Form 1041
A roadmap to preparing the fiduciary return

Summary

The preparation of The US Income Tax Return for Estates & Trusts (Form 1041) is an art that requires juggling oft-competing obligations between the tax authorities, personal representatives and beneficiaries. Many practitioners assume that "Form 1041 can't be much different than Form 1040" but are soon overwhelmed by the intricacies of Subchapter J of the Internal Revenue Code. This course will examine the basics of estates and trusts, provide an understanding of distributable net income (DNI) and income-in-respect of decedent (IRD), and offer a practical guide to completing the fiduciary income tax return.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Wealth versus Income Taxes

Tax liabilities do not cease upon death. In fact, decedents—or their surviving representatives—may have more filing obligations after death than before. Pre-death, an individual is typically only responsible for income tax, a tax assessed on earnings. However, post-death, the estate of the decedent may be liable for taxes on earnings, as well as on assets held by the decedent on the date of death (DOD).

This text will focus only on those taxes imposed by the federal government, although practitioners and taxpayers should be aware that individual states may also impose one or more types of tax on taxpayers over which they have jurisdiction. A decedent who was resident of one state but held assets or received earnings from another, may well be liable for taxes imposed by more than one state.

A. Estate Tax

The whole of the property owned by an individual, including both real and personal property, is deemed to be that person's estate. Upon death, this estate will be distributed in accordance with the terms of the decedent's will or trust or – if there is no governing instrument – by the laws of intestacy applicable in the state of the decedent's domicile.

The tax is assessed on the value of the decedent's estate on the DOD or, if elected, the Alternate Valuation Date (AVD), which is the earlier of the date of sale or distribution or if the asset is still held by the estate, no later than six months after the DOD. The AVD may be used only if the fair market value (FMV) of the decedent's assets on that date is less than on the DOD, thereby serving to decrease the value of the gross estate and the resulting tax liability.

The progressive tax is assessed on a net estate that exceeds the currently applicable exclusion.[1] **Form 706 U.S. Income Tax Return for Estates and Trusts** is due nine months after the DOD. This filing – not payment – deadline may be extended for an additional six months using **Form 4768 Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes**.

B. Gift Tax

Generally, all transfers of property interests without adequate consideration are gifts subject to gift tax. Gifts can include transfers of cash or property, payments made to third parties on behalf of another, interest-free loans, below-market sales, irrevocable transfers to a trust, and the creation of certain joint tenancies. Gifts are taxable in the year that they are made and are valued on the date they are completed (i.e. when the donor no longer has the power to change its disposition).[2]

The transfer of an asset into joint tenancy may be considered a completed gift depending upon governing state law. Generally, the gift is only complete when the asset is withdrawn by the noncontributing owner for his own use; but if the property remains in joint tenancy until the donor's death, the tenancy is treated as an inherited interest and its full value is includible in the decedent's estate.

[1] The applicable exclusion was raised from $5.49 million to $11.18 million with the enactment of the Tax Cuts and Jobs Act (TCJA), effective January 2018. The exclusion is adjusted annually for inflation – currently set to $11.58 million in 2020 – but scheduled to revert to the pre-TCJA base after 2025. The marginal tax rate begins at 18% and quickly rises to 40% on taxable estates in excess of $1 million.

[2] Treas. Reg. §§ 25.2511-1 and -2.

Each taxpayer is currently entitled to exclude the first $15,000 given to each donee in any calendar year.[3] This exemption is indexed for inflation and will remain unchanged until such time as inflation increases sufficiently for the exclusion amount to be increased to the next $1,000 increment.

All gifts in excess of the annual exclusion are reportable on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return**. Gift tax returns cannot be filed jointly since each spouse has a separate annual exclusion attributable only to him, unless both spouses agree to and elect gift-splitting, which allows a married couple to treat all gifts made by either spouse as made one-half by each spouse.[4]

Gifts are subject to the same tax rates and the applicable exclusion as estates. Gifts in excess of the annual exemption are reportable, but not taxable until they exceed the lifetime exclusion amount. Gifts in excess of the lifetime exclusion, in turn, reduce the allowable estate tax exclusion and may ultimately become taxable once the transfers cause the estate to exceed its tax-free exemption amount.

C. Inheritance Tax (also known as a Legacy or Succession Tax)

Unlike the Estate Tax, which is assessed upon the decedent for the privilege of *transferring* his property at death, an inheritance tax is charged to the heir for the privilege of *receiving* property from a decedent. Typically, such a tax is assessed by the state in which the decedent was domiciled (not resident).[5]

In some unfortunate cases, a decedent's estate might be subject to estate taxation based upon the value of his estate at death prior to distribution; then upon transfer, the decedent's heirs might also be taxed based upon the value of the assets distributed to them. Arguably a double tax, many states (including California[6]) no longer assess an inheritance tax, but instead impose an estate tax – referred to as the Pick-Up Tax – calculated as a percentage of the federal estate tax liability. However, because the federal credit for estate taxes paid to the state has been repealed,[7] even this tax has been eliminated. Only those states whose estate or inheritance tax structure has been established independently of the federal estate tax system still impose taxes on the decedent, the heir, or both.[8]

D. Generation-Skipping Tax (GST)

The GST is imposed on a direct transfer of property to a grandchild that would otherwise be subject to two levels of estate taxation if first taxed as part of the parent's estate, then transferred from parent to child, taxed as part of the child's estate, and finally transferred to

[3] To qualify for the annual exclusion, a gift must be a present interest, which is the immediate right to the use, possess, and enjoy the income from the property. The annual exclusion does not apply if these rights begin at some future time (Treas. Reg. §25.2503-3).

[4] Spouses must be U.S. citizens or residents, married at the time of the gift. They cannot remarry others before the end of the year.

[5] Residence provides a home to an individual for a temporary period, while domicile is a permanent home. Without a bright-line test, the distinction between residency and domiciliary often comes down to a taxpayer's intent which must be supported by facts and circumstances designed to convince tenacious state tax authorities that they do not have jurisdiction in the case at hand.

[6] California levied a tax on inheritances since 1893 and a tax on gifts since 1939. In 1982, California voted to repeal both.

[7] IRC § 2011 was repealed by The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

[8] Tax Foundation provides a map of states that levy estate and/or inheritance taxes [available at https://taxfoundation.org/state-estate-tax-state-inheritance-tax-2019/, last accessed April 20, 2020].

the grandchild.[9] Because GST is a flat tax assessed at the top bracket of the estate tax rate currently in effect, this tax usually exceeds that which would have otherwise been incurred at graduated rates if the property had been transferred and taxed at each successive generation.

Each transferor has a lifetime exemption and the tax is not applied to outright gifts that are excluded by the annual gift tax exclusion or qualified transfers for medical and tuition payments. Direct skip transfers made during lifetime are reported on **Form 709**; direct skips made at death are reported on **Form 706**.

E. Income Tax

So far, we've focused on wealth taxes assessed when assets are transferred at death or by gift. Next, we turn to earnings along with the attendant income taxes thereon. Presuming that most taxpayers do not die precisely at the close of an accounting period, earned income will have to be allocated between the decedent for all amounts received prior to the DOD and the estate[10] (or trust) thereafter.

Form 1040 U.S. Individual Income Tax Return must be used to report the decedent's portion of the income and must be filed by April 15th of the year following the DOD. The estate's portion of the income must be reported on **Form 1041 U.S. Income Tax Return for Estates and Trusts**, due by April 15th of the year following the DOD and for every year thereafter until the estate is closed.

While marginal tax rates are the same for individuals and estates, one should note that the brackets are considerably condensed for estates. Thus, they are effectively taxed at higher rates.

The remainder of this text is dedicated to the preparation of requisite income tax returns; **Forms 1040** and **1041**. We will discuss how to account for income- and expenses-in-respect-of-decedent, which elections are available to executors and trustees, and how to maximize allowable deductions. The goal will be to provide guidance and concise instructions to simplify the filing of all requisite returns.

SUMMARY: POSSIBLE TAXES DUE AT DEATH

Estate Tax – assessed based on the value of the decedent's holdings, FMV may be determined at the DOD or AVD if elected. **Form 706** is due nine months after DOD, but the filing deadline may be extended an additional six months with **Form 4768**.

Gift Tax – assessed based on the value of the property transferred for inadequate consideration on amounts in excess of annual exclusion ($15K). **Form 709** is due April 15th in the year after the gift was transferred.

GST Tax – assessed based on the value of property transferred to a skip person. GST transfers are reported on either **Form 709** if made during the transferor's lifetime or **Form 706** if made at death.

Income Tax – must report income attributable to the decedent on **Form 1040** and income attributable to the estate on **Form 1041**. Marginal tax rates for the estate are comparable to those for individual taxpayers, but the effective tax rate is higher since the tax brackets are narrower.

[9] IRC § 2612: GST is imposed on direct skips, taxable terminations, and taxable distributions made to a skip person defined as a relative who is at least two generations below the transferor, although relatives not descended from the transferor's grandparents are excluded. Spouses, former spouses, tax-exempt organizations and charitable trusts are non-skip persons. If the transferor's child is deceased, the grandchildren by that child are considered the first generation and are not skip persons. If the transferor has no lineal descendants and a niece or nephew of the transferor is deceased, the children of the deceased niece or nephew are not skip persons (IRC § 2651).

[10] An "estate" is created at the moment of death and becomes the liability of the fiduciary.

II. The Governing Instrument

Did the decedent leave a will? Did he have a trust? Did he die intestate? These are nigh the first questions that are asked after death; often before family members even plan their loved one's burial.

While planning for death is an onerous task that most individuals prefer to procrastinate (if not avoid altogether), it is a necessary task that should be done with diligence, especially if a person hopes to "speak from the grave." Advance planning gives everyone the power to make his wishes known regarding such matters as (1) the disposition of his real and personal property; (2) the naming of a guardian (for the care of his minor children), a custodian (to preserve assets for his minor children), or a conservator (in the event of his own incapacity); and (3) the appointment of a trusted individual to ensure that all of these wishes are carried out diligently. Conversely, lack of planning puts these matters into the hands of the state. When a person dies intestate (without a valid will in place), local statutes are relied upon to determine the distribution of the decedent's property. Typically, intestacy laws rank heirs according to proximity of kinship.

A. Will (or Last Testament)

A will – if properly drafted and admitted into probate – can accomplish all of the above based upon the decedent's preferences rather than arcane kinship rules. A will, however, cannot change the statutory rights of certain beneficiaries in contravention of local law; determine the disposition of non-probate property, such as jointly-held assets or those assets which have beneficiary designations;[11] **c**hange the provisions of other estate planning documents, such as life insurance beneficiary designations; or avoid the probate process, including all attendant costs and publicity. Nor can a will update itself. In other words, a will only serves to express a decedent's desires based upon the last time that he put pen to paper and cannot account for changes due to intervening circumstances.

B. Trusts

On the other hand, various legal documents may be drafted to overcome the short-comings and costs associated with the disposition of property under the terms of a will. The most common of these is the living trust (a.k.a. grantor or family trust), which creates a revocable legal entity during the grantor's lifetime that can be used to administer his affairs both before and after his death.

1. Living Trust

Common to all trusts, ownership of property is divided into two parts: (1) legal title, which vests in the trustee and (2) beneficial ownership interest, which is managed by the trustee for the benefit of the beneficiaries. Created by a document signed by the trustee, the trust instrument specifies the duties of the trustee (and successor trustees, if named), as well as the management and eventual distribution of the trust's income and principal to the trust's beneficiaries. Because title of all trust assets[12] has already

[11] The probate estate includes all of the decedent's property that is subject to administration by the personal representative. Non-probate assets include those that can pass directly (and immediately) to the heirs based upon the operation of law and do not require administration by the personal representative. Examples include assets owned jointly with right of survivorship; life insurance, annuities and retirement assets with valid beneficiary designations; bank accounts and other assets with "payable on death" or trust designations; securities or security accounts that are "transferable on death;" and assets in trust, if the trust document includes a plan for distribution after death.

[12] Trusts *must* be funded by transferring assets and re-titling them in the name of the trust at the time of the trust's creation, as well as upon acquisition of assets subsequent to creation. If left unfunded, a trust becomes an empty and useless "shell."

been transferred during the lifetime of the trustor, probate is not required to effect disposition at death.

The trustor has the right to revoke the trust and reclaim the ownership of all trust property at any time during his lifetime, but the trust becomes irrevocable on the DOD. The trust instrument (rather than a will) then controls the disposition of all trust property. However, because not all of the decedent's assets may have been properly titled in the name of the trust—whether intentionally or accidentally omitted—most trust instruments are accompanied by a pour-over will[13] which can be used to transfer non-trust assets into the trust.

Although a living trust is considered a separate legal entity, income earned by the trust is considered to have been earned by the grantor and, as such, is taxable to the grantor on the individual income tax return. And at death, trust assets are deemed to be a part of the grantor's gross estate.

Employer Identification Number (EIN)

As long as the trust's grantor is also the trustee, income is attributed to the grantor's Social Security Number (SSN) and reported on the grantor's personal **Form 1040**. Once a third-party successor trustee accepts appointment – whether because the grantor is alive but incapacitated or has passed away – an EIN must be obtained, and trust income must thereafter be reported on **Form 1041**.

If the grantor still retains the power (and capacity) to amend or revoke the trust, the fiduciary return should include only basic trust identifying information on Page 1. The remaining lines on which income, deductions and credits would normally be reported should be left blank. Instead, a statement should be attached to the return that (1) states that the trust is a grantor trust; (2) identifies the grantor by name and SSN; and (3) confirms that all reportable tax items have been furnished to the grantor for inclusion on his personal return.

Once the grantor dies or the trust becomes otherwise irrevocable, all reportable tax items must be included in their entirety on the fiduciary return identified by the trust's EIN.

2. Special Needs Trust (SNT)

Often an individual would like to accommodate special circumstances or ensure that his loved ones will be cared for in the event of his death. An SNT – also known as a Supplemental Needs Trust – can be used to ensure that a disabled beneficiary can enjoy the use of a decedent's property without jeopardizing the beneficiary's eligibility for government aid. Most often funded with the proceeds from an inheritance or personal injury litigation or insurance settlements, SNTs are designed to comply with Medicaid rules which severely limit the number and value of assets that an individual may own and still qualify for public benefits.

Pet owners abound who dearly care for their four-legged companions and would like to ensure that these creatures are loved and cared for long after the owners have passed away. Historically, however, pet trusts have failed to satisfy the rule against

[13] Property subject to a pour-over will passes under the terms of the trust but is subject to probate since it was not held in the trust at the time of death.

perpetuities,[14] which requires that the duration of a trust be measured against a *human* life.

Today, some courts allow (just as others invalidate) testamentary provisions for pets depending on the jurisdiction, although most do not intercede where a trust is carried out voluntarily. Nevertheless, it is commonly accepted that outright gifts of money or property to a pet cannot be made because animals, classified as property, cannot hold title to other property. A pet, of course, can be gifted to an individual, along with a cash bequest to defray the costs of the animal's future care. Alternatively, a trust – either testamentary or inter vivos [during life] – can be established, naming a human caregiver (not the pet) as the beneficiary.

C. Marital Estate Planning

Because trusts are becoming more prevalent and are often considered the favored vehicle to accomplish many estate planning objectives, we will take a closer look at those that our clients use most often. Keeping in mind that inter vivos trusts can, if properly funded, eliminate probate and ensure continuity of management in the event of the grantor's disability or death, it is important to note that the living trust, in and of itself, does *not* offer income or estate tax savings.

Trust income and deductions are reported on the grantor's individual tax return and are subject to the same regulations and limitations imposed on individual taxpayers. At death, when the trust becomes irrevocable, the trust is taxed as a separate entity subject to taxation on marginal brackets that are narrower than those applied to individual taxpayers. And because the trust assets belonged to the grantor, the estate will eligible for the same estate tax exclusion as if the assets were held in the individual's name. Thus, no tax savings are achieved, unless…

…an inter vivos trust is used to take advantage of the unlimited marital deduction (UMD). Of course, this can only be accomplished if the grantors are married (to each other).

The UMD is allowed and, in fact, must[15] be claimed for the value of property that is included in the decedent's estate but that is then transferred to the surviving spouse.[16] The deduction is available when (1) an outright transfer is made to the surviving spouse, (2) a marital trust is established that provides the surviving spouse an annual income interest for life and a general power of appointment, (3) the surviving spouse receives the benefit of life insurance or annuity proceeds payable to a trust naming the surviving spouse as beneficiary, or (4) the decedent's property is transferred to a qualified terminable interest property (QTIP) trust.[17]

[14] The rule originates from Common Law (*Duke of Norfolk's Case* of 1682). The Duke tried to pass his titles to his sons and succeeding generations, if certain conditions should occur. When the second son failed to pass his title on to his younger brother as per their father's instructions, the court held that shifting conditions could not exist indefinitely and held that tying up property long past the lives of those currently living was improper.

[15] The UMD is required for property transferred to the surviving spouse if the decedent and the surviving spouse are U.S. citizens or residents; and the property that passes to the survivor is includible in the decedent's estate and not otherwise deducted for federal estate tax purposes.

[16] IRC § 2056.

[17] A QTIP trust can be used to transfer property to a spouse that would otherwise be ineligible for the estate and gift tax deductions available to other marital transfers based upon the Terminable Interest Rule. If the decedent has chosen to make the surviving spouse's interest transient, allowing it to terminate in favor of another's interest contingent upon the occurrence of an event (i.e. a term of years or remarriage), no UMD is allowed [IRC § 2056(b)(3)(A)]. However, if the executor makes an irrevocable election when filing the estate tax return to treat some or all of the estate's assets as qualified terminable interest property, the UMD may be claimed.

A-B Trust

To achieve maximum tax savings, an estate plan for a married couple must take advantage of both the applicable exclusion amount and the UMD. Thus, if the couple's combined net worth exceeds the estate tax exemption in effect on DOD, an effective strategy would call for a taxable bequest to a trust in the amount of the applicable exclusion amount, *and* a marital bequest to the surviving spouse (who is eligible for the UMD) for the balance of the estate

At the death of the first spouse, a credit shelter trust—also known as a bypass trust—is established and funded with assets equal to the applicable exclusion amount, thereby avoiding taxation of these assets. All remaining assets then pass to the surviving spouse subject to the UMD, thereby postponing taxation of these assets until the death of the surviving spouse. Even though the surviving spouse may have access to the income generated from the bypass trust, those assets are not owned by the survivor and therefore will not become a part of the survivor's estate when that spouse later dies. Thus, assets equal to the current applicable exclusion amount are permanently sheltered from estate taxation.

This type of arrangement is often referred to as an A-B Trust, where the "A" Trust represents the portion of the assets protected from estate taxation by the UMD attributable to the surviving spouse and the "B" Trust represents those assets protected from estate taxation due to the applicable exclusion allowed to the decedent.[18]

A-B-C Trust

Alternatively, a married couple could use a three-prong approach, particularly when one spouse would like to provide for the children of a prior marriage using a "C" Trust.

Qualified Domestic Trust (QDOT)

U.S. tax law imposes restrictions on transfers to non-U.S. citizens for fear of losing jurisdiction and losing the ability to tax dollars that have left the country. With the enactment of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the marital deduction for the transfer of property to a non-citizen spouse is no longer allowed,[19] nor may one-half of jointly-held spousal property be excluded from the decedent's estate.[20]

However, the marital deduction is permitted—and the estate tax is deferred—if the estate of a citizen spouse is transferred to the non-citizen spouse in trust,[21] under the following conditions:

To qualify, QTIP property must be placed in a trust that satisfies the requirements of IRC § 2056(b)(7): (a) the trust's income must be paid at least annually to the surviving spouse; (b) none of the trust's principal may be distributed to anyone other than the surviving spouse during that spouse's lifetime; (c) unproductive assets—those not generating trust income—must be converted to productive property within a reasonable time; and (d) the executor must elect on a timely filed estate or gift tax return to have some or all of the trust property qualify for the marital deduction.

(Although a QTIP trust may appear similar to a QDOT, the latter is more limited, requiring a domestic trustee who is either a U.S. citizen with a tax home in the U.S. or a U.S. corporation.)

[18] An easy way to distinguish between the A- and B-Trusts, is to remember that the A-Trust includes assets allocated to the surviving spouse who is above ground and the B-Trust includes assets allocated to the decedent who is below ground.

[19] IRC § 2056(d)(1).

[20] IRC § 2040(a).

[21] IRC § 2056(d)(2).

- All trustees of the trust must be individual U.S. citizens or, if trust assets exceed $2 million, the trustee must be a domestic bank;
- The surviving spouse must receive all of the trust's income, paid out at least annually;
- The trust must pay the requisite tax on any income other than what is distributed annually to the surviving spouse, as well as the tax due upon the death of the surviving spouse; and
- An irrevocable election to treat the trust as a QDOT must be made on the decedent's estate tax return.

The estate tax will be triggered and based on the value of any distribution of trust principal or based upon the value of the trust's remainder on the death of the surviving spouse, whichever occurs first. The tax is due on the 15th day of the fourth month following the year in which the taxable event occurs.

WAYS TO SPEAK FROM THE GRAVE

- Intestacy statutes apply when a decedent dies without having a valid will in place. These state laws typically identify beneficiaries based on the degree of kinship shared with the decedent.
- A will can be used to publish the decedent's desires regarding the disposition of his property at death but is often time-consuming and expensive to probate.
- Instead, a revocable trust may be established and, if fully funded, can be used to transfer assets to the trust's beneficiaries outside of probate. A living trust may also be used to ensure that the grantor's assets can be managed during his lifetime if he becomes disabled or legally incapacitated.
- Third-party trusts, such as Special (or Supplemental) Needs Trusts, may be established by a relative or court-appointed guardian for the benefit of a disabled beneficiary without jeopardizing the disabled person's eligibility for Medicaid.
- Married couples can use A-B trusts to temporarily shelter A-Trust property from estate taxation on the death of the first spouse while B-Trust assets can be sheltered permanently by the decedent's applicable exclusion amount. An A-B-C Trust can be used to pass property to the surviving spouse and also preserve estate assets for third-party beneficiaries, such as the children of a prior marriage. A QDOT allows the estate tax due at death of the first spouse to be deferred until the death of the surviving non-citizen spouse.

III. The Players

We begin with an examination of those individuals involved in the post-death tax filing process.

A. The Decedent

He is, of course, the one person essential to the process; the one without whom there would be no purpose to or examination of post-death tax filings. While the focus of this manual will presume that the decedent was a U.S. citizen (or resident alien), we should note that special rules apply if in fact the decedent was a non-resident alien (NRA) at the time of death.

1. U.S. Citizens and Resident Aliens

U.S. citizens and residents are subject to the US estate and gift tax laws. For estate and gift tax purposes, residency is not determined in the same manner as it is for income tax purposes. Rather than by application of the Green Card or Substantial Presence Tests, a decedent quite simply is considered to have been a "resident" if he was domiciled in the U.S. at the time of his death. If he lived in the US, even for a brief period of time, and did not have any definite intention of returning to a foreign country,

he is deemed domiciled in the U.S.[22] The estate's executor must file an **Affidavit of Domicile** to certify the decedent's place of residence at the time of death.

Foreign estates—defined as those of U.S. citizens who are permanent residents of foreign countries, whose assets are located entirely abroad, and whose fiduciaries are foreign corporations located abroad—are subject to U.S. taxation only on income derived from U.S. sources or income that is effectively connected.

2. Non-resident Aliens

The gross estate of U.S. domiciled NRAs subject to U.S. estate taxation includes *all tangible and intangible property located in the U.S.*[23] The deduction for allowable administrative expenses is limited by the ratio of the NRA decedent's U.S. gross estate to his worldwide gross estate. NRAs are entitled to a limited marital deduction[24] and only allowed the unlimited marital deduction if the surviving spouse either already is a U.S. citizen or becomes a U.S. citizen by the due date (plus extensions) of the tax return, or if the assets are left to a QDOT, or if treaty provisions stipulate accordingly.[25] NRAs are allowed a mere $60,000 estate exclusion[26] (and no portability of a deceased spouse's unused estate tax exemption) rather than the inflation-adjusted amount exclusion currently allowed to U.S. citizens.[27] To ensure proper application of these provisions, NRAs must use **Form 706NA, United States Estate Tax Return - Estate of Nonresident Not a Citizen of the United States**.

NRAs are subject to tax on gifts of U.S. situated property (i.e. real estate and tangible personal property located within the U.S.). However, NRAs generally are exempt from gift tax on transfers of intangibles, such as stock and securities, regardless of where the property is situated.[28] Cash gifts are subject to U.S. gift tax. NRAs enjoy the same annual gift tax exclusion as U.S. citizens[29] but may not elect gift-splitting between spouses.[30] NRAs must report taxable gifts and compute the attendant gift tax liability on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return** but must diligently apply the nuanced rules since **Form 709** is shared with U.S. citizen and resident taxpayers and only the form's instructions – but not line entries – serve to highlight applicable rule differences.

[22] *Estate Planning Tools for Nonresident Aliens* available at Lexis Hub for New Attorneys.

[23] IRC § 2103.

[24] $157,000 in 2020.

[25] IRC §2056(d).

[26] Applicable Unified Credit in 2020 is $4,577,800 which equates to an estate exclusion of $11.58 million.

[27] IRC §2102(b).

[28] IRC §2501(a)(2).

[29] IRC §2503(b).

[30] IRC §2513(a)(1).

DECEDENT'S DOMICILE

- U.S. citizens, residents and those domiciled in the U.S. are subject to U.S estate tax. Domicile is determined by the taxpayer's intent to remain in the U.S.
- The Gross Estate of U.S. domiciled NRAs consists only of U.S. based property. Deductions & exclusions are limited. NRAs must pay gift tax on transfers of real estate & tangible (but not intangible) property.

B. The Fiduciary

The primary responsibility of the fiduciary or personal representative is to marshal and eventually distribute the decedent's assets as per the terms of the governing instrument, whether a will or trust or by court order if the decedent dies intestate.[31]

Although bestowed with many titles depending upon the manner in which the fiduciary is granted his authority,[32] all have a duty of loyalty to act in the best interest of the beneficiary and a duty of care to act with impartiality and prudence. The fiduciary must seek to avoid all conflicts of interest and cannot engage in self-dealing. The fiduciary may not delegate fundamental duties, must render periodic accounts to the beneficiaries, enforce and defend against claims on behalf of the trust, and avoid commingling. Depending on the jurisdiction in which he must act, he may be required to be licensed.

A fiduciary may be responsible for handling personal as well as business affairs. He will be called upon to perform a host of duties that entail accounting and bookkeeping functions, as well as legal obligations.

The decedent's personal representative must satisfy all filing obligations and tax liabilities of the decedent's estate, including all requisite but previously unfiled returns. Thus, the fiduciary must establish if any prior year income tax returns remain outstanding, gift tax returns should have been filed to account for taxable gifts at *any* time prior to the decedent's death (even in earlier years), and submit all Foreign Bank Account Reports (FBARs) as well as comply with foreign asset reporting as per the Foreign Accounts Tax Compliance Act (FATCA), if applicable.

Domiciliary and Ancillary Representatives

In some cases, ancillary probate proceedings will be required if any of the decedent's property was located out-of-state. Depending on state law, a resident representative may be required to handle all affairs that cannot be administered by a domiciliary representative. Both representatives will be required to file **Form 1041**; the domiciliary representative will be required to include all of the estate's income on his fiduciary return, while the ancillary representative will be required to report the income and expenses apportioned to him as the decedent's out-of-state representative.

Notifying the IRS

The fiduciary must notify the IRS of the assumption of his duties by submitting **Form 56 Notice Concerning Fiduciary Relationship** as soon as possible after creation of the fiduciary relationship and then, again, to notify the tax authority of the termination of the relationship once the administrative period for the trust or estate has concluded.

[31] Without a will or a trust, state law will determine who may act as administrator of the estate, usually giving preference to heirs (again, based upon closeness of relationship). The state will also appoint a fiduciary to care for a minor child and/or his share of the estate.

[32] Personal representatives or fiduciaries can include: **Executor** if acting under the terms of a will, **Administrator** if court-appointed, **Trustee** if named in a trust document, **Guardian** if charged with the care of another person, **Conservator** if court-appointed to manage the affairs of another; **Custodian** if asked to safeguard assets.

Power of Attorney

A Power of Attorney (POA) allows one person (the principal) to authorize another (the attorney-in-fact) to act on his behalf. Various types of POAs include a durable POA which remains effective even if the principal becomes incapacitated or incompetent, and a springing POA which does not become effective until the principal becomes disabled, amongst many others. However, POAs are valid only during the lifetime of the principal and expire automatically at death or sooner if the document contains an expiration date or the principal revokes the power.

Form 2848 Power of Attorney and Declaration of Representative must be used to appoint an attorney-in-fact to act on the principal's behalf regarding federal tax matters only. Most state tax authorities have comparable forms and do not grant authority to an agent pursuant to the federal form or any alternative blue-backed legal document.

C. The Beneficiary

Trusts and estates that otherwise do not satisfy the income threshold for filing will nevertheless have to submit **Form 1041** if any of the beneficiaries are NRAs.[33]

A recent Supreme Court decision[34] held that North Carolina (NC) could not tax the income of a New York trust simply because the beneficiary of the trust was a NC resident but otherwise had no nexus to the state, received no income distributions and did not possess or control any assets of the trust. By contrast, California that requires a trust's undistributed out-of-state income be apportioned and then taxed based on the residency of both trustees and beneficiaries.[35]

FIDUCIARIES & BENEFICIARIES

- Fiduciaries appointed to act on behalf of another—in life or after death—owe a duty of loyalty and care to the principal for whom they are acting. They must attend to all personal and business matters, including the management and preservation of the decedent's estate.
- Out-of-state and NRA beneficiaries may affect the filing requirements of estates and trusts.

IV. Taxation of Trusts and Estates

Regardless of the type of trust employed, the rules of taxation are applicable to all. Here is a step-by-step guide that the practitioner may follow to prepare a proper fiduciary return, with the exception that any trust income attributable to a grantor trust managed by the grantor is allocated and reported on the grantor's individual tax return.

Mis-reporting

Unfortunately, individuals unfamiliar with the rules for grantor trusts often apply for an EIN in the name of the revocable trust and then provide this number to the financial institutions where the trust assets are held. The payers, unaware of the error, issue **Forms 1099** at year-end incorrectly attributing income to the trust entity rather than to the grantor. Unless these improper 1099s can be re-issued using the grantor's SSN, the fiduciary will be required to file a tax return for the trust, claiming all

[33] Treas. Reg. § 1.6012-3(a).

[34] *North Carolina Dept. of Revenue v Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (June 21, 2019).

[35] R&TC, §§ 17743 and 17744.

income and then deducting comparable amounts for which the trustee has now issued 1099s to the grantor.[36]

Upon the grantor's death, the living trust becomes irrevocable. Trust provisions may call for a complete distribution of assets as soon as logistically feasible or may require a division of assets and the creation of additional trusts [see A-B Trusts, as an example]. At this juncture, new EINs must be assigned to each trust entity (or the decedent's estate if the inter vivos trust was not fully funded or the decedent's property passes under the provisions of a will).

While a simple estate plan may serve to convert all of a decedent's assets into one entity—whether a probate estate or a revocable trust—plans that are more complex require that various trust entities be funded as per the terms of the governing instrument(s). To accomplish this task, the trustee should seek guidance from an attorney who can interpret the trust provisions and then provide funding instructions *in writing*. Because subtle trust provisions may have significant impact,[37] it is best to let the legal expert determine the amount (asset value) that should be transferred to each trust, although the tax practitioner can then advise which specific assets should be transferred, considering both immediate and long-term tax consequences.

Once the respective trusts are funded (or a probate estate exists), **Form 1041** will have to be filed for each entity based upon the following rules…

A. Filing Requirements

Estates must file if they have gross income in excess of $600 or have an NRA beneficiary. Trusts must file if gross income exceeds $600, or they have *any* taxable income, or there is an NRA beneficiary. Any estate or trust required to file **Form 1041** must obtain an EIN.

To amend a previously filed fiduciary return, a new **Form 1041** must be filed.

Tax Year

For estates, the DOD marks the beginning of the first tax year, which can cover any period of twelve months or less that ends on the last day of a month. (The executor makes the choice of the tax year when the first tax return is filed.) Trusts, on the other hand, *must* use a calendar year, except a grantor trust that files **Form 1041** must use the same tax year as the grantor. Therefore, in the year of the grantor's death, the trust will be required to file using short tax year from the DOD through year-end. UNLESS…

[36] Treas. Reg. § 1.671-4(b)(2)(iii).

[37] Marital deduction formulas are divided into two types: pecuniary and fractional. A pecuniary formula funds a specific dollar amount, whereas a fractional formula funds the marital and credit shelter trust proportionally with each asset. There are a variety of pecuniary formulas available: Some formulas fund the marital trust (Trust A) first with Trust B receiving the residual; others fund the credit shelter (Trust B) first and give the residual to Trust A. Each method produces the same marital deduction amount for estate tax purposes, but the income and generation-skipping transfer tax consequences are markedly different. [Excerpted from Maroko &Landau, *Which Marital Deduction Formula Do You Use?* (1999), available at http://library.findlaw.com/1999/Aug/1/131038.html, last accessed April 21, 2020.]

IRC § 645 Election

The trustee of a qualified revocable trust (QRT)[38] may make an election to treat the trust as part of the decedent's estate; thereby minimizing duplicative filing requirements. **Form 8855 Election to Treat a Qualified Revocable Trust as Part of an Estate** is used to make the election and must be filed by the due date (plus extensions) for **Form 1041** for the first taxable year of the estate, regardless of whether there is sufficient income to require the filing of that return. The election period begins on the date of death and terminates when both the trust and estate have distributed all assets.

During the election period, **Form 1041** is filed for the combined estate and trust under the name and EIN of the estate—the trust is only required to file a separate **Form 1041** if it terminates during the election period.[39] If there is no probate estate, the trustee files **Form 1041** under the EIN for the trust[40] using rules applicable to estates. Therefore, a trust filing as an estate can use a fiscal year.

Some of the benefits of making the election could include:

- Only one (rather than two) fiduciary returns must be filed.
- Income and expenses may be netted to better advantage.
- The rules for passive losses are more favorable for estates than trusts.
- An estate can hold S-Corp stock for a longer period of time than a trust.
- Estimated taxes do not have to be paid during the first two years of administration.
- Taxes attributable to distributions may be delayed.

Beneficiaries must report income in the tax year in which the trust or estate year ends. For example, the estate of a decedent who died on February 17, 20XX, closes its first year on January 31, 20YY. The estate files a 20XX **Form 1041** for the first year. A calendar-year beneficiary then reports any allocated items from the Schedule K-1 on his or her year 20YY **Form 1040** even though the items are reported on a 20XX K-1.

Due Dates

A calendar-year fiduciary return is due on the 15th day of the fourth month after the close of the tax year. The filing deadlines may be automatically extended for 5½ months by filing **Form 7004 Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Return.** A late filing penalty of 5% of tax per month up to 25% plus late payment penalties and interest will be assessed but may be waived if an explanation showing reasonable cause for the delay is attached to the return. If a return is more than 60 days late, the minimum late filing penalty is the smaller of $330 or the tax due.[41]

Estimated Tax Payments

Estimated payments for estates are only required to be submitted for tax years ending two or more years after the decedent's death.[42] On the other hand, trusts are required to submit estimated payments if the tax liability is $1,000 or more and the total of withholdings and credits is less than the smaller of either 90% of the tax for the current year or 100% of the tax

[38] A QRT is any trust treated as owned by the decedent with the power to revoke that trust up until the DOD (e.g., a grantor trust).

[39] Treas. Reg. §1.645-1(h)(2)(i)(B).

[40] An EIN must be obtained for the QRT following the decedent's death.

[41] IRC § 6651(a).

[42] IRC § 6654(l).

from the previous year. If AGI in the previous year was more than $150,000, the safe harbor is 110% (not 100%) of the previous year's tax.[43]

NOTE: Estates and trusts are subject to the 3.8% Net Investment Income Tax (NIIT) and should include the resulting liability when calculating the quarterly estimated tax payment due.[44] To compute the surtax due, **Form 8960 Net Investment Income Tax Individuals, Estates, and Trusts** must be attached to **Form 1041**.

A trust (or an estate in its final year) may allocate estimated tax payments to beneficiaries[45] and must file **Form 1041-T Allocation of Estimated Tax Payments to Beneficiaries** by the 65th day after the close of the tax year. **Form 1041-T** can be filed with the fiduciary return or independently. A beneficiary is not required to include income distributed during the first 65 days of the following year in annualized income for the January 15th payment when a trust or estate elects to treat such income as if it were paid during the current year.[46]

Exemptions

- Estates: $600.
- Trusts: $300, if required to distribute all income currently (e.g., simple trust) or $100 if permitted to accumulate income (e.g., complex trust). Qualified disability trusts are allowed an exemption amount equal to that of single taxpayers.[47]

Simple trusts have no charitable beneficiaries and do not distribute principal but are, instead, required to distribute all of the trust's accounting income to beneficiaries annually. This income – whether or not actually distributed – is taxable to the beneficiaries. All other trusts (by default) are complex trusts and taxed only on income that has not been distributed.

BEWARE: The character of a trust could change from year to year, depending upon distributions that may be required by the governing instrument, court order or in the year of termination. Practitioners should not assume that the checkbox in Section A of the prior-year **Form 1041** will be similarly checked in ensuing years.

B. Income

1. Gross Income

Income earned by an estate or trust is reportable much like it would be for an individual taxpayer. In fact, business, rental and farm income is reported on the same Schedules C, E and F, respectively. Net Income as computed on these schedules is transferred to Lines 1 through 9 on the front page of **Form 1041**.[48]

[43] IRC § 6654(d).

[44] NIIT is assessed at a rate of 3.8% on the lesser of *undistributed* net investment income or the excess of Adjusted Gross Income (AGI) over the dollar amount at which the highest applicable income tax bracket begins ($12,951 in 2020). Simple trusts will generally not be subject to the tax (since they distribute all of their income) unless they have capital gains classified as principal.

[45] IRC § 643(g).

[46] Rev. Rul. 78-158.

[47] IRC § 642(b)(2)(C).

[48] Business income reported on Schedules C and F is subject to Self-employment Tax (SE Tax) on the decedent's final return but not on the fiduciary return.

Income earned on assets held by the estate or trust beginning on the day after the DOD until the assets are distributed to the beneficiaries is reportable on the fiduciary return, along with capital gains and losses resulting from the disposition of assets during the administration period (using Schedule D). Income that passes directly to beneficiaries outside of probate or trust administration (e.g., retirement and payable-on-death account distributions) is reportable on the beneficiary's individual **Form 1040.**

Nominee Recipients

In theory, financial institutions and other payers should issue a set of two **Forms 1099** in the year of death properly attributing pre-death income to the decedent's SSN and post-death income to the EIN of the estate or trust. But often, the allocation is not made and only one **Form 1099** is issued that includes both pre- and post-death income. The full amount of the 1099 income should be reported on the **Form 1040** or **Form 1041** to which the 1099 was issued. Then, to correct the improper reporting, the fiduciary should create a second line entry labeled as "Nominee Distribution" to subtract the amount of income that was improperly attributed by the payer. To provide a paper trail and facilitate document matching by the IRS, the fiduciary should then issue a 1099 from the incorrectly attributed payee to the correctly attributed payee using the same type of **Form 1099** as was originally received.

Capital Transactions

For property acquired from the decedent, the fiduciary's basis is the value of the assets as reported on the decedent's estate tax return or – if no **Form 706** was required to be filed – is the fair market value of the asset on the DOD.[49] For taxable estates, the fiduciary must provide beneficiaries with basis information on Schedule A of **Form 8971 Information Regarding Beneficiaries Acquiring Property from a Decedent**. Regardless of the fiduciary's actual holding period between the DOD and the date of disposition, all assets acquired from the decedent are deemed to have been held long-term.[50]

Assets transferred by a living grantor into an irrevocable trust are deemed to be completed gifts. As such, the basis of these assets is generally carried over from the donor's adjusted basis[51] and the holding period includes the donor's holding period.[52]

Capital gains are generally allocated to the fiduciary unless actually distributed to a beneficiary or used to make a charitable contribution.[53] However, capital gains may – in the alternate – be allocated and taxable to the beneficiary as per the terms of the governing instrument or based on applicable law in the governing jurisdiction. By contrast, all losses that exceed gains (after the usual netting)[54] – are allocated only to the fiduciary who may deduct up to $3K against ordinary income and then carry

[49] IRC § 1014.

[50] IRC § 1223(11).

[51] IRC § 1015.

[52] IRC § 1223(2).

[53] Treas. Reg. § 1.643(a)-3.

[54] Losses are netted against all gains except those required to be distributed to a specific beneficiary.

additional amounts forward indefinitely. Unused capital loss carryforwards are eventually passed through to the beneficiaries in the year of termination.[55]

IRC §643(e)(3) Election
While gains and losses are generally not recognized when non-cash property is distributed to a beneficiary, the fiduciary may elect to recognize the gain (but not loss due to related party rules); thereby, providing an additional basis step-up to the recipient beneficiary. The election is made by checking the box on **Form 1041**, Page 3, Line 7 and reporting the distribution on Schedule D as though a sale had occurred at the FMV as determined on the date of distribution.

Related Party Transactions
Losses resulting from the sale or exchange of property between related parties are non-deductible; gains from the sale or exchange of depreciable property are treated as ordinary income.[56]

Related parties include trustee and grantor; trustee or executor and beneficiary (even if they are parties to different trusts that have been created by the same grantor); trustees of trusts created by the same grantor; or trustee and a corporation with majority ownership held by the trust or grantor. Generally, *all* beneficiaries are deemed to be related.

Tax-exempt Income
A trust's tax-exempt income may be derived from life insurance benefits, municipal bond interest, personal injury compensation, and income from discharge of indebtedness.[57] If a trust or estate has tax-exempt income, some of its deductions may be disallowed or reduced.[58] For example, expenses directly attributable to tax-exempt income are not deductible (e.g., interest expense on debt incurred to buy tax-exempt bonds). Indirect expenses—those not specifically related to tax-exempt or taxable income[59]—must be reduced by the allocable amount attributable to tax-exempt income based on gross income using the following formula:

$$\frac{\text{Gross Tax-Exempt Income}}{\text{Gross Accounting Income}} \times \text{Indirect Expenses} = \text{Non-deductible Expenses}$$

The allocation calculation must be attached to the tax return and the fiduciary must answer "YES" to Question 1 under Other Information of **Form 1041**.

[55] IRC § 642(h).

[56] IRC §§ 267 and 1239, respectively.

[57] IRC §§ 101, 103, 104 and 108, respectively.

[58] IRC § 265.

[59] Only § 212 expenses for the production of income must be allocated; other expenses, such as state and local income taxes and business expenses, are deductible even if directly allocable to the exempt interest income. § 212 expenses are administrative expenses that are generally subject to the 2% AGI limitation and can include expenses for the production of income, investment management fees, fees for tax advice and preparation unrelated to **Form 1041**, legal fees to defend decedent against creditor's claims, and fiduciary fees, amongst others.

2. Deductions

Most deductions allowed to individuals are also allowed on fiduciary tax returns, including:

- Investment interest (limited to net investment income).
- Home mortgage interest if secured by a home that is owned by the estate or trust and a beneficiary who has a present or residual interest in the estate or trust uses the home as his principal or secondary residence.
- Interest paid on the unpaid portion of the estate tax attributable to the value of a reversionary or remainder interest in property.[60]
- State and local income tax (or, alternatively, sales tax), as well as personal and real property taxes not deducted elsewhere on the returns (e.g., Schedules C or E).[61]

Administration Expenses

Administration costs specific to the estate or trust are fully deductible and *not* subject to the customary 2% of AGI limitation.[62] Such costs – including but not limited to legal, trust accounting, fiduciary tax preparation, investment advisory (if they exceed those fees that would normally be incurred by an individual investor), appraisal, court, bond and trustee fees – are fully deductible if (1) the cost was incurred in connection with the administration of the estate or trust and (2) the cost would otherwise not have been incurred. In other words, the expenditure must be *unique* to the estate or trust and would not commonly have been incurred if an individual held the same property.[63]

NOTE: While the TCJA eliminated the deduction for Miscellaneous Itemized Expenses for individuals for tax years 2018 – 2025,[64] the IRS has confirmed that administration expenses remain deductible if incurred by estates and non-grantor trusts.[65]

Most administration expenses can be deducted on either **Form 706** or **Form 1041**, but not both.[66] If expenses for selling property are deducted on **Form 706**, the same expenses cannot be included in the basis of the asset when the sale is reported on **Form 1041**.

On the other hand, deductions-in-respect-of-decedent ("DRD") may be deducted on *both* returns,[67] if the expenses—including business expenses (IRC § 162), interest (IRC § 163), income and property taxes (IRC § 164), and expenses for the production

[60] IRC § 163(h)(2)(E).

[61] TCJA limited the deduction for the aggregate of these taxes to $10K for tax years 2018 – 2025. However, the $10K limitation does not apply to taxes paid in the course of a trade or business.

[62] IRC § 67(e)(1).

[63] Treas. Reg. § 1.67-4(a).

[64] IRC § 67(g).

[65] IRS Notice 2018-61.

[66] If the expenses are deducted on **Form 1041**, attach a signed statement stating, "These expenses have not been claimed as deductions for federal estate tax purposes and all rights to claim such deductions have been *irrevocably* waived." This statement is required even if no estate tax return (**Form 706**) is due.

[67] Deduct as a debt of the decedent on **Form 706** AND as an expense on **Form 1041**, Line 14.

of income (IRC § 212)—were incurred by the decedent prior to his death and were then paid by the estate after death.

If any estate tax is paid on **Form 706** on income-in-respect-of-decedent (IRD), the amount paid may be deducted on **Form 1041**.

Estates and trusts are not entitled to the § 179 expense deduction. Generally, depreciation and depletion deductions must be allocated between the trust and its income beneficiaries on the same basis as the accounting income is allocated to each. However, if the trust instrument requires that the fiduciary maintain a depreciation reserve (and the trustee actually does so), the depreciation expense is first allocated to the trust up to the amount of the reserve.[68]

For example, the trust instrument requires that 30% of its income must be distributed to Beneficiary #1, 20% to Beneficiary # 2, and 50% may be accumulated by the fiduciary. If the annual depreciation allowance totals $4,000, then the deduction will be allocated as follows: $1,200 to Bene 1, $800 to Bene 2, and $2,000 to the trust.

Charitable Deduction

A trust (or estate) may deduct charitable contributions *only* if (1) the contribution is required by the terms of the trust instrument or estate and (2) the payment is made from taxable gross income.[69] Unlike personal tax returns, the deduction for trusts and estates is not limited to a percentage of AGI.[70] However, the deduction must be reduced by the proportion of tax-exempt income included in gross accounting income unless the trust instrument or applicable state law requires that the charitable contribution be made solely from taxable income.[71]

Although paid in the current year, the trust may elect to push back some or all of the charitable deduction into the prior year. The election must be made by the due date (plus extensions) of the current return by attaching a statement that includes the fiduciary's name, address and identification number; the name and address of the recipient charitable organization; the amount and date of the contribution; and a statement that the election is being made under IRC § 642(c)(1).

Form 1041-A U.S. Information Return Trust Accumulation of Charitable Amounts must be filed each year a complex trust claims a charitable deduction but is not required for charitable remainder trusts, charitable lead trusts and pooled income funds. These entities must instead file **Form 5227 Split-Interest Trust Information Return**. **Form 1041-A** is also not required for an estate or simple trust.[72]

[68] Treas. Reg. §1.167(h)-1(b)].

[69] IRC § 642(c): Amounts paid from tax-exempt income or principal are not deductible unless such principal has been included in the taxable gross income of the trust or estate.

[70] The deduction is claimed on Schedule A, page 2, **Form 1041**.

[71] Treas. Reg. §1.642(c)-3(b)(2).

[72] **Form 1041-A** is due April 15th but may be extended for six months by submitting **Form 8868 Application for Automatic Extension of Time to File an Exempt Organization Return**.

3. Accounting Income & Distributable Net Income (DNI)

Accounting Income

Accounting income[73] is the amount of income that the income beneficiaries are entitled to receive from the trust each year. Such beneficiaries are distinguished from remainder beneficiaries who are entitled only to the trust's principal. The governing instrument may include a specific allocation between these types of beneficiaries or allow the trustee to make the allocation according to applicable state law, which typically requires that interest and dividends (classified as income) and capital gains (considered to be principal) be allocated to achieve fairness among the various beneficiaries.

A trust earned $3,000 of interest income and $2,000 capital gains and paid fiduciary fees of $600. The trust instrument allocates interest and dividends to "income;" capital gains to "principal" and requires that administrative costs be allocated equally between income and principal, as well as that all income be distributed to the income beneficiary each year. Thus, the beneficiary will receive $2,700 (= $3,000 interest - $300 trustee fees).

Accounting income does not determine how much of the trust's income is taxable, nor does it establish whether the trust or the beneficiaries will pay the applicable tax. Instead, the allocated tax liability is determined by the income distribution deduction.

FORM 1041 LINE ITEMS

- GROSS INCOME is computed on Page 1, Line 9.
- ADJUSTED TOTAL INCOME (the result of gross income less deductions) is computed on Page 1, Line 17.
- INCOME DISTRIBUTION DEDUCTION is computed on Page 2, Schedule B, Line 15 and transferred back to Page 1, Line 18.
- TAXABLE INCOME (the net after subtracting the income distribution, estate tax and qualified business income deductions) is computed on Page 1, Line 23.

Distributable Net Income (DNI)

DNI is the maximum amount of income for which the fiduciary can claim an income distribution deduction and the maximum amount required to be included in the beneficiary's gross income. Distributions in excess of DNI are usually treated as tax-free distributions of principal.

Distributions *required* to have been made as per the terms of the trust are deemed to have been made even if not actually paid during the taxable year; whereas *discretionary* distributions made by the fiduciary are taxable to the beneficiary only if actually made during the taxable year or during the first 65 days of the following year, if the fiduciary makes an IRC § 663(b) election by checking the box on **Form 1041**, Page 3, Line 6.

The income distribution deduction, therefore, is the lesser of *actual* distributions net of the tax-exempt income included in that distribution, or DNI less tax-exempt interest.

[73] Report on Line 9, Schedule B of **Form 1041** as "income required to be distributed currently" if simple trust; on Line 8 of Schedule B if complex trust.

DNI is "an approximation of the actual economic benefit available to the income beneficiaries"[74]

DNI = Adjusted Total Income + Net Tax-exempt Income + Gains Allocated to Beneficiaries – Charitable Contribution Deduction (made from gains) + Capital Losses – Capital Gains

Assume that Trust has $10K dividends, $10K capital gains, and $1,200 fiduciary fees:

Example A: *A simple trust is required to distribute <u>all</u> income, including capital gains…*
Adjusted Total Income. = 10 + 10 – 1.2 = 18.8
DNI = 18.8K since terms require total distribution of income & gains
→ Beneficiary's taxable income = 18.8
→ Trust's Taxable Income = 18.8 – 18.8 = 0

Example B: *Trust is not required to distribute capital gains…*
Adjusted Total Income. = 10 + 10 – 1.2 = 18.8
DNI = 18.8 – 10 gain = 8.8
→ Beneficiary's taxable income = 8.8
→ Trust's Taxable Income = 18.8 – 8.8 = 10

Income distributions are classified based on whether they are required to be distributed (Tier 1)[75] or are subject to the fiduciary's discretion and actually paid to the beneficiaries (Tier 2).[76] DNI is apportioned amongst multiple beneficiaries based on the amount and type of distribution made to each, but the trustee cannot designate which beneficiaries receive taxable income and which receive nontaxable distributions of principal. If DNI exceeds the income required to be distributed currently, it is first apportioned to the first-tier beneficiaries and then divided proportionately among beneficiaries receiving second-tier distributions.

Discretionary (Tier 2) distributions are generally deductible by the trust only in the year that the distributions are actually made but, to allow a fiduciary to complete his year-end accounting and make the required distributions, he may elect to treat amounts distributed in the first 65 days of the next tax year as though they were distributed in the current tax year by checking the box on Line 6, page 2 of **Form 1041**. Since simple trusts may not make discretionary distributions, this rule applies only to complex trusts.

[74] *Small Business Quickfinder Handbook*, Thomson Reuters CHECKPOINT (TY'19).

[75] For a simple trust, the DNI equals the accounting income and is entered on Schedule B, Line 9, **Form 1041**. For a complex trust, DNI is the percentage of accounting income required to be distributed under the terms of the trust.

[76] Enter on Schedule B, Line 10, **Form 1041.** Lump-sum gifts or specific bequests (paid all at once or in less than three installments) are not included on either line 9 or line 10 (IRC §663).

SUMMARY COMPARISON OF TRUST, DISTRIBUTABLE & TAXABLE INCOME			
	Adjusted Trust Income	**DNI**	**Trust's Taxable Inc.**
Ordinary Income	✓	✓	✓
Tax-exempt (TE) Income	✖	✓	✖
Dividends	✓	✓	✓
Capital Gains	✓	✖	✓
Fiduciary Fees	✓	✓	✓
Exemptions	✖	✖	✓
Income Distribution Deduction	✖	✖	**DNI – TE Income**

FIDUCIARY INCOME TAX REPORTING

- Generally, trusts and estates must file **Form 1041** if they have gross income in excess of $600. While trusts must use a calendar year, the executor of an estate may elect a fiscal year that covers any period up to twelve months after the DOD. No estimated tax payments are due for the first two years after the DOD for an estate, or when the tax liability is less than $1,000 for a trust. A $600 exemption is allowed to an estate, $300 to a simple trust, $100 to a complex trust.
- It is important to distinguish between accounting, taxable, and distributable net income which is the maximum taxable amount of distributions that can be made to the beneficiaries.
- Trusts and estates are entitled to many of the same deductions as individual taxpayers. Some of these deductions may be deducted on either **Form 1041** or **Form 706**, but not both. Deductible expenses must be pro-rated if the trust or estate has tax-exempt income. Charitable contributions may be deducted by the fiduciary only if the contribution is made from taxable gross income pursuant to the terms of the trust or will.

V. Termination of the Estate or Trust

An estate (or trust) is considered terminated when all assets have been distributed (except possibly for a nominal amount set aside for the payment of unascertained or contingent liabilities). Once terminated, the liability for tax reporting and payment shifts to the beneficiaries.

The IRS presumes that a fiduciary should be able to wind up a typical estate's affairs within two years. Failure to close an estate in a timely manner may cause the IRS to deem the estate as terminated; thereafter attributing all income, deductions and credits of the estate to the beneficiaries.[77]

A. Excess Deductions on Termination

If, in the *final* year, a trust (or an estate) has deductions—not including charitable contributions—which exceed gross income, these excess deductions may be allocated to the beneficiaries on Schedule K-1. The beneficiaries, in turn, may then claim the allocated deductions as Miscellaneous Itemized Deductions on Schedule A of **Form 1040** subject to the 2% AGI limitation. Unused deductions may not be carried forward by the beneficiaries.[78] The trust's or estate's unused capital losses may also be distributed to, deducted and carried forward by the beneficiaries.

With TCJA's elimination of Miscellaneous Itemized Deductions on the individual returns, taxpayers await specific guidance from the IRS with regards to the deductibility of deductions allocated from estates and trusts. Instructions for Schedule A, Line 16 seem to indicate that while federal estate tax paid on IRD remains deductible, no mention is made of excess deductions on termination of a trust or estate. Indeed, as per the Blue Book of the Joint

[77] IRC § 6901.

[78] Treas. Reg. § 1.642(h)-2.

Committee on Taxation, it appears that congressional intent was to eliminate the deduction for tax years 2018 – 2025.

NOTE: Excess deductions – except net operating and capital losses, as well as investment interest expenses – in years prior to the trust or estate's final year cannot be carried forward by the trust (or estate) and are forever lost.

B. Fiduciary Liability

Since the fiduciary remains liable for all obligations of the estate or trust until termination, it is best that he does not make a final distribution to the beneficiaries, lest he must reclaim the distributed funds [long spent!] from the beneficiaries in the event another liability surprisingly surfaces at a later date. While creditors' claims must usually be discharged within one year from the DOD (although this deadline may vary according to state law), tax liabilities cannot be considered final until the applicable statute of limitations has passed or closing letters[79] have been received from the tax authorities.

As per Treas. Reg. §20.2204-1, the personal representative may request to be discharged from personal liability for estate tax by writing to the district director by filing **Form 5495 A Request for Discharge from Personal Liability under Internal Revenue Code Section 2204 or 6905**.[80] The IRS must notify the personal representative of any tax liability within nine months of filing the request or **Form 706**, whichever is later.

FINISHING UP

- Prior to the enactment of TCJA, excess deductions in the final year of an estate or trust could be passed through to the beneficiaries, who could then claim them on their individual tax returns as Miscellaneous Itemized Deductions.
- The personal representative remains personally liable for all tax liabilities until the statute has tolled or his request for discharge of liability has been approved by the IRS.

VI. Interplay between 1041 and Other Returns

We have now devoted considerable attention to the income tax filing requirements for estates and trusts. It is time to circle back and examine the overlap between income and estate taxation, where applicable.

1. Income-in-Respect-of-Decedent (IRD)

IRD is *income* that had been earned by a taxpayer prior to his death but that had not yet been paid to him. IRD is taxable to the recipient in the year of receipt, whether the recipient is the decedent's estate or the decedent's beneficiary. If IRD is paid to the estate, it is reported by the fiduciary on **Form 1041**. If IRD is paid directly to a beneficiary, it is reported on the beneficiary's individual **Form 1040**.

Strangely, IRD is also deemed to be as *asset* reportable on the decedent's **Form 706**. Thus, IRD is taxed first as part of the decedent's net worth on the estate tax return and then again

[79] The IRS has announced that Account Transcripts will be made available to authorized tax professionals in lieu of closing letters for all estate tax returns filed on or after June 1, 2015.

[80] **Form 5495** may not be filed until after the tax returns for which the personal representative is seeking to be discharged have been filed. Separate requests must be filed with each Service Center responsible for processing multiple returns filed. The request for discharge for estate tax may be attached to **Form 706** when filed or submitted independently any time within 3 years after filing the estate tax return.

as revenue on the fiduciary's (or beneficiary's) income tax return. To mitigate the effects of this double taxation, Congress allows fiduciaries (beneficiaries) to deduct an allocable percentage of any estate tax paid that was attributable to IRD.[81]

2. The Estate Tax Deduction (ETD)

ETD is equal to the estate tax paid on IRD, which can only be calculated by preparing **Form 706** *twice*, once with the IRD included and then again without. The difference between the resulting tax liabilities represents the estate tax attributable solely to the IRD. It is this amount that may be claimed as an income tax deduction by the fiduciary (beneficiary).

ETD must be claimed in the same year that the corresponding IRD is included in the fiduciary's (beneficiary's) income. ETD may be deducted as an above-the-line deduction on fiduciary's return (**Form 1041**, Line 19) or as a Miscellaneous Itemized Deduction *not* subject to the 2% AGI limitation on the beneficiary's return (Schedule A, Line 16).[82] While the deduction was not eliminated by TCJA's prohibition on most miscellaneous expenses, ETD can only offer a tax benefit to a beneficiary who itemizes deductions and completes Schedule A. If the fiduciary or beneficiary is subject to AMT, ETD is neither a preference nor adjustment item and is not added back to taxable income when computing alternative minimum taxable income.

[81] IRC § 691.

[82] IRC § 67(b)(8).

APPENDIX A
Glossary of Terms

Accounting Income	Includes income and expense items that are used to calculate the amount of income beneficiaries are entitled to receive from the trust each year—items allocated to principal are not used in the calculation.
Administrator	Appointed by a court to manage the assets and liabilities of an intestate decedent.
Alternate Valuation Date (AVD)	Valuation date six months (not 180 days) after the date of a person's death. For estate tax purposes, the executor may place a value on the estate as of the date of death or on the alternate valuation date. To use the alternative valuation date, the estate value and tax must be less than on the DOD.
Annual Exclusion	This is the amount (adjusted for inflation) of gifted property that can be transferred to each donee annually without the incurrence of any gift tax.
Applicable Exclusion Amount	Formerly known as the Unified Estate and Gift Tax Credit, it was renamed in 1997.
Bypass Trust	Also known as the Credit-shelter Trust, or B-Trust, its assets are protected from estate taxation by the decedent's applicable exclusion.
Complex Trust	A trust that may (but is not required to) distribute income or principal to its beneficiaries or make charitable contributions.
Date of Death (DOD)	The crucial date used to establish the transfer of legal responsibility for the payment of tax from the decedent to his personal representative, as well as the date used to value the decedent's worth, and the date used to determine the start of the tax period for the estate and fiduciary tax returns.
Direct Skips	A transfer of property, subject to gift or estate tax, made to a skip person.
Distributable Net Income (DNI)	This is maximum amount of trust income that can be taxed to the beneficiary.
Domicile	The place where an individual permanently resides or, whenever he is absent, the place to which he intends to return. Both domicile and residency may determine the tax status of a decedent.
Estate	All property—regardless where situated—owned by an individual.
Executor	Named in the decedent's will to manage the estate.
Fair Market Value (FMV)	The price at which willing buyers and willing sellers agree to an exchange in an arm's length transaction. FMV is used to determine the tax base upon which the Estate Tax is assessed.
Fiduciary	An individual charged with the responsibility for acting in the best interests of another. Held to the highest standards, the fiduciary is both ethically and legally obligated to discharge his duties in good faith, with diligence and care, and may become liable for any breach.
Generation-skipping Tax (GST)	Imposed on transfers that skip an intervening generation in an attempt to avoid one level of estate taxation.
Gift	Transfer of property for inadequate consideration.
Grantor	Also known as Trustor, this individual is the creator of a trust and the one who gives assets to the trust.
Grantor Trust	A trust over which the grantor (creator) continues to exercise control or receive beneficial enjoyment.

Income-in-Respect-of-Decedent (IRD)	Decedent's accrued, but not yet received income that is taxed to the estate or heir that actually receives the income.
Inheritance Tax	Also known as the Succession or Legacy Tax, it is assessed to the heir for the privilege of receiving property from a decedent.
Intestacy	Dying without having made a legal will. State rules will apply to distribution of the decedent's estate; heirs will generally be determined based upon their family relationship to the decedent. If there are no identifiable heirs, the estate will escheat and be legally assigned to the government.
Living Trust	Also known as an Inter Vivos Trust, this trust is one that is created and takes effect during the grantor's lifetime.
Marital Trust	Also known as A-Trust, its assets are protected from taxation upon the death of the first spouse by the unlimited marital deduction.
Non-probate Assets	These can pass directly to the heirs based on contracts or operation of law.
Personal Representative	Fiduciary who may be an executor, an administrator, a trustee, a guardian, or a custodian.
Power of Attorney (POA)	Allows the authorized attorney-in-fact to act on behalf of the principal who appointed him.
Probate	The judicial process used to validate a will.
Qualified Domestic Trust (QDOT)	Trust that can be used to defer the estate tax on assets transferred at death to a non-citizen spouse.
Qualified Revocable Trust (QRT)	An election (IRC §645) to treat trust assets as part of an estate, thereby combining the trust's tax filing requirements with those of the estate.
Qlfd Terminable Int Ppty Trust (QTIP)	This trust allows the grantor to provide for a surviving spouse and still specify how the trust's assets will be distributed once the surviving spouse passes.
Residency	A duration of stay required by state and local laws that entitles a qualified individual to the legal protection and benefits provided by applicable statutes. However, residency does not always determine domicile or citizenship, which generally requires a pledge or debt of allegiance.
Simple Trust	A trust that is required to distribute all of its accounting income (but not principal) to its beneficiaries in the year earned and has no charitable beneficiaries.
Skip Person	A skip person is a relative two or more generations below the transferor (i.e. grandchildren, grandnieces, grand-nephews and their descendants) or an unrelated person more than 37-1/2 years younger than the transferor.
Trustee	The person appointed under the terms of the trust instrument to administer the trust.
Special Needs Trust (SNT)	Designed to provide benefits to, and protect the assets of, physically or mentally disabled persons and still allow such persons to qualify for governmental health care benefits, especially long-term nursing care benefits, under the Medicaid welfare program.
Unlimited Marital Deduction (UMD)	The amount that may transfer between citizen spouses, effectively eliminating any tax on spousal inheritances.
Will	A legally enforceable declaration of a person's last wishes, primarily designed to outline his desires regarding the disposition of his assets (i.e. testamentary disposition).