The Income Tax Return for an Administrative Trust

with Peter James Lingane, EA, CFP

John and Mary own their assets in a living trust in equal shares. John dies and the trustee reports the post death income by filing a return for an interim "administrative trust[1]." The trustee also elects under IRC §645 to have the administrative trust taxed as if the trust assets were part of the probate estate.

The 645 Election

§645 allows a "qualified revocable trust" to be taxed as part of the decedent's estate. A qualified revocable trust is defined as comprising those trust assets which the decedent could have retitled in his or her name before death.

The election provides several advantages, including the opportunity to elect a fiscal year. The election procedure is laid out in Prop. Reg. 1.645-1, Dec. 18 (19?), 2000.

> If a couple's living trust allows either grantor to revoke the entire trust, should the entire trust be treated as an estate during the administrative period, or does the qualified trust include only the decedent's share of the trust assets?
>
> The qualified trust probably includes only the decedent's share.
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> The effect of reporting only the decedent's share according to the rules for an estate means that the survivor's share of the income is reported in the calendar year realized whereas the decedent's share is reported in the following year if the estate chooses a

Allocation Between the Survivor's Share and the Decedent's Share.

The key to preparing the return for an administrative trust, indeed the key to preparing most trust returns, is to understand the allocation of the trust's income and expenses.

The administrative trust is usually a partial grantor trust because the Survivor has the right to do whatever he or she wants with their share of the assets. Neither Lacerte nor ProSystems *fx* software include an option to treat part of a trust by the grantor trust rules but a work around is not difficult[2] if the tax professional separately prepares an allocation of the receipts and expenses.

The share allocated to the survivor's assets is taxed according to the rules for individuals. The balance is allocated to the decedent and is taxed according to the rules for trusts, or for estates if the trustee makes the 645 election.

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[1] A probate estate, and a By-Pass or QTIP Trust after the death of the income beneficiary, are other examples of an administrative trust.

[2] Example 5, "The Income Taxation of Trusts" at www.lingane.com/tax/seminars/taxing_trusts00.pdf.

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Our example assumes that a total of $30,000 was received between death and the end of the tax year. This was $20,000 in interest and ordinary dividends and $10,000 in capital gain distributions. The expenses are $500 for tax preparation.

We have simplified this example by assuming that no income or expenses were accrued as of the date of death[3] and that the trustee elected to share each receipt and disbursement equally[4] between the survivor's and decedent's shares.

As shown in the following table, one half of each item is reported by the survivor on their Form 1040. The decedent's share of each item is reported on the trust's 1041.

No Distributions	Amount	Survivor's Share	Decedent's Share
Interest, Dividends	$20,000	$10,000	$10,000
CGD	$10,000	$ 5,000	$ 5,000
Tax Preparation	$500		$250
Misc., 2% of AGI		$250	

Tax preparation is a deductible expense to the administrative trust but it is an itemized deduction subject to 2% of AGI (and AMT) on the survivor's 1040.

What other items of income and expense are treated differently on the 1040 and 1041?

Allocation of Receipts and Expenses During Administration[5]

A bequest can be for specific property ("one hundred shares of IBM stock") or for a pecuniary amount ("$10,000" or "that amount which is determined by ....") or for the residue ("the remainder of my estate shall be divided among ....")

A specific bequest receives the specified asset plus income less expenses from the date of death directly attributed to that asset. The beneficiary who receives the IBM stock also receives the post death portion of any dividends and pays any brokerage fees and tax liability.

A pecuniary bequest includes nothing beyond the pecuniary amount. If payment is delayed beyond twelve months, interest is paid on the bequest. If a bequest is for

[3] Income and expense accrued as of death are not included in accounting income with the result that any tax liability is normally paid by the administrative trust.

[4] In general, the trustee will allocate the trust assets so that, in aggregate, one half of the total value is allocated to the survivor and one half to the decedent. For example, if the trust included a $500,000 home and $500,000 in stocks and bonds, the home might be allocated to the survivor's share and the stocks and bonds to the decedent's share.

Income and expenses are traced to the asset allocation. Thus mortgage interest and real estate tax related to the home would appear on the survivor's tax return and the interest, dividends, gains and expenses related to the investment portfolio would appear on the administrative trust's 1041.

[5] California Probate Code §§16345-16347. These rules are modified by any instructions in the trust.

$10,000, and this amount is paid eleven months after death, the heir receives $10,000, period. Any tax liability[6] is paid by the administrative trust.

Since trust expenses and income taxes, including interest paid on a pecuniary bequest, reduce the residue due to the residuary beneficiaries. it is fair to say that expenses during administration are paid by the residuary beneficiaries.

Since California living trusts usually include a pecuniary/residuary formula[7], income and expenses and taxes during administration will commonly not be shared among the decedent's beneficiaries but will be paid from the residuary share.

Allocation of Taxable Income Among the Trust and the Decedent's Beneficiaries

If there are no distributions, or if the only distributions are to pecuniary beneficiaries, any income tax is paid by the administrative trust[8]. If $10,000 is distributed to the pecuniary beneficiary, taxable income is allocated as follows.

	Amount	Survivor's Share	Pecuniary Beneficiary	Residuary Beneficiary	Administrative Trust
Interest, Dividends	$20,000	$10,000			$9,750
CGD	$10,000	$ 5,000			$ 5,000
Tax Preparation	$500				
Misc., 2% of AGI		$250			

In order to shift taxable income, there must be distributions to the residuary beneficiaries. In order to shift capital gains, there must be distributions to the residuary beneficiaries and the trust must authorize the distribution of gains.

The amount of shifted income depends on the size of the distribution. If the distribution exceeds DNI[9] and the trust says nothing about distributing gains,

Distribution Exceeds DNI	Amount	Survivor's Share	Pecuniary Beneficiary	Residuary Beneficiary	Administrative Trust
Interest, Dividends	$20,000	$10,000		$9,750	
CGD	$10,000	$ 5,000			$ 5,000
Tax Preparation	$500				
Misc., 2% of AGI		$250			

[6] If an appreciated or IRD asset is distributed in fulfillment of a pecuniary bequest, the administrative trust must recognize the appreciation or IRD income. An estate, or an administrative trust which elects to be treated as an estate, recognizes a loss in fulfillment of a pecuniary distribution.

[7] Jackie Patterson estimated that 90% of California living trusts are drafted with some kind of pecuniary formula in her remarks to the California CPA Foundation's "2001 Estate Planning Conference" on July 19th. We will neglect non pecuniary (fractional) funding formulas.

[8] The "separate share rule" requires separate accounting for taxable income distributed to each class of beneficiaries. Excess distributions to one class do not carryout DNI allocated to other beneficiaries. Reg. 1.663(c)-1 through 1.663(c)-6, *Federal Register* **64** (248) 72540-72545, December 28, 1999.

[9] DNI is calculated on Schedule B of Form 1041. In this example, DNI is $9.750 which is the algebraic sum of the decedent's share of the interest, dividends and tax preparation fee.

The taxable income shifted to the beneficiaries is net of deductible trust expenses.

In the termination year, all income and gains (and losses, NOLs, excess deductions et cetera) are shifted to the residuary beneficiary.

Termination Year	Amount	Survivor's Share	Pecuniary Beneficiary	Residuary Beneficiary	Administrative Trust
Interest, Dividends	$20,000	$10,000		$9,750	
CGD	$10,000	$ 5,000		$ 5,000	
Tax Preparation	$500				
Misc., 2% of AGI		$250			

What if the Beneficiaries are Trusts?

California trusts are not operational until funded. Thus instructions to "pay $1,000 a month" or to "pay all income" are not operative until the trust is funded[10]. Unless the document addresses distributions during administration, which is uncommon, the only authorized payment during administration is interest on pecuniary bequests when distribution is delayed by more than a year.

An interim distribution of principal may be necessary to ease cash flow difficulties.

When John and Mary are Husband and Wife

A married California couple will usually create a By-Pass Trust at the first death and will fund this trust with as much of the decedent's gross estate as is possible without paying federal estate tax. The tax free amount is $675,000 in the current year assuming no prior taxable gifts.

The balance of the decedent's estate commonly passes to the surviving spouse either outright or in the form of a QTIP trust.

> Observation. Since the newly increased applicable exclusion amounts reduce the amount of estate taxes saved by the typical California estate plan, we are likely to see more decedents leaving their assets to the surviving spouse free of trust.

In the termination year, the administrative trust distributes the decedent's share of the accounting income and gains to the Residuary Trust. The Residuary Trust, whether that be a QTIP or By-Pass Trust, typically distributes the accounting income to the surviving spouse. The overall effect of these cascading distributions is often that the decedent's share of the gains are reported on the Residuary Trust's 1041 and everything else is reported on the surviving spouse's 1040.

[10] This is illustrated in Bruner vs. Commissioner, 3 TC 1051 (July 4, 1944) where 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 trust and received by the beneficiary tax paid if the distribution is delayed to a subsequent tax year.

Termination Year	Amount	Survivor's Share	Decedent's Share	Residuary Trust 1041	Survivor's 1040
Interest, Dividends	$20,000	$10,000	$9,750		$19,750
CGD	$10,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000
Tax Preparation	$500				
Misc., 2% of AGI		$250			$250

How much money does each entity receive in this example?

- The pecuniary trust receives the pecuniary amount, period.
- The residuary trust receives the rest of the decedent's assets net of all gains, losses, receipts and expenses which are allocated to the decedent's share.

  The residuary trust pays the accounting income to the income beneficiary.
- The surviving spouse receives their share of the assets, receipts and expenses plus, generally, the accounting income from the residuary trust. In this example, the surviving spouse receives one half of the assets plus $19,750.

Hubert Regulations[11]

The Supreme Court decided in Commissioner *vs.* Hubert (1997) that expenses such as the fee to prepare the Form 706 or probate fees, which would not have been incurred but for the decedent's death and the subsequent "transmission" of the decedent's assets to the heirs, are not deductible on the administrative trust's 1041.

Expenses which relate to "management" of the decedent's assets during administration can be deducted on either the 706 or the 1041. Traditionally, these expenses have been claimed on the 1041 in a no tax estate because claiming the expenses on the Form 706 provides no tax benefit.

The IRS's view is that charging non marital management expenses against the marital share effectively reduces the marital share and therefore only a smaller marital deduction is allowed on the Form 706. Since California allocates all expenses to the marital share when the trust includes a pecuniary by-pass/residuary marital formula, there is a risk that paying all administrative expenses at the trust level could save income taxes but cause a larger estate tax.

I say "could" because the IRS provides no pecuniary by-pass/residual marital example in the regulation and does not define the word "attributable." It would be great if we could look to state law but the IRS asserts that some expenses must be allocated to each asset, then those expenses "attributable" to a non marital pecuniary will have to be claimed on the Form 706. Stay tuned.

[11] §20.2056(b)-4, *Federal Register* **64**(232) 67763-67767, December 3, 1999.

Formalities Matter With Hostile Beneficiaries

We have seen that the surviving spouse will generally report most of the income and deductions if he or she is the income beneficiary. This is probably how the personal return would have been prepared if the tax professional had not performed the allocations discussed above. Skipping the formalities means, in many situations, nothing worst than having the By-Pass or the QTIP trust pay some tax that should have been paid by the other. This is seldom a big deal when the same beneficiaries are common to the By-Pass and QTIP Trusts.

But the formal allocation of receipts between the By-Pass and QTIP Trusts can matter when someone other than the surviving spouse is the income beneficiary or when the remainder beneficiaries are different, especially if the numbers are large and the beneficiaries are hostile.

Additional Information

Peter James Lingane, "Changes Affecting the Preparation of an Income Tax Return for a Decedent's Living Trust," *The California Enrolled Agent*, April 2001 and references therein.

Jacqueline A. Patterson, "Post Death Distribution and Trust Administration - What's New?", 2001 Estate Planning Conference, California CPA Education Foundation, July 2001.

David B. Gaw, "A Practical Workshop on Trust Administration of the Living Trust," California CPA Education Foundation, updated annually.

"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.

For a reference covering other aspects of trust taxation, see PPC's "1041 Deskbook."

For a comparison of the administrative trust vis-a-vis the immediate creation construct, see "California Trust Practice" by John A. Hartog and George R. Dirkes, Matthew Bender & Company, Inc., 2000, §§3.02 - 3.06.