INCOME TAX RETURN FOR A DECEDENT'S LIVING TRUST

by Peter James Lingane

Synopsis. This article illustrates the preparation of the income tax return for a California revocable living trust at the death of the first spouse. Particular attention is paid to California's Principal and Income Act, effective January 1, 2000, the Separate Share Regulations, effective December 28, 1999, the 645 Election, effective August 6, 1997 and the Hubert Regulations, promulgated December 3, 1999.

The 645 Election treats a decedent's qualified revocable trust as an estate for income tax purposes. This allows a fiscal year, the deduction of certain losses and additional benefits.

By this Election, the fiduciary adopts the concept of an interim administrative trust. This means that the by-pass and marital deduction subtrusts do not file tax returns until funded.

Another consequence is that a pecuniary formula subtrust does not share in the income or in the appreciation or market risk prior to funding. The residuary share pays most of the expenses and income taxes and is allocated all earnings, gains and losses.

The Hubert Regulations may require that certain expenses be paid from a pecuniary non marital share during administration even though these expenses would not be allocated to a pecuniary share under state law.

The 645 Election puts a premium on distribution planning since an administrative trust is only entitled to a deduction if income is actually distributed, even if the subtrusts require distribution of income currently. Thus the decision to make or withhold a distribution can shift the income tax liability from one subtrust to the other.

If the fiduciary elects to treat the decedent's living trust as a separate administrative entity for tax purposes, it is implausible for the fiduciary to also claim that the subtrusts exist from the date of death. The 645 Election thus represents a hazard for advocates of the immediate creation construct in that the allocations of income, post-death appreciation and tax may differ from what was anticipated when the trust was drafted.

Separate share calculations for allocating DNI are burdensome. It is hoped that the IRS will not challenge reasonable approximations.

Acknowledgement. This analysis benefited from discussions with David B. Gaw and Michael C. Ferguson, for which I am grateful. These gentlemen do not necessarily agree with all of the conclusions herein and all errors and omissions are my own.

Disclaimer. This article was prepared for educational purposes and to stimulate professional discussion. Please advise of errors and alternate interpretations.

I am not qualified to provide legal advice. Nothing herein should be construed as such.

Accuracy is not guaranteed. Your professional responsibility is to confirm my interpretations with primary sources and legal counsel before application to a real situation.

Peter Lingane is licensed as a tax professional or "Enrolled Agent" by the federal government and as a planning professional by the Certified Financial Planner Board of Standards. His Lafayette, California practice emphasizes planning and compliance for individuals, trusts and estates. Peter can be reached at (925) 299-0472 or online via www.lingane.com/tax.

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The Administrative Trust Construct. The gross estate for federal purposes includes everything owned or controlled by the decedent. If the executor and trustee so elect under §645 of the Internal Revenue Code, that part of the gross estate which passes to the heirs by will, by intestate succession or by the terms of a qualified revocable trust are combined[1] into a single administrative trust for income tax reporting.

The administrative trust includes the decedent's life insurance, IRAs and pensions when the estate or revocable trust is named as the beneficiary.

When the revocable trust is a joint trust, the administrative trust includes assets owned by the survivor. The administrative trust is therefore treated as a partial grantor trust until such time as these assets are distributed. While uncommon, the surviving co-trustor need not be the decedent's spouse.

A common California estate plan is for the assets of a married couple to be divided at the first death among a By-Pass Trust, also known as a B trust or as a credit shelter or exemption trust, a trust qualifies for the marital deduction, and the survivor's revocable grantor trust.

Receipts and disbursements from the qualified revocable trust or from the probate estate, if any, are first allocated between the decedent's and survivor's shares.

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

⇓

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

⇓

By-Pass Trust

The decedent's share is subsequently allocated between the share belonging to the By-Pass Trust and the share or shares which qualify for the marital deduction.

Taxable income, other than IRD, credits and deductions, are allocated to the subtrusts and probate estate, if any, during the period of administration in proportion to the net fiduciary accounting income (FAI) allocated to each share. IRD is allocated by a special procedure as will be discussed.

The fiduciary is guided in the allocation between Income and Principal by what the trust says and, where the document is silent, by state law. Broadly speaking, interest and dividends and net business income are Income while IRD and gains and losses are Principal. The decedent's debts are paid from Principal and post death expenses are shared between Income and Principal.

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[1] 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 a combined income tax return. Essentially, a statement signed by the executor and by the trustee is attached to the estate's initial federal and California tax returns referencing §645 and listing the EIN numbers for the estate and the administrative trust.

Trusts and estates are allowed a deduction for taxable income distributed to the beneficiaries. This income distribution deduction is related to the smaller of the amount distributed or Distributable Net Income (DNI.) To ensure the equitable allocation of taxable income, the Separate Share Rule[2] requires that DNI and the amount distributed be accumulated separately for each beneficiary.

DNI measures the taxable and tax exempt income that could, potentially, be distributed to the beneficiaries. An operational definition of DNI is the taxable and tax exempt receipts allocated to Income plus any ordinary income such as IRD which is allocated to Principal, less all deductible expenses. Occasionally, capital gains are included in DNI.

Fiduciary accounting allocates receipts and disbursements between Income and Principal. Tax accounting allocates reportable income and deductible expenses between the trust and its beneficiaries. DNI differs from FAI because of differences in reportable income and expenses. DNI also considers all deductible expenses whereas FAI is not reduced by those expenses which are allocated to Principal.

Court accountings[3] track both Principal and Income. Transactions which do not affect the Income account are not relevant for income tax purposes. Thus the bookkeeping can be less comprehensive if there is no court accounting.

The funding decision must usually be delayed until date of death asset values are re-evaluated on the alternate valuation date and until the trustee has an opportunity to weigh income and estate tax effects. This delay means that the tax preparer will have to repeat the allocation of income and expenses. Consequently, it is prudent to set up the bookkeeping so that it is not labor intensive to repeat the calculations after the trustee determines the final asset allocations.

Comparison to the Immediate Creation Alternative. California fiduciaries often prepare income tax returns by treating the subtrusts as if they were funded on the date of death. There are advantages and disadvantages as compared to the administrative trust approach[4]. There can also be differences in tax liability and in the allocation of accounting income and tax liability.

If the subtrusts are created at death, accounting income prior to formal funding is shared among the subtrusts. Thirty five percent of the income from a million dollar estate might be allocated to a marital deduction trust, for example, with the rest flowing to a by-pass trust. Each subtrust files its own income tax return and is eligible for a deduction for income distributed or required to be distributed.

Since the subtrusts are treated as if the distribution date were the date of death, taxable income is never realized if assets appreciate before actual funding.

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[2] 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.

[3] Prob C §§1060-1064.

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

In contrast, if an administrative trust is responsible for the assets until the subtrusts are funded, the administrative trust files an income tax return and the subtrusts do not. California statutes and case law make clear that the income beneficiaries are entitled to accounting income during administration unless the documents say otherwise[5]. The fiduciary therefore must allocate accounting income between the subtrusts. The administrative trust receives a deduction only if there are distributions[6] to the subtrusts or to the beneficiaries of the subtrusts.

When the subtrusts are funded by a fractional formula, accounting income prior to funding is shared between the subtrusts under both the immediate creation and administrative trust constructs.

The result is different when one or the other subtrust is funded by a pecuniary formula. Accounting income is shared under the immediate creation approach but flows only to the residuary share[7] with an administrative trust. If a million dollar estate is distributed between a pecuniary marital trust and a residuary by-pass trust, the administrative trust approach means that no accounting income prior to funding belongs to the surviving spouse unless he or she is a beneficiary of the by-pass trust.

The administrative trust approach therefore allows the trust document to be drafted to allocate tax liability prior to funding to either the by-pass or martial

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[5] Prob C §16345 says that an income interest begins on the date of death if the subtrust is created by a will or if, as with a subtrust created from a revocable living trust, the subtrust succeeds to the income interest of the decedent even if there is an intervening period of administration.

This statute, and Prob C §12005, reflect California case law going back seventy-five years. In re Estate of Dare (235 P. 725, 1925), the California Appeals Court held that the beneficiary was entitled to income from the date of death since the testatrix intended the bequest "should constitute in effect a bequest for the maintenance of her adopted daughter." This case also enunciates the need for the executor to allocate disbursements between Income and Principal and anticipates the adoption of California's first Principal and Income Act sixteen years later.

[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 trust and received by the beneficiary tax paid if the distribution is delayed to a subsequent tax year.

[7] 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.

See also §3.06[1], "California Trust Practice," *op. cit*. "Income earned during administration is allocated to the residue except for net income earned from property specifically devised and interest due on delayed distribution of pecuniary gifts." §3.04[2][a] is directly on point. "The trustee may find that the estate planner has drafted the trust instrument in a manner which effectively compels use of the administrative trust. The most obvious example involves a plan providing for a pecuniary marital deduction gift and using the proper delay in actual funding *to permit the bypass trust to benefit from the asset appreciation and income of the entire trust* (emphasis added.)"

shares and to either protect the by-pass share from market depreciation immediately after death or to insure that market gain - and risk - accrues to the by-pass share.

An administrative trust tends to accelerate income tax because the trust does not receive a deduction for undistributed income and because taxable income is realized when appreciated property funds a pecuniary subtrust.

If the fiduciary elects to treat the decedent's revocable living trust as a separate administrative entity for income tax purposes under IRC §645, it is implausible for the fiduciary to also claim that the subtrusts exist from the date of death. Thus the 645 election 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 administrative trust additional options with respect to certain losses, estimated taxes, S-corporation shareholdings, choice of year end and charitable contributions[8]. For example,

- 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[9]. 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 first income tax reporting and the initial 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.

  The assumption herein is that the survivor's grantor trust must report its allocated income on a calendar year basis.
- 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[10]. 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

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[8] "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.

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

[10] IRC §72(u).

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 last 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. The probate estate might still be open and assets undistributed due to litigation or other reasons on the date that the 645 election terminates.

Allocations as of the Date of Death. The first steps in preparing the income tax return for an administrative trust are to determine the value of the decedent's taxable estate, the net values of the administrative trust and probate estate, if any, and the net values of the Decedent's and Survivor's Shares of the administrative trust/probate estate.

An important consideration in valuing the decedent's share of the administrative trust is whether each community asset is to be split down the middle *pro rata* or allocated item by item so that the aggregate allocated to the Decedent's Share equals the aggregate allocated to the Survivor's Share.

When the decedent's estate is mid-sized and there are substantial community assets outside the control of the administrative trust, the aggregate theory of community property may allow more money to the By-Pass and marital deduction trusts. This can reduce future estate and GST tax liabilities.

Ideally, the spouses have executed an aggregate agreement pursuant to California Probate Code 100. It is unresolved whether a non pro rata allocation is valid in the absence of a written agreement. If invalid, a non pro rata allocation of IRD assets represents a sale and repurchase which triggers an income tax liability[11].

This is more than a theoretical possibility[12] since the IRS initiated, but later dropped, audits on just this issue in Northern California a half dozen years ago.

Be sure that the trustee understands the issues surrounding the allocation of community property. Document the trustee's decision!

John and Mary will serve as the married couple in our example. As shown in the table, the total value of John and Mary's assets as of John's death is $1,771,000.

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[11] Example 18A-10 in PPC's "1041 Workbook" illustrates the serious income tax implications that a non-pro rata distribution can have. See also

Jerry A. Kasner, "Community Property Interests in Retirement Plans: Some Interesting Developments," **2**(4) *Cal Tr. & Est. Q.*, Winter 1996

Steven E. Trytten, "Aggregate Theory Agreements: Don't Get 'Bogg'ed' Down", **5**(3) *Cal Tr. & Est. Q.*, Fall 1999

Edward V. Brennan, "Practicalities of Post-Mortem Distribution Planning for Community Property Retirement Benefits and IRAs-Trusts as Beneficiaries, Separate Shares and Aggregate Theory Agreements," **5**(4) *Cal Tr. & Est. Q.*, Winter 1999

[12] "A Practical Workshop on Trust Administration of the Living Trust," David B. Gaw, California CPA Education Foundation, 1999, p. 64.

Everything is community property[13] and therefore the decedent's share is $885,500.

	Value	Estate/Admin Trust	Outside Admin Trust
Cash	50,000	50,000	
Marketable Securities	400,000	400,000	
Limited Partnership (JT)	50,000	50,000	
Real Estate			
Residential Rental	500,000	500,000	
Personal Residence	300,000	300,000	
Raw Land	50,000	50,000	
Personal Property	20,000	20,000	
Accounts Receivable			
Accrued interest, rents	1,000	1,000	
Life insurance	50,000	50,000	
IRAs, Other IRD	300,000		300,000
PV of pensions, annuities	50,000		50,000
Total	1,771,000	1,421,000	350,000
Less one half CP Share	<885,,500>		
Decedent's Share	885,500		

John's interests in the partnership and in the life insurance form the probate estate. The partnership interest is distributed to the surviving spouse and the life insurance is distributed[14] to the administrative trust through the pour-over will. The IRAs and pensions are not part of either the estate or of the administrative trust since they pass directly to the surviving spouse via a beneficiary designation.

John and Mary's liabilities as of the date of John's death are shown in the next table. Funeral expenses, those administrative costs related to the filing of the 706 and transferring the assets to the beneficiaries and the cost of John's last illness are his separate debts[15]. The other liabilities are community obligations.

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[13] The attorney probated the partnership as a specific devise after concluding that it was community rather than joint tenancy property. See Estate of Wayne-Chi Young, 110 TC 24, for a discussion of some of the legal standards to be met to claim property titled as JT is really community property.

It is easy to argue community property for brokerage and bank accounts and for real estate purchased years ago but the argument is weakened if these accounts are not retitled after being advised to do so. Another no-no is for the surviving spouse to take title without a court order; that is, to treat the property as joint tenancy with right of survivorship rather than as community property.

California has a TOD for brokerage accounts and has recently adopted a CPWROS for real estate. The latter is effective for transfers after December 31, 2000.

[14] The estate is the beneficiary of the life insurance policy. The attorney will file a petition to effect these transfers under the expedited procedure authorized by section 13150 of the California Probate Code for probate estates which do not exceed $100,000.

[15] Funeral expenses are considered the decedent's separate debts in California. There can be an increase in estate tax if estate transmission expenses are allocated to the marital deduction share.

For more on estate transmission expenses, see IRS Reg. 20.2056(b)-4 published in the Federal Register December 3, 1999 (64 FR 232, pp. 67763-7).

The decedent's share of these liabilities is $80,775 and the survivor's share is $63,775.

	Liability	Decedent's Share	Survivor's Share
Funeral Expense	5,000	5,000	
Estate Transmission Expense	10,000	10,000	
Last Illness	2,000	2,000	
Federal Income Tax Liability (CP)	16,000	8,000	8,000
CA Income Tax Liability (CP)	4,000	2,000	2,000
Real Estate Tax Liens (CP)	6,000	3,000	3,000
Overpaid SS, Pension (CP)	1,500	750	750
Other Debts (CP)			
Utilities	50	25	25
Mortgage, 10 yr., 8% (CP)	100,000	50,000	50,000
Total	144,550	80,750	63,750

John's net share is worth $804,725 net of liabilities as of the date of death. The instructions in the living trust call for the By-Pass trust to be funded to the applicable exclusion amount. This is only possible if the Decedent's Share of the estate/administrative trust exceeds the applicable exclusion amount after distributing the decedent's half interest in the limited partnership.

The fundamental decision affecting the value of the Decedent's Share of the estate/administrative trust is whether each item of community property should be allocated half to each spouse. Allocating community property pro rata means that the Decedent's Share of the estate/administrative trust is $710,500, less $80,775 in liabilities.

	Net Equity	Estate/Trust	Outside	Liabilities
Decedent	804,725	710,500	175,000	<80,775>
Survivor	821,725	710,550	175,000	<63,775>
Total	1,626,450	1,421,000	350,000	<144,550>

After distributing the decedent's half interest in the limited partnership, there is not enough value left to fund the By-Pass Trust to the applicable exclusion amount ($650,000 at the time of John's death in 1999.)

If the allocation is based on the aggregate theory of community property, the Decedent's Share of the estate/trust is $885,500, less $80,775 in liabilities.

	Net Equity	Estate/Trust	Outside	Liabilities
Decedent	804,725	885,500		<80,775>
Survivor	821,725	535,500	350,000	<63,775>
Total	1,626,450	1,421,000	350,000	<144,550>

After distributing the decedent's half interest in the limited partnership, there is enough value left to fund the By-Pass Trust to the $650,000 exclusion amount and an additional $129,725 can go to a marital deduction trust where it will be forever free of GST tax.

After reviewing with counsel her authority to effect an aggregate allocation of community property even though there is no written agreement, Mary decides on an aggregate allocation.

The preparer now knows the date of death valuations for the By-Pass, marital deduction QTIP and Survivor's Trusts. The "Other" category includes the IRAs, pensions and limited partnership interest.

	Net Value	By-Pass	QTIP	Survivor's	Other
Decedent	804,725	650,000	129,725		25,000
Survivor	821,725			471,725	375,000
Total	1,626,450	650,000	104,725	471,725	400,000

Actual funding values will differ from the targets shown above because of market value changes between death and funding and because of receipts and disbursements during administration.

The subtrusts can be funded with property or with cash. The instructions might say that property used to fund the subtrusts is to be valued as of the date of death, with an equitable allocation of post death appreciation, or as of the date of distribution. When the document is silent, California law values distributed property as of the date of distribution[16].

Allocating Taxable Income During Administration. DNI is generally allocated in proportion to the accounting income allocated to each share[17]. IRD is allocated among all shares by 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[18]. 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.

   In the present example, the half interest in the limited partnership is being treated as a specific devise entitled to Income. It is a separate share.

2. Next, interest on a delayed pecuniary bequest is paid from accounting income[19], or from Principal if Income is not sufficient. Even when a pecuniary bequest gets no Income, it is still treated as a separate share[20].

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[16] Prob C §21118

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

[18] Prob C §§16340(a) and 12002

[19] Prob C §§16340(b) and 12003. Interest is required beginning one year after the date of death. The rate of interest is specified in Prob. C §12001.

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

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[21]."

   Allocating accounting income by relative fair market value is a change[22] from prior California law which had based the allocation on relative inventory values.

Applying the Allocation Formulas. There is no established practice as to how the allocations are to be performed. The fiduciary needs to choose solutions which are reasonable, equitable and impartial[23]. For example,

How does one allocate changes in fair market values among the shares? In the example, the changes were allocated pro rata. This produces the same result as an allocation based on inventory values.

How does one account for negative cash balances? In the example, negative balances were included in the computation of each share's fair market value.

How does one allocate year-end adjustments, such as the reduction in deductible expense for tax exempt income and 2% of AGI? Year-end distributions can play havoc when allocation factors are updated daily. For example, a beneficiary paid on Monday is not allocated any of the taxable gain realized when a pecuniary distribution is satisfied with appreciated property on Tuesday. The fiduciary must review the calculated allocation factors and should be prepared to substitute factors approximating the relative fair market values over a representative period.

How does one allocate receipts and disbursements to the grantor share? Allocate receipts and disbursements and realized gains and losses between the grantor and residuary shares by the relative fair market value procedure. Do not allocate any gain or loss to the grantor share when distributing property in satisfaction of a pecuniary bequest.

How is the value of the residuary share determined? The value of the residuary share is the fair market value of the decedent's share, which changes in response to market forces, receipts, expenses and distributions, less the pecuniary amount.

How does one allocate liabilities and receivables? The allocation of liabilities and receivables changes the relative fair market value of the assets allocated to each share given that the net worth of each share is fixed. For example, allocating a

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[21] Prob C §§16341 and 12006

[22] "Staff Report: 2000 California UPIA," California Law Revision Commission, *op. cit.*, p. 26.

[23] IRS 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 by paragraph (b) of this section."

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*** ...." This is essentially a restatement of Probate Code §16003 "If a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them and shall act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries."

$100,000 liability to a $650,000 by-pass trust increases by about 15% the share of the assets allocated to the by-pass trust.

In the example, funeral expenses, the decedent's separate debts and estate transmission expenses were allocated to the by-pass share. The decedent's share of the community debts and receivables was allocated between the by-pass and marital deduction shares based on relative net worth on the date of death. The survivor's community debts and receivables were allocated to the grantor share. This produced the following allocation.

	Liability	By-Pass Share	Marital Share	Survivor's Share
Funeral Expense	5,000	5,000		
Estate Transmission Expense	10,000	10,000		
Last Illness	2,000	2,000		
Federal Income Tax Liability (CP)	16,000	6,400	1,600	8,000
CA Income Tax Liability (CP)	4,000	1,600	400	2,000
Real Estate Tax Liens (CP)	6,000	2,400	600	3,000
Overpaid SS, Pension (CP)	1,500	600	150	750
Other Debts (CP)				
Utilities	50	20	5	25
Mortgage, 10 yr., 8% (CP)	100,000	40,000	10,000	50,000
Total	144,550	68,020	12,755	63,775

Preparing the Initial Tax Return. The allocation of taxable income between the administrative and Survivor's Trusts and the allocation of accounting income between the By-Pass and Marital Trusts are discussed item by item below. The results are summarized on the grantor letters included later in this article and in additional tables posted at http://lingane.com/tax/seminars/tables.pdf.

Summary of Fiduciary and Tax Accounts

Schedule A (Assets at Fair Market and Inventory Values)
Schedules A-1 and A-2 (Accounts/Receivable and Liabilities)
Schedule A-3 (Balance Sheet by Share)

Schedules B (Receipts in Chronological Order)
Schedule B-1 (Receipts by Category)

Schedule C (Disbursements in Chronological Order)
Schedule C-1 (Disbursements by Category)
Schedule C-2 (Receipts and Disbursements by a Trade or Business)
Schedule C-3 (Compensation of Fiduciary and of Attorneys for Fiduciary and of Agents with a Family or Affiliate Relationship to Fiduciary)

Schedule D (Capital Changes)

Schedule G. (Summary of Allocation of Receipts and Disbursements)

There are small differences between the grantor letters and the information in the above tables due to rounding.

The assets in the administrative trust include a residence and personal property, an investment portfolio, rental property, receivables (life insurance, accrued interest and rent) and liabilities (estate transmission expenses, medical bills, mortgage, tax liens and other debts.)

The first receipts and disbursements are allocated in proportion to the relative fair market values of the assets allocated to each share as of the date of death (see the following table.) After each distribution, the allocation factors are updated and the new factors applied to subsequent receipts and disbursements beginning on the day after the distribution. The taxable income or allowable deduction associated with each receipt and disbursement was allocated by the same methodology[24].

	Net Worth	=	FMV	+	Receivables	-	Liabilities
By-pass Share	$ 650,000		697,620		20,400		68,020
Marital Share	$ 155,725		163,380		5,100		12,755
Survivor's Grantor Share	$ 420,725		459,000		25,500		63,775
Total	$1,226,450		1,320,000		51,000		144,550

Interest. There is $500 in ordinary interest and $1,000 from US securities.

The ordinary interest includes $100 in interest accrued on the GNMA securities as of the date of death. The Principal and Income Act, in a change from prior practice, allocates periodic receipts due after death to Income[25].

See Schedule B-2, "Receipts by Account" for details as to amounts and timing. The schedule of accounts was chosen to reflect the accounting and tax differences and the reporting of some income under the decedent's Social Security number[26]

Dividends. There are $5,000 in ordinary dividends, $1,000 in capital gain distributions and $3,500 from a California municipal bond fund. The capital gain distributions were allocated to Principal and the other dividends to Income.

One municipal bond dividend was declared in late 1999 but was not paid until January 2000. This introduces a timing difference between tax and accounting since the dividend is reported in 1999 for tax and in 2000 for accounting.

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[24] The calculations were done with software developed specifically for this purpose. I am not aware of commercially available software which supports separate shares as of mid year 2000.

[25] Prob C §16346(b).

[26] When there is a delay in transferring brokerage accounts to the EIN number of the administrative trust, some post death transactions may be reported under the decedent's Social Security number or that of the survivor and some under the EIN of the administrative trust.

All transactions from the date of death are included in the fiduciary accounting. It is easier to reconcile the Forms 1099 to the entries on the trust's and survivor's income tax returns if post death transactions which are reported under another EIN are journaled to specifically identified accounts.

The trust accounting must be completed before the income and deductions for the survivor's grantor return can be computed. This is a disadvantage. However, it is not wise to try to accelerate the preparation of the survivor's return since it may be necessary to amend the survivor's return if material inaccuracies are discovered when the accounting is completed.

It is preferable to estimate the tax liability, to pay based on the estimate and to extend the time for filing the beneficiaries' tax returns when additional time is needed to complete the accounting.

Schedule B-2, "Receipts by Account" has details as to amounts and timing.

Capital Transactions. Accounting gain or loss can be different from the taxable gain or loss. Accounting gain or loss[27] is the difference between the sales price and the inventory value; selling expenses are allocated to Principal and deducted currently. Taxable gain or loss is usually[28] the gross sales price less selling expenses less basis. Taxable income is sometimes realized when making distributions but distributions never trigger an accounting gain.

Gain and losses from transactions during administration are allocated to Principal and to the residuary share. Gains and losses are not included in DNI except in the termination year or when the trust says to include gains and losses in DNI.

The GNMAs return $500 in principal, a bit each month. These receipts reduce inventory value and basis and are reported on the tax return at no gain.

The sale of a mutual fund produces a $10,000 long term gain. Another is sold for a $15,000 long term loss. Some of the proceeds are reinvested and there is a $15,000 short term gain when this stock is sold a few months later. Overall, these transactions produce a $10,000 short term gain.

The mutual fund transactions are allocated to Principal and are treated identically for accounting and tax.. See Schedule C-1 "Disbursements by Account" and Schedule D "Capital Changes" for details as to amounts and timing.

Life Insurance Proceeds are allocated to Principal when the probate estate is distributed. An adjusting entry reduces accounts receivable. The proceeds are not reportable for tax. The insurance company did not pay interest on the proceeds.

Rental Income. Net income[29] from a trade or business is usually included in DNI and usually allocated to accounting Income.

What is a trade or business for court accountings? Is a rental property a business? A rental property is usually not a qualified family owned business on the Form 706. On the other hand, Probate Code §§16352 and 16356 suggest that a rental property might be a business since the fiduciary can choose to account separately for the management of rental properties or to commingle the rental receipts and expenses with the other receipts and expenses.

There is $900 in accrued monthly rent as of the date of death. When paid, the accrued rent is allocated to Income under the periodic payment after death rule. Rent is included in DNI.

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[27] "Handling a Fiduciary Accounting" by Sharon A. Isenhour, Bart J. Schenone and Grace F. Tam, Continuing Education of the (California) Bar Action Guide, 1999, p. 31. This publication has not been updated for the changes which became effective January 1, 2000.

[28] Selling expenses are tax deductible administrative expenses if the sale is necessary to pay the decedent's debts or administrative expenses or taxes, to manage the assets or to effect their distribution and are otherwise added to basis. PPC's "1041 Deskbook", Key Issue 12A. Presumably, commissions and other purchasing expenses are treated analogously and are charged to Principal. If selling expenses are deducted for tax, DNI is smaller and, possibly, less taxable income is distributed.

[29] The calculation is to be shown on a schedule with detail comparable to that of Schedules C or F.

The tenant's failure to make timely rent payments prompts the fiduciary to hire an attorney. The legal fees are charged to Income and reduce DNI.

The new tenant pays a security deposit. The deposit is not reportable for tax and is allocated to Principal for fiduciary accounting. An adjusting entry increases A/P.

While refurbishing the unit for the new tenant, some unexpected repair work is encountered. Repairs are charged to accounting Income and to DNI.

The rental property produces a net DNI loss, before depreciation. A limited deduction for a rental loss with active participation is allowed an administrative trust which elects to be treated as an estate. Any limitation of this loss by the passive loss rules occurs on the beneficiaries' tax returns.

Since the fiduciary does not create a depreciation reserve, there is no adjustment to accounting income[30].

See Schedule C-2 "Receipts and Disbursements by a Trade or Business" for the details as to amounts and timing. As required for count accountings, legal fees are also listed separately on Schedule C-3 "Compensation of Fiduciary or of Attorneys for Fiduciary or of Agents with a Family or Affiliate Relationship to Fiduciary."

<u>The Residence and Personal Property</u> are deeded to the survivor. The fair market value was unchanged from the date of death. The fiduciary also distributed the real estate tax lien on the residence.

For fiduciary accounting, a property distribution is allocated to Principal at its inventory value and the distributed liability is not considered. For tax, the value of a distribution is the smaller of basis or FMV plus any gain or loss recognized by the trust on the distribution less any distributed liability. In this instance, the accounting distribution is larger than the tax distribution by the amount of the real estate lien.

<u>Real Estate Liens</u> on the rental property and raw land are paid in December. These taxes are charged to Income and DNI and there is a reduction in accounts payable.

<u>Portfolio Management Fees</u> are paid quarterly. At the end of the fiscal year, these fees are reduced, for tax, by a portion of the tax exempt income. This reduces both the tax exempt income and the deductible fees. Because of these adjustments at the administrative trust level, no further adjustments are appropriate on the beneficiaries' personal income tax returns.

Management fees are also reduced, for tax, by 2% of the trust's AGI. The portion of the fee allocated to the grantor share is not reduced by 2% of the trust's AGI since it will be reduced on the survivor's personal return by 2% of the survivor's AGI.

The unadjusted fees are allocated equally between Income and Principal.

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[30] Depreciation is passed directly to the beneficiaries and reported on their income tax returns.

Estates are not allowed a reserve unless authorized in the document. However, trusts, including possibly an administrative trust, are allowed a reserve; see Prob C §16372(b) The tax code allows a deduction against DNI if the fiduciary maintains a depreciation reserve but denies this deduction to an estate and, presumably, to a §645 administrative trust.

Other possible adjustments to FAI include working capital, see Prob C §16352. Working capital does not affect DNI.

Bank Charges are administrative expenses not subject to 2% of AGI. They are allocated equally between Income and Principal.

Bank charges are not deductible on the grantor's return.

Debts and Miscellaneous Distributions. The fiduciary pays the surviving spouse $25,000 a few days after death. This payment reimburses the survivor for some of the decedent's debts and provides living expenses during administration.

Pre-existing debts and liens are Principal obligations. Payment does not affect accounting Income.

Not all debts are deductible for fiduciary income tax purposes. Real estate tax liens, state income taxes and accrued mortgage interest are deductible. Funeral expenses, transmission and administrative expenses claimed on Form 706, Social Security repayments, federal income tax liabilities and credit card liabilities are not deductible. Non deductible debt is $38,550.

In April, the fiduciary pays the balances due on the federal and California tax returns filed jointly by the decedent and the surviving spouse. The decedent's half of the federal payment is a non deductible expense, the decedent's half of the California payment is a deductible expense and the survivor's half of both payments is a distribution. An adjusting entry reflects the reduction in accounts payable.

In April, the fiduciary makes estimated payments on behalf of the surviving spouse. These payments are distributions.

Even though an administrative trust need not make estimated payments during its first two years, the fiduciary makes estimated payments on behalf of this trust. The California payment is deductible against DNI on the trust's federal Form 1041.

Since all accounting income will be distributed to each share, any income tax liability of the administrative trust arises from Principal. Therefore, the estimated tax payments are charged against Principal.

Year-end Distributions. The fiduciary distributes cash and shares of an appreciated mutual fund to the surviving spouse. The FMV of the mutual fund is larger than the inventory value and the basis. The distribution is valued for accounting at the inventory value and at basis for tax.

The unrealized gain on the mutual fund is not recognized since this is not a pecuniary distribution. The surviving spouse receives the appreciated mutual fund at a carryover basis.

Within 65 days of the close of the trust's fiscal year, the fiduciary distributes $20,000 in cash to the QTIP trust.

The fiduciary distributes cash, an appreciated mutual fund and the appreciated rental property to the by-pass trust. FMV of the mutual fund exceeds inventory value and basis. The rental property is subject to a mortgage.

For tax purposes, the distribution to the fractional by-pass trust is the value of the cash plus the basis of the mutual fund and of the rental property less the mortgage liability. The beneficiary receives the distribution with a carryover basis and a long term holding period.

An estate recognizes gain or loss when distributing appreciated or depreciated property in satisfaction of a pecuniary bequest[31]. If this were a pecuniary distribution, the value of the distribution would also include both a long term 20% gain and a 25% depreciation recapture[32], the basis would be stepped up to FMV and the holding period would begin on the day after distribution. These gains would be allocated to the residuary share.

There is no accounting gain or loss when distributing appreciated property.

Mary chooses the distribution date so that no accrued income is included with the property distribution.

Is accrued income treated as an additional distribution? Who pays the tax on distributed accrued income? A distribution of property is valued for tax at the smaller of the basis in the hands of the fiduciary or FMV[33]. Accrued income affects FMV but not basis. Therefore, accrued income is not an additional distribution. The beneficiary to whom the accrued income is distributed pays the tax when the income is received. The net effect is that a beneficiary receives more after tax value when a property distribution includes accrued income. This extra value represents a transfer from the residuary beneficiaries.

Year-end Adjustments. The fiduciary journals an adjusting entry to reduce the basis in the rental property by the amount of depreciation. Depreciation is based on the stepped-up basis following John's death. Depreciation is allocated among all shares for tax but has no effect for accounting.

The fiduciary pays the fee for income tax preparation.

By year's end, much of the by-pass and grantor shares have been distributed. Thus, a fair market value of assets allocation formula would allocate most of the depreciation and other adjustments to the martial deduction share. The fiduciary does not consider this to be an equitable result and re-allocates these adjustments in the relative values existing as of the end of the second quarter. These ratios approximate the relative share values during the year.

Section 642(g) Election. An estate is allowed a Form 706 deduction for necessary expenses during administration and for the decedent's debts. The payment of these expenses and liabilities may also qualify as an income tax

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[31] If the trust says that the trustee is to fund the By-Pass Trust with *the largest amount* that can pass free of Federal estate tax using assets valued *as of the date of distribution*, the administrative trust will realize taxable income if the By-Pass Trust is funded with appreciated assets.

Whereas, if the trust says that the By-Pass Trust is to be funded with *the largest fraction*, there will be no gain when funding the By-Pass Trust with appreciated assets. There will also be no gain if assets are to be valued *as of the date of death.*

[32] Recaptured depreciation upon a pecuniary distribution is included in DNI but is not part of fiduciary accounting. See PPC's "1041 Deskbook", Example 16B. Inclusion in DNI makes sense since it was the beneficiaries who benefited from the prior deduction for depreciation.

[33] IRC 643(e)

deduction. Some expenses are allowed as a deduction for both estate and income tax purposes while others are allowed as a deduction for only one or the other[34].

When expenses are deductible on the Form 706 or Form 1041, the IRS assumes that the deduction will be taken on the 706. If the fiduciary takes the deduction on the 1041, an irrevocable election must be filed under §642(g) with the Form 1041 saying that the deduction was not taken on the Form 706.

It may be necessary to make the election in more than one year if the expenses are paid over several years. The election is filed in duplicate and is needed even if no estate tax return is required.

Grantor Letter, Fractional Formula. The fiduciary and tax accounting are summarized in the grantor letter on the following page. This letter would accompany the federal Form 1041 and a similar letter, with somewhat different entries, would accompany California's Form 541.

Copies of the grantor letters are provided to Mary. Mary probably needs to report this income on a calendar year basis. Therefore, the preparer should provide an interim accounting as of the end of each calendar year.

The grantor letter is information packed. Consider the first entry, Interest. There is $500 in ordinary interest which is allocated among the by-pass, marital and grantor shares. By reference to Schedule B-1, we see that this is composed of $390 reported under the EIN of the trust and $110 reported under the decedent's Social Security number and nomineed to the trust.

A portion of the Tax Exempt Income is allocated against Portfolio Fees for tax accounting.

Capital Gains and Capital Gain Distributions are allocated to Principal.

The Rental produced a $1,000 net loss for tax accounting. Because the allocation factors changed as a result of distributions during the year, a net gain was allocated to the grantor share and a net loss was allocated between the by-pass and marital shares.

The accounting includes a security deposit, life insurance proceeds, federal income tax, mortgage payments and funeral and estate transmission expenses. These are non reportable receipts and non deductible expenses.

Depreciation flows directly to the beneficiaries and is not included in DNI.

The portfolio management fee is reduced for tax only. A portion of the bank charges is not deductible with respect to the grantor's personal income tax return.

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[34] Illustration 12-1 in PPC's "1041 Deskbook" summarizes what can be deducted where.

Estate of John Xxxxx **94-0000005**

ALLOCATION OF INCOME, DEDUCTIONS AND CREDITS - FRACTIONAL FORMULA

All items of income, deduction and credit attributed to Mary Xxxxx as grantor of the Survivor's Trust under IRC §671-678 are reported on this schedule and are excluded from the amounts on the attached Form 1041.

	Accounting Income					Tax Accounting (* included in DNI)		
	Principal	**Fract'l By-Pass**	**Fract'l, Marital**	**Mary Xxxxx**	**Total**	**Estate** 94-0000005	**Mary Xxxxx** 000-00-6279	**Total**
RECEIPTS								
Interest		325	76	99	500	401*	99	500
Interest on US Securities		716	170	114	1,000	886*	114	1,000
Tax Exempt Dividends		2,364	559	577	3,500	2,923*	577	3,500
Less allocation to Portfolio Fees						(338)*	(51)	(389)
Dividends		3,568	842	590	5,000	4,410*	590	5,000
Capital Gain Distributions	882			118	1,000	882	118	1,000
Net S/T Capital Gain	8,819			1,181	10,000	8,819	1,181	10,000
Net Rental Income before depreciation		(995)	(265)	261	(1,000)	(1,261)*	204	(1,000)
Plus non reportable receipts	3,560			440	4,000			
Less non deductible disbursements	(4,450)			(550)	(5,000)			
Non Reportable (life insurance proceeds)	50,000							
DISBURSEMENTS								
Depreciation (separately stated on K-1)						9,095	1,359	10,454
RE Tax		357	84	59	500	441*	59	500
Portfolio Management Fee	1,772	1,434	339	455	4,000	3,545*	455	4,000
Less allocation to TE income						(338)*	(51)	(389)
Less 2% of AGI						(208)*		(239)
Accounting Fees	348	260	88	104	800	696*	104	800
State Income & Estimated Tax	2,250			2,000	2,250	4,250*	2,000	4,250
Bank Charges	33	27	6	14	80	66*		66
Non Deductible (706, mortgage, federal tax)	129,050				129,050			
ALLOCATED DNI		**549**	**20**			**569**		

Estate management expenses were allocated among the shares and deducted for tax accounting.

Since the fiduciary did not wrap up the affairs of the administrative trust in this fiscal year, the trust does not distribute its share of capital gains and losses to the beneficiaries. The trust makes estimated tax payments in anticipation of paying income tax on these gains. The trust also pays the decedent's federal and state income tax liability. The state payments are deductible on the federal return.

For purposes of the income distribution deduction, individual DNI items were allocated between the by-pass and marital shares in proportion to accounting income[35] received by each. This produces the DNI allocation shown on Schedule G and at the bottom of the grantor letter.

As summarized on Schedule C-1, the fiduciary makes distributions to the by-pass and marital deduction shares which exceed the allocated DNI. Thus the administrative trust is entitled to a full deduction for DNI.

Approximate Treatment. Keeping the books on an administrative trust in the manner just illustrated is a lot of work. This is a simplified example and yet the variable allocation factors required by the Separate Share Rule forced a sophisticated computational method involving fifty accounts and two hundred journal entries. All of this increases expense. Therefore, it is hoped that the IRS will not challenge approximate methods when the errors are not material.

An approximate method might be to allocate receipts and disbursements in constant ratios. The constant ratios might equal, for example, the relative net equity determined after a prompt distribution of the residence, personal property and some cash to the surviving spouse.

In the present circumstance, all taxable income from the administrative trust is reported on the personal return of the surviving spouse. A modest shift in DNI caused by an approximate allocation method does not change or reallocate the tax burden under this situation.

Even when the income beneficiaries are different, the shift in DNI is not likely to be material except when the estate is large. Of course, hostile beneficiaries might consider even a modest shift in DNI to be material!

Strict application of the relative FMV at the time of the distribution method can work injustices since the ordering of distributions affects the relative allocations.

Distributions from a probate estate are likely to be contemporaneous, and thus more susceptible to approximate methods and freer of distribution timing anomalies, since probate distributions must await court approval.

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[35] State tax payments were allocated to Principal. They are not included in accounting income but are included in DNI. It was considered reasonable to allocate the DNI deduction resulting from state tax 80:20 between the by-pass and QTIP shares. This is about the accounting income ratio for the other DNI components.

IRD items are included in DNI. When an IRD item is not included in accounting income, Reg. 1.663(c)-2(b)(3) mandates the method for allocating DNI.

"Reasonable, equitable and impartial" are the standards for choosing an allocation method. The tax practitioner should consider less expensive, approximate methods to the relative FMV at the time of the distribution method.

Pecuniary By-Pass Trust. What would the grantor letter look like if the by-pass trust were funded by a pecuniary formula?

- The accounting income which is allocated to the by-pass share under a fractional formula moves to the residuary share since the pecuniary share does not receive accounting income during administration under California law.

  The Hubert regulations[36] forbid the payment of estate administration expense from the marital share if the expense is "attributed" to a non marital share. The penalty is denial of a portion of the marital deduction on the Form 706.

  It is hard to imagine an estate where at least some of the administration expense is not attributable to each share and thus these regulations appear to be in conflict with California law, which allocates all expenses to the residuary share, when the marital share is the residuary share.

  The issue is not whether the administrative expenses are deductible on the Form 1041 but rather which share(s) pay these expenses.

  In the presence instance, the estate management expense attributed to the non marital share is shown on the grantor letter under the "Pecuniary By-Pass" column and the marital share was reimbursed for this expense. It is not clear that this reimbursement is either required or lawful.

  See Schedule G for additional detail.

- The trust realizes both 20% and 25% capital gains when the appreciated mutual fund and rental property are distributed to the pecuniary share. These gains are allocated to the residuary marital deduction share and are not included in the fiduciary accounting.

DNI is allocated to the residuary share. The administrative trust is allowed a full deduction since the distribution to the residuary share exceeds DNI.

The grantor letter for a pecuniary by-pass subtrust is on the following page.

[36] Federal Registry, Vol. 64, No. 232, December 3, 1999.

Estate of John Xxxxx — 94-0000005

ALLOCATION OF INCOME, DEDUCTIONS AND CREDITS - PECUNIARY FORMULA

All items of income, deduction and credit attributed to Mary Xxxxx as grantor of the Survivor's Trust under IRC §671-678 are reported on this schedule and are excluded from the amounts on the attached Form 1041.

The residuary marital share was reimbursed for disbursements shown for the pecuniary share. This achieves the result required by §20.2056(b)-4, Example 5.

	Accounting Income					Tax Accounting (* included in DNI)		
	Principal	**Pecuniary By-Pass**	**Residuary Marital**	**Mary Xxxxx**	**Total**	**Estate** 94-0000005	**Mary Xxxxx** 000-00-6279	**Total**
RECEIPTS								
Interest			401	99	500	401*	99	500
Interest on US Securities			886	114	1,000	886*	114	1,000
Tax Exempt Dividends			2,923	577	3,500	2,923*	577	3,500
Less allocation to Portfolio Fees						(338)*	(51)	(389)
Dividends			4,410	590	5,000	4,410*	590	5,000
Capital Gain Distributions	882			118	1,000	882	118	1,000
Net S/T Capital Gain	8,819			1,181	10,000	8,819	1,181	10,000
L/T Gain on Pecuniary Distributions	85,000				85,000	85,000		85,000
25% Gain on Pecuniary Distributions	10,454				10,454	10,454		10,454
Net Rental Income before depreciation			(1,261)	261	(1,000)	(1,261)*	204	(1,000)
Plus non reportable receipts	3,560			440	4,000			
Less non deductible disbursements	(4,450)			(550)	(5,000)			
Non Reportable (life insurance proceeds)	50,000							
DISBURSEMENTS								
Depreciation (separately stated on K-1)						9,095	1,359	10,454
RE Tax			441	59	500	441*	59	500
Portfolio Management Fee	339	2,867	339	455	4,000	3,545*	455	4,000
Less allocation to TE income						(338)*	(51)	(389)
Less 2% of AGI						(208)*		(239)
Accounting Fees	88	520	88	104	800	696*	104	800
State Income & Estimated Tax	2,250			2,000	2,250	4,250*	2,000	4,250
Bank Charges	6	54	6	14	80	66*		66
Non Deductible (706, mortgage, federal tax)	129,050				129,050			
ALLOCATED DNI			**569**			**569**		

The Final Tax Return. The differences between the initial and final income tax return for the estate/administrative trust are that most income, deductions, suspended losses and credits are distributed on the final return and that the final Form 1041 shows no balance due.

In order to achieve this result,

- Capital gains are included in DNI in the termination year.
- Property distributions carryout unrealized gains and suspended passive losses are added to basis. The trust claims a distribution deduction for the smaller of adjusted basis or FMV. Estates can claim basis on pecuniary distributions and, in effect, distribute unrealized losses.
- NOL and capital loss carryovers are distributed to the residuary beneficiaries. These can be carried to additional tax years.
- Excess deductions in the final year are passed through to the beneficiaries. These are deductible in the termination year on Schedule A as miscellaneous itemized deductions subject to 2% of AGI and are AMT exclusion items.

  Where there is the latitude to do so, excess deductions on termination should be charged against related business income so that they are characterized as NOL since NOL is not subject to the 2% limitation and can be spread over more than one tax year.
- An election under 643(g) treats unused estimated tax payments as if made by beneficiaries.

The following carryovers are lost forever:

- AMT tax credit
- Foreign tax credit
- Investment interest expense
- Excess charitable contributions.

Software Comments. The 1999 release of ProSystems *fx* does not include the §645 election to treat the administrative trust as an estate but the required statement can be prepared using the "footnotes" option on their screen A-9.

It was necessary to override gross income for purposes of allocating management fees to tax exempt income because the software treated the nomineed gains on Sch. D as losses and excluded them from the calculation. This was done on their screen A-4, boxes 40 and 51.

Bank charges must be coded as "admin" on ProSystems' screen A-1, box 141 or these charges won't be included in the 2% of AGI calculation.