CHANGES AFFECTING THE PREPARATION OF THE INCOME TAX RETURN FOR A DECEDENT'S LIVING TRUST

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<u>Introduction</u>. The new 645 Election, California's new Uniform Principal and Income Act and new IRS regulations make significant changes in the preparation of the income tax return for a decedent's living trust.

Consider the situation of John and Mary, a California couple who hold most of their assets as community property inside a joint revocable living trust. On John's death, the trust language directs division among three trusts.

1. A By-Pass Trust, also known as a B trust or credit shelter trust
2. A trust that qualifies for the marital deduction
3. A grantor trust containing the survivor's share of the property. This trust is revocable by the survivor during her lifetime.

There may also be a probate estate comprising those assets which pass to the heirs by will or by the rules of intestate succession.

Several income tax returns need to be filed in the year of death. One reports the couple's income up to the decedent's death and the survivor's income thereafter. The other returns are for the probate estate, if any, and for one or more trusts. These report the after death income from the decedent's share of the property.

One way to prepare these returns is to treat the division of assets as occurring on the date of death and to nominee one half of the post death income to the surviving spouse and to nominee the other half *pro rata* among the subtrusts.

For example, if the decedent died in a year when the applicable exclusion amount was $650,000 and the couple's net worth was two million dollars, the assets and income might be divided as follows.

	Assets	Income
Survivor's Share	$1 million	50%
By-Pass Trust	$650,000	32.5%
Marital Trust	$350,000	17.5%

This approach is known as the "immediate creation" construct.

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An alternative construct is to imagine that the revocable living trust becomes a separate taxable entity on the date of death. The "administrative trust" requires its own EIN and allocates the trust's post death income, whether reported under the EIN of the decedent or of the surviving spouse, among the surviving spouse and the subtrusts.

These alternative approaches have advantages and disadvantages[2]. The immediate creation construct is understandable and simpler to implement whereas the administrative trust construct makes it possible to optimize the allocation of post death appreciation, losses and deductions among the surviving spouse and the subtrusts and it avoids the filing of returns for the subtrusts until such time as there are distributions.

The Taxpayer Relief Act of 1997 allows executor and trustee to elect under §645 of the Internal Revenue Code (IRC), to combine[3] the income from the probate estate with the income from the decedent's share of the revocable living trust on single return for income tax reporting. The 645 Election also allows a fiscal year, the deduction of certain losses and other benefits.

By making this election, the fiduciary is adopting, perhaps unwittingly, the administrative trust construct. This has the following implications.

1. A tax return must be filed for the qualified revocable trust for the year of death and possibly later years. The 645 election is attached to the initial return. There is no taxable income because the income credits and deductions are reported on the return for the estate.

   It is unclear whether the income is be reported on this return and then nomineed to the estate return or whether the income is reported directly on the estate return.

2. When the revocable trust is a joint trust, the administrative trust includes assets owned by the survivor. The trust is therefore treated as a partial grantor trust until such time as these assets are distributed.

   The return for a joint trust is easier to understand if supporting schedules report all of the income received by the trust after death and show the allocation between the decedent's share and the survivor's share.

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[2] §§3.02 - 3.06 in "California Trust Practice" by John A. Hartog and George R. Dirkes, Matthew Bender & Company, Inc., 2000.

[3] IRC §645 allows income and deductions for a "qualified revocable trust" to be determined according to the rules for an estate and to be reported on a common income tax return with the income and deductions of the estate, if any. California conforms.

Rev. Proc. 98-13 sets out the procedure for reporting the income from a qualified revocable trust. In essence, a statement is signed by the executor and by the trustee and is attached to the trust's initial federal and California returns referencing §645 and listing the EIN numbers for the estate and trust.

See also the newly proposed regulations "Election to Treat Trust as Part of an Estate," 65 Federal Register 79015-79024 (December 18, 2000.) These regulations would supercede Rev. Proc. 98-13.

In addition,

- The 645 election is attached to the initial return. This causes the decedent's share of the income, deductions and credits to be excluded from the trust's return and reported on the estate's return
- A grantor letter is also attached to the trust's return. This excludes[4] the survivor's (grantor) share of the income, deductions and credits.

Because of the 645 and grantor exclusions, there is no taxable income left to be reported by the administrative trust.

3. If one or the other subtrust is funded by a pecuniary formula, accounting income and post death gains and losses are not shared but flow exclusively to the residuary share[5]. This may cause income taxes and distributions to be allocated differently from the immediate creation construct.

   The administrative trust only receives a distribution deduction if there are distributions[6] to the subtrusts or to the beneficiaries of the subtrusts. Thus income might be trapped at the trust level even if the subtrusts require the distribution of income whereas there would be no income trapping using the immediate creation construct.

The 645 Election thus represents a hazard for advocates of the immediate creation approach in that the election could produce allocations of income, post-death appreciation and tax which were not anticipated when the trust was drafted.

Why Make the 645 Election? This election allows the fiduciary additional options with respect to certain losses, estimated taxes, S-corporation shareholdings, choice of year end and charitable contributions[7].

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[4] IRC §§671-678 and California Rev & Tax §17731.

[5] In §10.7 of CEB's "Drafting California Revocable Living Trusts", 2000 edition, Marc Stern advises "Because the marital (or in §10.31 by-pass) gift is a pecuniary amount under the formula, it will not share in the trust income earned during the period of administration following the deceased spouse's death, unless the instrument affirmatively provides that the pecuniary amount be treated as a residuary bequest solely for the purpose of allocation during the administration or predivision period." Mr. Stern is likely basing this view on Prob C §§16340 and 12006.

[6] Bruner vs. Commissioner, 3 TC 1051 (July 4, 1944.) The court held that the obligation to pay accounting Income is an obligation of the subtrusts and not an obligation of the estate. In effect, an executor may make a distribution, and receive a deduction under IRC §162(c), but an executor is not entitled to a deduction under §162(b) if income is not distributed.

A corollary is that the income is taxed to the beneficiary if it is distributed in the same tax year as received by the administrative trust but that the income is taxable to the administrative trust, and received by the beneficiary tax paid, if the distribution is delayed to a subsequent tax year.

[7] "Internal Revenue Code Section 645. Post-Mortem Election to Treat Revocable Trust as Part of an Estate" by James R. Chisholm and William Finestone, 51st Annual Institute on Federal Taxation, USC Law School, January 1999. Available from the Versa-Tape Company, Pasadena, CA.

- An estate is allowed a limited deduction for rental losses under the active participation rules for taxable years within two years of death. A trust is not.
- An estate can recognize loss when distributing property in satisfaction of a pecuniary bequest[8]. A trust cannot.
- An estate is exempt from estimated taxes for two years. A trust is not.
- An estate is a qualified S-Corporation share holder for a reasonable period after death whereas a revocable trust is a qualified shareholder for only two years.
- An estate is allowed to elect a fiscal year end. Trusts must use a calendar year.

  A fiscal year delays the initial income tax reporting and tax payment. This can produce savings because of the time value of money. Extra time can also be a convenience when death occurs late in the year.
- An estate is entitled to a charitable deduction for income permanently set aside for charities. A trust is only allowed a deduction for an actual distribution.
- Certain trusts must recognize annual appreciation in an annuity contract as ordinary income[9]. An estate is exempt.

The 645 election requires the consent and cooperation of the executor of the probate estate and an agreement on how any income tax liability is to be apportioned. Thus the election should not be considered unless relations are congenial.

The election is irrevocable and automatically terminates on the earlier of the date when the assets are distributed or the end of the tax year ending no later than six months after the final determination of federal estate tax liability. As discussed by Chisholm and Finestone, *op. cit.*, the meaning of the phrase "final determination" is unclear and the election might terminate before all of the assets are distributed.

Allocation of Income and Deductions. Trusts and estates are allowed a deduction for taxable income distributed to the beneficiaries. The deduction is related to the smaller of the amount distributed or the Distributable Net Income (DNI.)

DNI measures the taxable and tax exempt income that could, potentially, be distributed to the beneficiaries. An operational definition is that DNI equals the taxable and tax exempt receipts allocated to Income plus any ordinary

[8] IRC §267(b)(13). Both estates and trusts recognize gains on pecuniary distributions.

[9] IRC §72(u).

income, such as IRD, which is allocated to Principal less all deductible expenses. Occasionally, capital gains and losses are included in DNI.

To ensure the equitable allocation of taxable income, DNI and distributions must[10] be accumulated separately for each "share."

The regulation includes a definition of a separate share. To cut to the quick, the By-Pass and marital deduction trusts are separate shares and the survivor's grantor trust is probably a third share.

Receipts and disbursements from the living trust or from the probate estate, if any, are first allocated between the decedent's and survivor's shares. The decedent's allocation is subsequently divided among the share belonging to the By-Pass Trust and the share or shares which qualify for the marital deduction.

RECEIPT or DISBURSEMENT ⟹ **SURVIVOR'S SHARE**

⇓

DECEDENT'S SHARE ⟹ **Marital Deduction Trust** and/or **Surviving Spouse**

⇓

By-Pass Trust

The taxable income and deductions associated with these receipts and disbursements are generally allocated among the shares in proportion to the accounting income received by each share[11]. IRD is allocated among all shares in proportion to relative share value.

If the trust does not specify a procedure for allocating accounting income among the separate shares during administration, the default is state law.

In California,

1. If a beneficiary receives a specific item of property, the beneficiary is allocated the fiduciary accounting income (for tax, read DNI) traceable to the property[12]. A devise where the beneficiary gets the Income is treated as a separate share.

   If the trust document denies the beneficiary the Income from the specifically devised property, the devise is not treated as a separate share.

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[10] Reg. 1.663(c), December 28, 1999.

See also Key Issues 17G, 18A and 18B in PPC's "1041 Workbook" and "New Separate Share Regulations Have Substantial Impact on Postmortem Estate and Qualified Trust Administration" by Jerry A. Kasner, *CEB Estate Planning & California Probate*, **22**(1), August 2000.

[11] Reg. 1.663(c)-2(b)

[12] Prob C §§16340(a) and 12002

2. Interest on a delayed pecuniary bequest is paid from accounting income[13].

   Even when a formula pecuniary bequest gets no Income, it is still treated as a separate share[14].

3. Any remaining accounting income (for tax, any remaining DNI) is allocated among the remaining beneficiaries in proportion to their relative ownership of the "undistributed principal assets, using values as of the distribution dates and without reducing the values by any unpaid principal obligations[15]."

   This is the statutory provision that excludes a pecuniary subtrust from sharing in income and expenses during administration.

   Allocating accounting income by relative fair market value is a change[16]. Prior California law had based the allocation on relative inventory values.

The Hubert Regulations. Following its defeat at the US Supreme Court, the IRS clarified the regulations[17] related to the allocation of expenses between the marital and non marital shares for estate tax purposes. These "Hubert regulations" also impact the preparation of the Form 1041.

The allocation of liabilities as of the date of death affects the relative FMV of the assets allocated to each share, given that the net worth of each share is fixed. The relative FMV of each share's assets affects the allocation of accounting income during administration.

For example, allocating a $100,000 liability to a by-pass share worth $650,000 necessarily increases the assets allocated to this share by $100,000 or by about 15%. In turn, this increased relative FMV means that 15% more accounting income and DNI are allocated to the by-pass share.

Consistent with the Hubert regulations, estate transmission expenses[18] and the decedent's separate debts and receivables should be allocated to the by-pass share. The decedent's share of community debts and receivables should be allocated between the by-pass and marital deduction shares, and the survivor's separate and community debts and receivables should be allocated to the survivor's share.

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[13] Prob C §§16340(b) and 12003. Interest is required from one year after the date of death.

[14] Reg. 1.663(c)-4(b)

[15] Prob C §§16341 and 12006

[16] "Staff Report: 2000 California UPIA," California Law Revision Commission, www.clrc.gov, p. 26.

[17] Reg. 20.2056(b)-4

[18] Estate transmission expenses relate to the Form 706 and to transferring John's share of the assets to his beneficiaries. In California, funeral and last illness expenses are the decedent's separate debts.

Estate management expenses are generally deductible[19] on the Form 1041 or on the Form 706. There is no tax benefit from taking these expenses on the Form 706 unless there is a taxable estate.

However, the Hubert regulations require that management expenses attributable to the non marital share must be taken on the Form 706 if they would otherwise be paid from the marital share.

- Management expenses may be taken on the Form 1041 when the marital deduction subtrust is funded by a pecuniary formula. All expenses are either offset by receipts belonging to the non marital share or paid from the non marital share. See Example 7 in the regulations.
- The regulations do not address a marital share funded by a residuary formula where the usual California procedures would cause disbursements during administration to be paid from the marital share. There does not appear to be a conflict with the Hubert regulations because California law does not attribute any management expenses to the non marital share in this situation.

A concern is that the IRS might insist that, when the estate is divided by a pecuniary by-pass/residual marital formula, some expenses must be attributed to the non marital share even though local law would not attribute any expenses to a non marital pecuniary share. The regulations only address the meaning of the phrase "expenses not attributable to the marital share" in the context of a specific devise.

This concern was sparked by the AICPA's April 19, 1999 response to the proposed regulations. The proposed regulations "would effectively replace state law principal and income acts with a federal standard ...." [20] In the final regulation, the IRS acknowledges and does not deny this result.

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[19] An estate is allowed a Form 706 deduction for necessary expenses during administration and payment may also qualify as an income tax deduction. Illustration 12-1 in PPC's "1041 Deskbook" summarizes what can be deducted where.

When expenses are deductible on the Form 706 or Form 1041, the assumption is that the deduction will be taken on the 706. If the fiduciary deducts expenses on the Form 1041, an irrevocable election, described in Reg. 1.642(g)-1, is required.

[20] See David E. Lajoie, "Fiduciary Income Tax Issues, Appendix E," *1999 Estate Planning Conference,* California CPA Foundation.

The proposed regulation §20.2056(b)-4(e)(2)(i), see *Federal Register* on December 16, 1998, says "For marital deduction purposes, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of any estate management expenses incurred in connection with property that passed to a beneficiary other than the surviving spouse ***if a beneficiary other than the surviving spouse is entitled to the income from the property*** and the expenses are charged to the deductible property interest which passed to the surviving spouse (emphasis added.)"

The italicized language, which is consistent with the allocation of expenses by California Probate Code §16430, was deleted from the final regulations. This change may signal that the IRS intends that a portion of the management expenses be attributed to a non marital pecuniary share even when this is not consistent with state law.

Approximate Separate Share Treatment. The changing allocation factors required by the Separate Share Rule force a sophisticated computational method which can involve hundreds of journal entries for even an uncomplicated administration. Therefore, it is to be hoped that the IRS will not challenge approximate methods when the errors are not material.

In the present circumstance, all taxable income is reported on the personal return of the surviving spouse. A modest shift in DNI caused by an approximate allocation method would neither change nor reallocate the tax burden.

The allocation method needs to be reasonable, equitable and impartial[21]. The practitioner should consider the method laid out in the California Probate Code as only one possibility and should not dismiss less expensive methods simply because they happen to be approximate.

Miscellaneous Expenses. Investment planning fees are deductible on individual returns subject to 2% of AGI.

It has been argued that such fees are ordinary administrative expenses on a trust return, not subject to the 2% limitation, since such fees would not have been incurred except that the property was held in trust. This is relevant in California since the Prudent Investor Act practically forces the non professional trustee to seek investment advice. The Sixth Circuit agreed with this argument in O'Neill but the Court of Federal Claims vigorously disagreed in Mellon Bank[22]), a Pennsylvania case.

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[21] Reg. §1.663(c)-2(c). Computations and valuations. For purposes of calculating distributable net income for each separate share, the fiduciary must use a ***reasonable and equitable*** method to make the allocations, calculations, and valuations required ... (emphasis added.)

Prob C §16335(b). In exercising a discretionary power of administration regarding a matter within the scope of this chapter, ... the fiduciary shall administer the trust or decedent's estate ***impartially*** .... (emphasis added.)

[22] O'Neill v. Comm., 994 F.2d 302 (6th Cir. 1993); Mellon Bank NA et al. v. U.S., 86 AFTR2d Par. 2000-5081 (2000).