taxpayer and (b) allocating depreciation or depletion between the fiduciary and beneficiaries may be better for a trust than an estate. But on the other hand, the §645 election allows (a) the ability to use a non calendar year, (b) to deduct some passive losses under §469(i), (c) to deduct and amortize some reforestation expenses, (d) to receive a charitable deduction beyond unrelated business income (under §681(a)). A §645 election can also affect the trust’s state and local taxes where state fiduciary taxes are driven by federal AGI or federal taxable income.

#### **DNI**

DNI is the trust income available to distribute to trust beneficiaries.<sup>102</sup> DNI is the maximum amount of income taxed to a trust beneficiary. DNI is reported on Schedule B (of Form 1041), as determined by the trust instrument. A trust’s income distribution deduction is the lesser of (a) DNI or (b) distributions to beneficiary (excluding distributed

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<sup>93</sup> Treas. Reg. §1.641(b)-3.

<sup>94</sup> Treas. Reg. §1.645-1(f)(2)(ii).

<sup>95</sup> Treas. Reg. §1.645-1(d)(2)(i).

<sup>96</sup> Treas. Reg. §1.645-1(e)(2)(ii).

<sup>97</sup> Treas. Reg. §1.645-1(c)(1)(ii).

<sup>98</sup> Treas. Reg. §1.645-1(c)(1)(ii).

<sup>99</sup> Treas. Reg. §§1.645-1(e)(2)(iii)(A); 1.663(c)-4.

<sup>100</sup> Treas. Reg. §1.663(c)-1.

<sup>101</sup> Code §642(c); Treas. Reg. §1.645-1(e)(2)(iv).

<sup>102</sup> Code §643; Treas. Regs. §§1.643(a)-0 – 1.643(a)-7; Price, *Contemporary Estate Planning*, §10.4.4.

tax exempt interest). Trusts must take the income distribution deduction, so trusts cannot elect to pay taxes on distributions for beneficiaries.<sup>103</sup> DNI is the upper limit of the income distribution deduction, which a trust can take.

#### *Trust: Simple or Complex?*

A complex trust is a trust where (1) not all income has to be distributed current, (2) that allows income to be distributed or set aside for charitable contributions, or (3) that distributes principal (including a simple trust in its final year).<sup>104</sup> The IRS considers a trust a simple trust if (1) all income is distributed currently, (2) no income can be distributed or set aside for charitable contributions, and (3) the trust does not distribute principal, while any trust that does not fit those criteria is a complex trust.<sup>105</sup> The simple or complex trust determination is made annually based on the trust's terms. Estates follow the complex trust income tax rules.

#### *Separate Share Rule*

The separate share rule protects multiple beneficiaries of an estate or trust from paying taxes on each other's money.<sup>106</sup> When separate shares exist, DNI must be calculated separately for each share. The separate share rule provides that a beneficiary is taxed only on the income belonging to and distributed to that beneficiary's separate share. The separate share rule keeps a beneficiary from being taxed on all DNI being distributed, including income paid to another beneficiary. Separate share calculations and each beneficiary's DNI should be reported on separate statements attached to Form 1041.

Assuming the estate meets the Form 1041 threshold requirements, the Form 1041 must be filed on either a calendar or fiscal year basis as described above. In some cases, it is possible to coordinate or sync the tax years to minimize the number of returns that must be filed, even to one return for the tax year.

The estate's personal representative or executor files both returns, by April 15 of the year after the tax year.<sup>107</sup> Form 1041 is filed at the IRS Service Center of the personal representative's domicile.<sup>108</sup>

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<sup>103</sup> Code §§652 and 662.

<sup>104</sup> Treas. Reg. §1.661(a)-1.

<sup>105</sup> Code §§651-652; Treas. Reg. §1.651(a)-1; Price, *Contemporary Estate Planning*, §10.49. Code §§661-663, Price, *Contemporary Estate Planning*, §16.4.10. Allocate a simple trust's deduction. Treas. Reg. §1.652(b)-3.

<sup>106</sup> Code §663(c); Treas. Regs. §§1.663(c)-1 - 1.663(c)-5; Price, *Contemporary Estate Planning*, §12.37.

<sup>107</sup> Code §6012(b)(1); Treas. Reg. §1.6072-1(b).

<sup>108</sup> Treas. Reg. §1.6091-2(a).

### C. Portability: Should You File Form 706?

#### To Port or Not to Port<sup>109</sup>

Portability is a great estate planning tool for married couples.<sup>110</sup> Portability arose in 2010 and was made permanent by ATRA in 2012.<sup>111</sup> Just as estate planning has undergone a sweeping paradigm shift from an estate tax focus to an income tax focus, so “portability may be viewed as a paradigm shift in estate planning for married couples.”<sup>112</sup> Portability is part of Congress’ favorable treatment of married taxpayers, along with the marital deduction and unlimited gifting between married spouses. Portability is not available for a spouse’s unused gift or GST tax exemptions. This may be due to dynastic wealth concerns.

Often portability is a good idea - especially for spouses whose net worth is close to or could become close to the federal estate tax exemption during their remaining lifetime. But portability may not be as useful to spouses with lower net worth or income where there is no possibility of reaching the federal estate tax exemption. For those clients, portability may actually be uneconomical – the pursuit of a phantom tax benefit, which incurs more time and expenses than it is worth.

Portability presents a choice between inheriting outright vis-à-vis inheriting in trust.<sup>113</sup> Portability has numerous advantages vis-à-vis using trusts in an estate plan, including: (1) simplicity, (2) stepped up basis when the surviving spouse dies, (3) use with depreciating assets, (4) use with retirement assets, (5) use with a residence, (6) IRD tax efficiency (by not funding the first spouse’s unused estate tax exemption with IRD), (7) market declines after the first spouse’s death, (8) lower state exemption amount (for states with an estate tax), (9) avoid state estate taxes, (10) create a grantor trust for descendants, and (11) avoiding complex tax funding formulas.<sup>114</sup>

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<sup>109</sup> Jonathan G. Blattmachr, Austin W. Bramwell, and Diana S.C. Zeydel, “Portability or No: The Death of the Credit Shelter Trust?” *Journal of Taxation*, 118:5 (May 2013), available at (<http://www.milbank.com/images/content/1/6/16244/Portability-or-No-The-Death-of-the-Credit-Shelter-Trust-Journ.pdf>).

<sup>110</sup> For two millennia, marriage has been defined by state law as a legal union between a man and woman. In the wake of *United States v. Windsor*, 570 U.S. \_\_\_, (2013), 133 S.Ct. 2675, the U.S. Government now recognizes same sex marriages if the couples were married in states which allow same sex marriage, so portability would be available to validly married same sex couples. The Supreme Court is now considering *Obergefell v. Hodges*, Docket No. 14-556, which asks: (1) if the Fourteenth Amendment requires a state to license a same sex marriage, and (2) if the Fourteenth Amendment requires a state to recognize a same sex marriage validly performed in another state. See Joshua S. Rubenstein, Esq., of Kattin Muchin Rosenman LLP (New York, NY)’s paper, “Estate Planning for Same Sex Unmarried Couples,” Kansas City Estate Planning Symposium (April 23-24, 2015), on file with the authors

<sup>111</sup> Code §2010 (“portability” as the “deceased spousal unused exclusion amount” or “DSUE amount”). And Code §2010(c)(2) tells us the applicable exclusion amount is “the sum of (A) the basis exclusion amount, and (B) [for a surviving spouse], the deceased spousal unused exclusion amount.” Price, *Contemporary Estate Planning*, §§2.12, 12.27.

<sup>112</sup> Blattmachr, “Portability or No,” 233.

<sup>113</sup> This section draws on excellent portability materials presented by Thomas W. Abendroth, Esq., of Schiff Hardin LLP (Chicago, IL), to the Kansas City Estate Planning Symposium (April 23-24, 2015). Abendroth and Blattmachr’s portability reflections are on file with the authors and have been incorporated here.

<sup>114</sup> Blattmachr, “Portability or No,” 234-236.

But trusts also have some advantages over portability: (1) using the first spouse's GST exemption (which can be wasted with portability), (2) creditors' claims of the surviving spouse, (3) protection from unwise financial decisions, (4) no DSUE indexing for inflation, (5) estate tax credits (which can be wasted with portability), (6) remarriage forfeiture if the surviving spouse remarries and survives the new spouse, (7) shelter of appreciation and income, and (8) avoiding potential audit issues with filing Form 706.<sup>115</sup> By using portability (and not a trust), various issues arise: (1) income tax consequences, (2) Form 706 must be filed, (3) the effect of inherited exemptions, and (4) second marriages.<sup>116</sup> A trust can shift income to any beneficiary, so that it is not taxed in the surviving spouse's hands.<sup>117</sup> If a trust is used instead of portability, Form 706 may not be required. A trust can be beneficial for a surviving spouse if the first spouse did not use their gift tax exemption and left a large unused estate tax exemption. And a QTIP trust would work better in a second marriage scenario.<sup>118</sup>

Portability is useful where: (1) a small first estate exists, (2) with very wealthy clients to fund a grantor trust for descendants, (3) to achieve stepped up basis flexibility, (4) state death tax planning, (5) small nonmarital share, (6) to avoid funding the nonmarital share with IRD assets, or (7) for older, childless couples.<sup>119</sup>

Portability must be elected by filing a Form 706 estate tax return for the deceased spouse.<sup>120</sup> The American Institute of Certified Public Accountants (AICPA) has written the IRS to recommend a short Form 706-EZ be published that would allow the portability election where no estate tax is owed.<sup>121</sup> But for now, the regular Form 706 must be filed to elect portability.

#### **D. Allocating Items that are Deductible on the 1041/Final 1040/706**

Just as tax elections can be a labyrinthine maze, so allocating deductible items can be very complicated. Some deductible items are only deductible on one tax return, but several items can potentially be deducted in different places to various effects. For

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<sup>115</sup> Id., 236.

<sup>116</sup> Id., 238-240.

<sup>117</sup> Id., 239.

<sup>118</sup> Id., 240. A qualified terminable interest property (QTIP) trust qualifies for the marital deduction. A QTIP is (1) a trust, under which (2) the surviving spouse is entitled to the trust's income for life, and (3) the property cannot be appointed to anyone but the surviving spouse. A reverse QTIP election treats the first spouse as the GST transferor. A partial QTIP election allocates assets between (1) the QTIP trust for the surviving spouse's benefit and (2) the deceased spouse's estate. Code §2056; Treas. Regs. §§ 20.2056(b)-5(f)(4), 20.2056(b)-7(d)(2); Price, *Contemporary Estate Planning*, §5.23 (QTIP); Code §2652(a)(1); Treas. Reg. §26.2652-2(a); Price, *Contemporary Estate Planning*, §2.28 (reverse QTIP); Treas. Reg. §20.2056(b)-7(b)(2); Price, *Contemporary Estate Planning*, §5.23.4 (partial QTIP).

<sup>119</sup> Id., 241-242.

<sup>120</sup> Code §2010(c)(5).

<sup>121</sup> See Journal of Accountancy update, available at <http://journalofaccountancy.com/news/2015/mar/irs-portability-relief-201511999.html>. AICPA letter available at

[http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/aicpa\\_comments\\_on\\_portability\\_relief\\_ext\\_end\\_request-3-19%2015-submitted-es.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/aicpa_comments_on_portability_relief_ext_end_request-3-19%2015-submitted-es.pdf).

example, the decedent's final medical expenses can be deducted on the decedent's final Form 1040 income tax return or on the estate's Form 706 estate tax return.<sup>122</sup>

### **Deducting Estate Expenses**

Estate administration and other expenses are deductible, usually on Form 706 to determine the gross estate's value, and thus the estate tax (if any) owed.<sup>123</sup> Medical expenses paid before the decedent's death can be included in the medical expense deduction on the decedent's final Form 1040. Estate administration expenses can be deducted on the final Form 1040 if the executor or trustee waives the right to deduct expenses on Form 706, such as where Form 706 need not be filed. The executor can elect to treat medical expenses paid by the estate as paid by the decedent when the medical services were provided, but the expenses have to be paid within a year of the decedent's death. For this election, the executor should attach a statement to the decedent's final Form 1040 stating the expenses (1) were not and (2) will not be claimed on the Form 706 estate tax return.<sup>124</sup> Importantly, medical expenses deducted from estate taxes (Form 706) are fully deductible, while medical expenses deducted from income taxes are only deductible if over 10% of the decedent's AGI (7.5% of the decedent's AGI for taxpayers over 65 years old).<sup>125</sup>

The decedent's final Form 1040 can take the standard deduction, which the trust cannot claim on Form 1041, but the trust avoids self employment income tax, which the estate does not.<sup>126</sup> A simple trust can take a \$300 exemption, but a complex trust only a \$100 exemption.<sup>127</sup> Estates usually follow the income tax rules for complex trusts, but can take a \$600 personal exemption.<sup>128</sup>

Deductible expenses include funeral expenses and administration expenses. A deductible administration expense must be actually and necessarily incurred to administer the estate, including (1) asset collection, (2) debt payment, and (3) distributions to heirs.<sup>129</sup> Attorney's fees, executor's or trustee's commissions, and other related expenses are also deductible. Credits against the estate tax would be claimed.<sup>130</sup>

### **Tracing**

Another Form 1040 vis-à-vis Form 1041 issue is tracing income and expenses. Tracing arose before the 1954 IRS Code and the *Dean* case, but DNI and the 1954 Code simplified the tracing issue.<sup>131</sup> When deciding whether an income or expense item is properly allocated to Form 1040 or 1041, look at whether the item is associated with the decedent's Social Security number (Form 1040) or the estate's EIN (Form 1041).

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<sup>122</sup> Price, *Contemporary Estate Planning*, §12.13.

<sup>123</sup> Price, *Contemporary Estate Planning*, §2.16; Sembler, *Planning an Estate*, §§15:16 – 15:31.

<sup>124</sup> Treas. Regs. §§1.642(g)-1; 20.2053-1(d).

<sup>125</sup> Code §213; Price, *Contemporary Estate Planning*, §12.3.4.

<sup>126</sup> Code §63(c)(6); Price, *Contemporary Estate Planning*, §10.4.6.

<sup>127</sup> Code §642(b); Price, *Contemporary Estate Planning*, §10.4.6.

<sup>128</sup> *Id.*

<sup>129</sup> Treas. Reg. §20.2053-3(a).

<sup>130</sup> Code §§2010-2016; Price, *Contemporary Estate Planning*, §2.17.

<sup>131</sup> Acker, *Income Taxation*, A-4; *Dean v. IRS*, 102 F.2d 699 (10<sup>th</sup> Cir. 1939).

### *Form 706 vis-à-vis Form 1041 Deductions*

When weighing allocating deductions to Form 706 vis-à-vis Form 1041, best interests and tax efficiency questions arise – where will the items yield the greatest tax savings or beneficial impact for the client?

Traditionally, accountants and attorneys recommended allocating deductions to Form 706 in lieu of Form 1041. But historically the federal estate tax was a major estate planning focus during the client's life and a sizable tax issue after the client's death, to be paid from life insurance proceeds or by liquidating a large part of the estate or trust. Since Congress has dramatically raised the federal estate tax exemption in recent years and apparently made those changes a permanent feature of the tax landscape, estate tax planning is often not an issue for clients and portability is then the only reason to file an estate tax return. And portability carries a cost-benefit analysis: many clients wish to avoid the cost of preparing the Form 706, especially if the surviving spouse's net worth and expected future income puts them well below the estate tax threshold, so that claiming portability may well be viewed by some clients as a futile tax election. If either spouse's net worth is millions of dollars below the tax trigger, why do expensive planning for an unlikely contingency?

In the wake of Congress' sweeping estate tax gambit, many accountants and attorneys see a paradigm shift from estate taxes to income tax planning, and a renewed focus on the Form 1041, while often relegating Form 706 to the fabled typewriter table from a bygone era. Where countless estate plans used to be designed with A-B credit shelter and marital trusts, to keep assets out of the spouse's estate and avoid large estate tax liabilities, while using gifts (and carryover basis) to drain the estate's deep money reservoir to tax free shallows, now many estate plans are being designed to hold assets outright until death to give the heirs a stepped up basis (a major income tax benefit) as more and more estates' volume is a mere bucket from the rising oceans of estate tax exemption.<sup>132</sup> Estates and trusts is now a brave new world where income taxes trump transfer taxes.<sup>133</sup>

Let's review each form's deductible items in more depth. The 10 Form 1041 deductibles include: (1) interest<sup>134</sup>, (2) taxes<sup>135</sup>, (3) fiduciary fees<sup>136</sup>, (4) charitable deduction<sup>137</sup>, (5) attorney, accountant, and return preparer fees<sup>138</sup>, (6) other deductions not subject to the 2% floor (attach schedule)<sup>139</sup>, (7) net operating loss deduction<sup>140</sup>, (8) allowable

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<sup>132</sup> Code §1015(a) (carryover basis); Code §1014(a)(1) (stepped up basis).

<sup>133</sup> This paradigm shift looks hopeful, unlike Aldous Huxley's classic novel *Brave New World* (1932).

<sup>134</sup> Form 1041, Line 10; Form 1041 instructions, pg. 22.

<sup>135</sup> Form 1041, Line 11; Form 1041 instructions, pp. 22-23.

<sup>136</sup> Form 1041, Line 12; Form 1041 instructions, pg. 23.

<sup>137</sup> Form 1041, Line 13; Code §§642(c), 170; Acker, *Income Taxation*, A-43 – A-45.

<sup>138</sup> Form 1041, Line 14;

<sup>139</sup> Form 1041, Line 15a; Form 1041 instructions, pp. 23-24.

<sup>140</sup> Form 1041, Line 15b; Form 1041 instructions, pg. 24; see Blattmachr, *Income Taxation*, §3:2.1[D]; Acker, *Income Taxation*, A-36; Code §642(d).

miscellaneous itemized deductions subject to the 2% floor<sup>141</sup>, (9), income distribution deduction<sup>142</sup>, (10) estate tax deduction including certain generation-skipping taxes (attach computation)<sup>143</sup>, and (11) exemption.<sup>144</sup> The 13 final Form 1040 deductibles include: (1) educator expenses<sup>145</sup>, (2) certain business expenses<sup>146</sup>, (3) the health savings account deduction<sup>147</sup>, (4) moving expenses<sup>148</sup>, (5) self employment tax deduction<sup>149</sup>, (6) self employed SEP, simple, or qualified plan deduction<sup>150</sup>, (7) self employed health insurance deduction<sup>151</sup>, (8) early savings withdrawal penalty<sup>152</sup>, (9) alimony paid<sup>153</sup>, (10) IRA deduction<sup>154</sup>, (11) student loan interest deduction<sup>155</sup>, (12) the tuition and fees deduction<sup>156</sup>, and (13) the domestic production activities deduction.<sup>157</sup> An elections checklist could be consulted as a guide.<sup>158</sup> Estate taxes paid are deductible.<sup>159</sup>

The 9 Form 706 deductions include: (1) funeral expenses and estate administration expenses (subject to claims)<sup>160</sup>, (2) decedent's debts<sup>161</sup>, (3) mortgages and liens<sup>162</sup>, (4) net losses during estate administration<sup>163</sup>, (5) estate administration expenses (not subject to claims)<sup>164</sup>, (6) bequests to surviving spouse<sup>165</sup>, (7) charitable or public bequests<sup>166</sup>, (8) Treas. Reg. §20.2010-2T(a)(7)(ii) assets<sup>167</sup>, and (9) state death tax deduction.<sup>168</sup> A smart Form 706 elections checklist should also be consulted.<sup>169</sup>

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<sup>141</sup> Form 1041, Line 15c; Form 1041 instructions, pp. 24-25; Acker, *Income Taxation*, A-46 – A-47; Code §67; Price, *Contemporary Estate Planning*, §10.4.7.

<sup>142</sup> Form 1041, Line 18; Form 1041 instructions, pg. 25; Code §§651-652, 661-663; Price, *Contemporary Estate Planning*, §10.4.5.

<sup>143</sup> Form 1041, Line 19; Form 1041 instructions, pg. 25.

<sup>144</sup> Form 1041, Line 20; Form 1041 instructions, pg. 25.

<sup>145</sup> Form 1040, Line 23; Form 1040 instructions, pg. 30.

<sup>146</sup> Form 1040, Line 24; Form 1040 instructions, pg. 30.

<sup>147</sup> Form 1040, Line 25; Form 1040 instructions, pg. 30.

<sup>148</sup> Form 1040, Line 26; Form 1040 instructions, pg. 30.

<sup>149</sup> Form 1040, Line 27; Form 1040 instructions, pg. 31.

<sup>150</sup> Form 1040, Line 28; Form 1040 instructions, pg. 31.

<sup>151</sup> Form 1040, Line 29; Form 1040 instructions, pp. 31-32.

<sup>152</sup> Form 1040, Line 30; Form 1040 instructions, pg. 32.

<sup>153</sup> Form 1040, Line 31a; Form 1040 instructions, pg. 32.

<sup>154</sup> Form 1040, Line 32; Form 1040 instructions, pp. 32-35.

<sup>155</sup> Form 1040, Line 33; Form 1040 instructions, pg. 36.

<sup>156</sup> Form 1040, Line 34; Form 1040 instructions, pg. 37.

<sup>157</sup> Form 1040, Line 35; Form 1040 instructions, pg. 37; Code 199; Acker, *Income Taxation*, A-36 – A-37.

<sup>158</sup> Price, *Contemporary Estate Planning*, §12.49.

<sup>159</sup> Code §691(c); Acker, *Income Taxation*, A-45.

<sup>160</sup> Schedule J (Form 706) and Form 706, Part 5, Item No. 14; Form 706 instructions, pp. 31-32.

<sup>161</sup> Schedule K (Form 706) and Form 706, Part 5, Item No. 15; Form 706 instructions, pp. 32-33.

<sup>162</sup> Schedule K (Form 706) and Form 706, Part 5, Item No. 16; Form 706 instructions, pp. 32-33.

<sup>163</sup> Schedule L (Form 706) and Form 706, Part 5, Item No. 19; Form 706 instructions, pp. 33-34.

<sup>164</sup> Schedule L (Form 706) and Form 706, Part 5, Item No. 20; Form 706 instructions, pp. 33-34.

<sup>165</sup> Schedule M (Form 706) and Form 706, Part 5, Item No. 21; Form 706 instructions, pp. 34-37. Jeffrey N. Pennell, *Estate Tax Marital Deduction* (Bloomberg BNA, 843-3<sup>rd</sup>, 2013).

<sup>166</sup> Schedule O (Form 706) and Form 706, Part 5, Item No. 22; Form 706 instructions, pp. 37-38. Edward J. Beckwith & Natanya H. Allan, *Estate and Gift Tax Charitable Deductions* (Bloomberg BNA, 839-2<sup>nd</sup>, 2014).

<sup>167</sup> Form 706, Part 5, Item No. 23; Form 706 instructions, pg. 16.

<sup>168</sup> Form 706, Part 2, Line 3b; Form 706 instructions, pp. 5-6.

<sup>169</sup> Price, *Contemporary Estate Planning*, §12.49.

### *Fiduciary Fees*

Fiduciary fees are a key overlap area, deductible on both the Form 706 and Form 1041. Under *Knight*, an estate's fiduciary fees are often subject to the 2% itemized deduction floor.<sup>170</sup> A person may take a miscellaneous itemized deduction to the extent the item's cost exceeds 2% of the person's adjusted gross income.<sup>171</sup> Some itemized deductions are deductible in full, but any costs outside Code 67(b)'s ambit are miscellaneous itemized deductions, so the 2% floor applies.<sup>172</sup> An estate's fiduciary fees, including for investment advisory services, are not on the 67(b) list, so the 2% floor applies.<sup>173</sup> An individual's investment advisory expenses are fully deductible costs.<sup>174</sup> Using this logic, an estate can only fully deduct fiduciary fees if the money was (a) "paid or incurred in connection with" the estate's administration and (b) "would not have been incurred if the property" was not in the estate.<sup>175</sup> *Knight* teaches that the 2% floor often applies to an estate's fiduciary fees.

### *Federal Estate Tax*

If the federal estate tax is owed, Form 706 deductions should be taken first, as the federal estate tax is up to 40% of the estate's value. Second, Form 1041 deductions would be taken, since the fiduciary income tax rate reaches the highest individual income tax level at a mere \$12,150 of income. And last but not least, the final Form 1040 deductions would be taken, since the individual income tax rate applies to a decedent's estate.<sup>176</sup>

### *No Federal Estate Tax*

If the federal estate tax is not owed (and regardless of whether portability is elected on the federal estate tax return), Form 1041 deductions would be taken first, since the fiduciary income tax rate reaches the highest individual income tax level at a mere \$12,150 of income. And second, the final Form 1040 deductions would be taken, since the individual income tax rate applies to a decedent's estate.<sup>177</sup>

## **E. Passive Activity Losses and Basis Adjustments**

Since 1986, Congress has distinguished between passive activity losses and business losses, and the IRS Code "bars" using a passive activity loss "as an offset against income from unrelated sources."<sup>178</sup> Publication 925 summarizes the passive activity loss rules.<sup>179</sup>

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<sup>170</sup> *Knight v. IRS*, 552 U.S. 181 (2008); Publication 559, pg. 23 (fiduciary fees). *Knight* was about trusts, "but the analysis applies equally to estates." *Knight*, 552 U.S. 181, n.1. See Robert S. Balter and Jonathan G. Blattmachr, "Knight v. Comr.: The Two Percent Floor and a Fiduciary's Investment Advisory Fees," *Tax Management Memorandum* (Bloomberg BNA, 2008), available at [http://www.rsbpc.com/sites/default/files/users/RobertBalter/pdfs/Knight%20v%20Comm'r%20\(with%20Blattmachr\)%20Tax%20Mgmt%20Memo%20\(April%202008\).pdf](http://www.rsbpc.com/sites/default/files/users/RobertBalter/pdfs/Knight%20v%20Comm'r%20(with%20Blattmachr)%20Tax%20Mgmt%20Memo%20(April%202008).pdf).

<sup>171</sup> Code §§63(d), 67(a).

<sup>172</sup> Code §67(b) (fully deductible itemized deductions a/k/a 2% AGI floor exceptions).

<sup>173</sup> Code §67(e).

<sup>174</sup> Code §212.

<sup>175</sup> Code §67(e)(1).

<sup>176</sup> Price, *Contemporary Estate Planning*, §12.11.

<sup>177</sup> Price, *Contemporary Estate Planning*, §12.12.

<sup>178</sup> Code §469; Marvin A. Chirelstein, *Federal Income Taxation* (Foundation Press, 10<sup>th</sup> ed., 2005), 318. In 1976, Congress honed the business loss rules by requiring the business asset be "at risk" to claim a loss.

A passive activity loss is a passive activity deduction that is greater than the taxpayer's passive activity income.<sup>180</sup>

A passive activity loss is usually not allowed.<sup>181</sup> When they are allowed, passive activity losses should be reported on the proper schedule.<sup>182</sup> A passive activity loss cannot be "passed out" to an estate beneficiary unless the loss occurred in the estate's termination year.<sup>183</sup> There are two kinds of passive activities: (1) a trade or business that the taxpayer does not materially participate in or (2) rental activities conducted by a non real estate professional, even if the taxpayer materially participates in the rental activity.<sup>184</sup> A trade or business activity is an activity involving: (1) the conduct of a trade or business, (2) conducted in anticipation of starting a trade or business, or (3) §174 deductible research or experimental expenditures.<sup>185</sup> But a trade or business activity does not include rental activity or a property rental incidental to holding the property for investment.<sup>186</sup> Trade or business activities are reporting on Schedules C, E, or F.<sup>187</sup> The material participation tests are listed in Publication 925.<sup>188</sup> Publication 925 also lists a variety of non-passive activities.<sup>189</sup> Form 8582 is used to report pass activity loss limitations.<sup>190</sup>

A fiduciary would report a passive activity loss where the estate or trust had incurred a loss engaging in a passive activity, such as owning a business, renting real estate, or any other enterprising endeavor where the fiduciary was not materially participating on the estate or trust's behalf. But Treasury Regulations do not define "material participation" as to estate or trusts, so fiduciaries do not have a clear standard to measure passive activity losses.<sup>191</sup> In a grantor trust, material participation is decided at the grantor level.<sup>192</sup> If the estate or trust distributes an interest in a passive activity, the property's basis immediately before the distribution is increased by the passive activity losses allocable to the interest, and the losses cannot be deducted (Code §469(j)(12)).<sup>193</sup>

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Code §465; Chirelstein, *Federal Income Taxation*, 316. Congress sowed "material participation" rules into Code §469's regulatory soil. The two required hallmarks for a business loss are (1) "at risk" business assets and (2) "material participation"; if an estate fails the tests, it cannot claim the passive activity loss. *Id.*, 316-321. IRS Tax Topic 425 (passive activities), available at <http://www.irs.gov/taxtopics/tc425.html>.

<sup>179</sup> Code §469. Working oil & gas interests are not passive activities. Code §469(c)(3); Form 1041 instructions, pg. 21. Andres, *Kansas Probate Handbook*, §5.5.4(m); Price, *Contemporary Estate Planning*, §10.4.8.

<sup>180</sup> Pub 925, pp. 6-8 (listing various categories of passive activity income and deductions).

<sup>181</sup> Code §469(a)(2)(A); Pub 925, pg. 2.

<sup>182</sup> Pub 925, pg. 12.

<sup>183</sup> *Baker v. IRS*, T.C. Memo 1990-107; Acker, *Income Taxation*, A-50.

<sup>184</sup> Code §469(c); Pub 925, pg. 3.

<sup>185</sup> Pub 925, pg. 3.

<sup>186</sup> Code §469(c)(2); Pub 925, pg. 3.

<sup>187</sup> Pub 925, pg. 3.

<sup>188</sup> Pub 925, pg. 5.

<sup>189</sup> Pub 925, pg. 5.

<sup>190</sup> Form 8582-CR calculates the credit amount allowed for the current year.

<sup>191</sup> Form 1041 instructions, pg. 21.

<sup>192</sup> Form 1041 instructions, pg. 21.

<sup>193</sup> Form 1041 instructions, pg. 21.

If (1) the decedent actively participated in the activity before death and (2) an estate's tax year ends within 2 years of the decedent's death, up to \$25,000 of deductions and deduction equivalent credits are allowed from rental real estate activities where the decedent actively participated.<sup>194</sup> Excess losses or credits are suspended for the year and carried forward.<sup>195</sup> Portfolio income includes interest, dividends, royalties, and annuity income. If an estate or trust has portfolio income, it is not treated as passive activity income, so passive losses and credits cannot be used to offset the portfolio income. An estate or trust's portfolio income must be separately accounted for.<sup>196</sup> Special passive activity loss rules apply to bankruptcy estates, but those are beyond this paper's scope.<sup>197</sup> Estates and complex trusts allocate their deductions when computing distributable net income (DNI) according to Code §469 (the passive activity loss rules), and report the results in Boxes 5-9 of Schedule K-1 (of Form 1041).<sup>198</sup> Where the loss is deductible, the estate would take a basis adjustment after incurring the loss.<sup>199</sup>

#### *Net Investment Income Tax (NIIT)*

Passive activities may trigger net investment income taxes for an estate or trust.<sup>200</sup> Form 8960 is filed with the IRS to report NIIT, a tax added to the federal income tax landscape by the Affordable Care Act (2010). For individuals, the NIIT applies if a U.S. citizen or legal resident has net investment income (NII) and modified adjusted gross income over \$250,000 if married filing jointly, \$200,000 if single and head of household, or \$125,000 if married filing separately. Individual taxpayers report NIIT tax from Form 8960 on Line 60, box b (page 2) of Form 1040.

The NIIT can apply to individuals, estates, and trusts. The NIIT is a 3.8% Medicare contribution tax on NII of some taxpayers effective for 2013 and beyond. NII includes interest (including substitute interest), dividends (including constructive dividends, and distributions treated as dividends), non-qualified annuities, royalties, rents (other than income derived in the ordinary course of a trade or business that is not a passive trade or business), trades and businesses the client is passively involved in or trades or businesses that consist of trading financial instruments or commodities, investment of working capital, and some capital gains.<sup>201</sup> NII does not include: sale of some active interests in

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<sup>194</sup> Code §469(i)(4). A trust materially participated only if the trustee participated on a “regular, continual, and substantial basis.” Code §469(h)(1). A Texas federal court allowed a trust to deduct losses, but the IRS views the issue as a clear passive activity loss and not deductible. *Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003); TAM 200733023, TAM 201317010; *Frank Aragona Trust v. IRS*, 142 T.C. No. 9 (2014); PLR 201029014 (trust must establish material participation through trustee’s activity);

Acker, *Income Taxation*, A-50 – A-52.

<sup>195</sup> Form 1041 instructions, pg. 21.

<sup>196</sup> Form 1041 instructions, pg. 21.

<sup>197</sup> Form 1041 instructions, pg. 15.

<sup>198</sup> Form 1041 instructions, pg. 36.

<sup>199</sup> Code §469(g)(2); Price, *Contemporary Estate Planning*, §12.3.5.

<sup>200</sup> Code §1411 (NIIT); Treas. Regs. §§1.1(i)-1T, 1.1411-4 (“net investment income” defined), 1.1411-5, 1.1411-6 (working capital investment), 1.1411-7 (exclusion for sale of active interests in partnerships and S corps), 1.1411-8 (exclusion for qualified plan distributions), 1.1411-9 (exclusion for self-employment income); Form 8960 instructions; Acker, *Income Taxation*, A-64 – A-75.

<sup>201</sup> See e.g. Publication 550; Publication 559, pp. 15-24 (Form 1041); Publication 925.

partnerships and S corporations, distributions from certain qualified plans, or self-employment income.

Estates and trusts, unless specifically exempted from the NIIT, have NIIT liability if they have undistributed net investment income and their adjusted gross income is over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year. For estates and trusts, the 3.8% NIIT tax applies to the lesser of (a) undistributed net investment income or (b) mount of AGI in excess of the dollar amount at which the highest tax bracket applicable to an estate or trust begins for the tax year. Estates and trusts report and pay NIIT on Form 1041.

#### *NIIT Trust Exemptions*

The NIIT does not apply to trusts (1) which are exempt from federal income taxes, (2) whose unexpired interests (present or future interests) are devoted to charitable purpose(s), (3) grantor trusts, (4) or trusts not classified as trusts for federal income tax purposes.<sup>202</sup>

#### **F. Reporting of Transfers on Schedule G and Life Interests**

Schedule G (of Form 706) is where the estate taxes are computed for transfers made by the decedent during the decedent's life, which are included in the decedent's estate under Code §§2035(a), 2036, 2037, or 2038.<sup>203</sup> Schedule G includes extensive instructions.<sup>204</sup>

A life interest is a retained estate in property, which the decedent holds until death, such as the right to live in a house, which has been given or sold to a relative.<sup>205</sup> A life interest transfer is a form of life estate *pur autre vie* (a French phrase meaning "for another's life"), to wit, a life estate based on another measuring life.<sup>206</sup> If the decedent transfers her life estate to her husband, her husband then has a life estate in the property measured by the deceased wife's lifetime.

Life interest transfers are reported on Schedule G according to the Form 706 instructions.<sup>207</sup> Three data points about each transfer need to be reported: (1) the type of transfer, (2) the transfer date, and (3) the amount or value of the transferred property.<sup>208</sup> A transfer by trust or otherwise which removes property from the decedent's gross estate should be reported by attaching a copy of the trust or transfer document to Schedule G.<sup>209</sup> Reportable transfer types include: (1) gift taxes for gifts within the last 3 years of the decedent's life (§2035(b)), (2) other transfers within the last 3 years of the decedent's life (§2035(a)), (3) transfers with retained life estates (§2036), (4) transfers taking effect at

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<sup>202</sup> Code §§170(c)(2)(B), 671-679, 1411(e)(2); Prop. Reg. §1.1411-3(b).

<sup>203</sup> Andres, *Kansas Probate Handbook*, §5.1.4(j).

<sup>204</sup> Form 1041 instructions, pp. 30-33.

<sup>205</sup> Black's Law Dictionary, 946; McGovern, *Wills, Trusts and Estates*, 353-356.

<sup>206</sup> Black's Law Dictionary, 1270.

<sup>207</sup> Form 706 instructions, pp. 26-28.

<sup>208</sup> Form 706 instructions, pg. 28. The amount or value of the transfer is usually the date of death value, unless an alternate valuation is elected under Code §2032.

<sup>209</sup> Form 706 instructions, pg. 28; see also Andres, *Kansas Probate Handbook*, §5.1.4(j).

death (2037), and (5) revocable transfers (§2038).<sup>210</sup> Special rules exist for valuing some transfers among family members.<sup>211</sup>

### **Conclusion**

We have explored various tax aspects of estates and trusts. Regardless of an estate or trust's size, careful tax planning is crucial for the fiduciary to satisfy the estate and/or trust's (or beneficiary's) best interests. Tax planning is crucial during the client's life and after the client's death via their estate and/or trust. Portability, various other tax elections, and/or allocating different credits and deductions could be appropriate or tax efficient in some cases for clients, but not in others. A fiduciary should make the decisions in consultation with an accountant and attorney to ensure optimal tax treatment.

Planning ideas are often once in lifetime opportunities, like withering leaves of grass or falling flower petals, leaving but memories as the seasons change.<sup>212</sup> We should serve clients by seizing beneficial opportunities, since as the poet Rudyard Kipling reminds us, these moments of possibility "vanish at the morning's breath!"<sup>213</sup>

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<sup>210</sup> Form 706 instructions, pp. 26-27.

<sup>211</sup> Form 706 instructions, pp. 27-28; Code §§2701-2704.

<sup>212</sup> *Isaiah* 40.8 and *Ecclesiastes* 3.1-8; Walt Whitman, *Leaves of Grass*.

<sup>213</sup> "Possibilities," in Rudyard Kipling, *Complete Verse* (Doubleday, 1989), 44. Rudyard Kipling (1865-1936) was the first English Nobel Laureate in 1907 and the youngest Laureate in Literature in history.