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Companion to PPC's

1041 Deskbook

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Interactive Self-study CPE

Companion to PPC's 1041 Deskbook

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's 1041 Deskbook consists of two interactive self-study CPE courses.These are companion courses to *PPC's 1041 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of estate and trust taxation on the Form 1041. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 1

IRD AND DEDUCTIONS (T41TG091)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course looks at various issues pertinent to estates and trusts related to income in respect of a decedent (IRD) and deductions. Lesson one discusses IRD in detail, including an examination of the different types of IRD that are available. Lesson two covers deductions recorded on the Form 1041 and how they relate to deductions on the Form 706. Lesson three discusses other deductions, including the 2% of adjusted gross income (AGI) floor. Lesson four takes a closer look at net operating losses (NOLs).

PUBLICATION/REVISION DATE: December 2009

RECOMMENDED FOR: Users of *PPC's 1041 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of income taxes

CPE CREDIT: 9 QAS Hours, 9 Registry Hours

9 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Income in Respect of a Decedent

Completion of this lesson will enable you to:
- Define income in respect of a decedent (IRD) and determine when and how it is reported.
- Identify the different types of IRD, such as compensation, business, farming, investments, property sales, pass-through entities, retirement plan distributions, and other sources.
- Determine the tax effects of distributing and transferring IRD assets.

Lesson 2—Deductions—Interaction with Form 706

Completion of this lesson will enable you to:
- Identify the rules for determining where administration expenses can be deducted.
- Recognize deductions in respect of a decedent (DRD) and assess related issues.
- Determine how to claim a deduction for estate tax paid on IRD.

Lesson 3—Other Deductions

Completion of this lesson will enable you to:

- Assess issues related to deducting investment advisory fees, casualty and theft losses, and other deductions not subject to the 2% of AGI floor.
- Identify the rules for miscellaneous itemized deductions subject to the 2% of AGI floor, indirect expenses, and expenses for maintaining estate property.

Lesson 4—Net Operating Losses

Completion of this lesson will enable you to:

- Explain net operating losses (NOLs), recompute them in carryback and carryforward years, and summarize the related rules.
- Assess issues related to filing a refund claim for NOL carryback, electing to forgo NOL carryback, and unused NOLs that pass through to beneficiaries.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
T41TG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Income in Respect of a Decedent

Introduction

Amounts of gross income that a decedent was entitled to receive, but were not includible in his or her final tax return, are considered income in respect of a decedent (IRD). Common examples of IRD include wages, retirement plan distributions, interest, dividends, gain on sales of property, installment notes collected, sales of farm crops and livestock, royalties, etc. These amounts must be reported when received by the decedent's estate or beneficiaries. The income has the same character in the hands of the recipient as it had in the hands of the decedent. The IRD is subject to both estate tax and income tax; however, IRC Sec. 691(c) provides relief in the form of an income tax deduction for estate tax paid on the IRD.

Likewise, when an individual dies, certain expenses for which he or she was liable at the date of death are referred to as deductions in respect of the decedent (DRD) and are deductible on both the estate tax return (Form 706) and Form 1041.

Upon an individual's death, the basis of property in the hands of the person acquiring it is generally the fair market value at the date of death. Without a provision to the contrary, this "step-up" (or "step-down") in basis would apply not only to the underlying property, but also to any income associated with it. Therefore, to ensure such income is subject to income tax, Congress added IRC Sec. 1014(c), which provides that the basis adjustment rules do not apply to property that is income in respect of a decedent (IRD) under IRC Sec. 691.

Learning Objectives:

Completion of this lesson will enable you to:

- Define income in respect of a decedent (IRD) and determine when and how it is reported.
- Identify the different types of IRD, such as compensation, business, farming, investments, property sales, pass-through entities, retirement plan distributions, and other sources.
- Determine the tax effects of distributing and transferring IRD assets.

The Basics of Income in Respect of a Decedent (IRD)

Overview of IRD

Although income in respect of a decedent (IRD) is not defined in the Code, the term generally refers to gross income a decedent was entitled to receive at the time of death but was not included in his or her final Form 1040 (or any prior return) under his or her regular method of accounting. Since individuals are usually cash basis taxpayers, IRD generally arises when money or property is received after the decedent's death that was attributable to activities and efforts of the decedent while he or she was alive.

IRD represents income that would have been taxable to the decedent if he or she had lived and received the income personally. Thus, IRD includes:

1. all accrued income of a cash-basis taxpayer at the time of death,
2. income accrued solely by reason of the decedent's death by an accrual-basis taxpayer, and
3. income to which the decedent had a contingent claim at the time of his or her death.

Some of the more common items that may, under the particular facts and circumstances, be IRD include amounts received after the decedent's death as compensation for the decedent's personal services, zero-basis accounts receivable, investment income, installment sales, certain property dispositions, survivor payments under employment contracts, retirement plan distributions, and income from pass-through entities.

How IRD Is Taxed

When an amount a decedent was entitled to receive is IRD, it is subject to income tax as well as estate tax and possibly the generation-skipping transfer (GST) tax. The income taxability results from the denial of a step-up in basis to items of IRD. Since the decedent's tax basis in these items was zero, the zero basis will "carry over" to the recipient, resulting in taxable income upon actual or constructive receipt. If the item is not IRD, it is subject only to estate (and possibly GST) tax. If the item *is* IRD, it may be subject to both income tax and transfer tax liability.

Example 1A-1 IRD is subject to double taxation.

When Martha died, she owned a one-year, $100,000 certificate of deposit at First National Bank, with interest payable at maturity in December 2009. The interest was not credited on a monthly basis to Martha's account, but was payable in full upon the certificate's maturity. The accrued but unpaid interest at the time of her death in November 2009 was $3,500. Her estate is in the 45% federal estate tax bracket and the 35% income tax bracket. The estate received all the interest in December 2009.

Of the $3,500 accrued interest, $1,575 (45%) will be owed as federal estate tax, and $1,225 (35%) will be owed as income tax, for a total tax of $2,800 (80%). However, the effective total tax rate will be reduced when the tax savings provided by IRC Sec. 691(c), described below, is taken into account.

The nature of the IRD in this example is straightforward, since the $3,500 accrued but unpaid interest income is clearly IRD. In many cases, however, the distinction is not so obvious.

Variation: If the interest had been credited to Martha on a monthly basis, she would have been in constructive receipt of the interest income. In that case, the annual Form 1099-INT issued by First National Bank to Martha would report the interest credited to her account each year. As a result, the only IRD from such interest income upon Martha's death would be the amount allocable to the period of time between the last crediting of interest income and the date of Martha's death (assuming the executor timely notifies the bank of the date of death).

To mitigate the effect of double taxation, the estate (or successor who collects the IRD) can deduct the federal (not state) estate (and GST) tax attributable to the IRD as a miscellaneous itemized deduction, which is not subject to the 2% of AGI limit. Although for individuals, certain itemized deductions are reduced by 3% (1% for 2009) of the amount that adjusted gross income exceeds $166,800 for 2009 ($79,975 for married filing jointly), this phase-out rule does not apply to estates and trusts. If there is more than one IRD recipient, the Section 691(c) deduction is allocated among the IRD recipients on a pro rata basis.

Who Reports IRD?

Typical recipients of IRD include the decedent's estate, a trust established under decedent's will, a trust functioning as a will substitute, a beneficiary who acquired the right to receive IRD from the estate or trust before payment was made, a beneficiary of a pension, IRA, 401(k) plan, or similar retirement benefit, or a person or an entity acquiring the right to the IRD by operation of law (for example, a surviving joint tenant).

If the probate estate acquires the right to receive the IRD from the decedent, it will report the income in the year of receipt. Generally, if the probate estate distributes the right to another person in satisfaction of a bequest, devise, or inheritance, the distributee reports the income in the year the income is received. Similarly, if a person acquires the right to the income by reason of the decedent's death, that person reports the income when it is received. However, if the right to receive IRD is distributed to a beneficiary in satisfaction of a pecuniary (fixed-dollar) bequest, income recognition is accelerated and reportable by the estate or trust, rather than the beneficiary.

If the right to receive the IRD is transferred for a reason *other than* bequest, devise, inheritance, or pursuant to the right of another person to receive the amount as a result of the decedent's death, the transfer is taxable to the transferor. Therefore, the governing instrument should be carefully reviewed when the right to receive IRD is transferred.

Example 1A-2 IRD taxable when income is received.

At the time of his death in November 2009, Tom Brown owned Series EE United States savings bonds with his grandson, Ricky, listed as co-owner. The bonds are scheduled to mature in 2010, and the entire amount of interest from inception has been deferred.

Upon maturity, all interest accruing on the bonds, both before and after Tom's death, is taxable to Ricky. The pre-death portion of the interest is IRD.

Example 1A-3 Distribution of right to receive IRD under terms of will.

John died in 2007, owning an installment note receivable with $50,000 of deferred gain qualifying as IRD. The estate received principal payments in 2008 and recognized $20,000 of associated gain as IRD on Form 1041. In December 2008, the estate properly distributed the residue of the estate, including the note receivable, to a testamentary trust created in the will. The trust collected the remaining note proceeds in 2009.

The trust reports the remaining gain on the installment note in 2009 as IRD. The transfer of the note receivable to the trust in 2008 was not a taxable event.

Example 1A-4 Death of successor-in-interest.

Harold died in 2006, leaving his entire estate to his wife, Maude. Due to the marital deduction, the estate was not subject to the estate tax. Included in the estate was $100,000 due from renewal commissions on life insurance policies Harold had sold during his lifetime. Maude died in 2009, leaving her entire estate, including the right to receive the remaining $65,000 of Harold's commissions, to her son, Bill.

The receipt of commission payments is IRD taxable to Maude during her life, to Maude's estate during the period of administration, and then to Bill. If the successor (Maude) dies before collecting the IRD, it is taxable as IRD to the next successor (Bill) if:

1. the right to receive the amount was acquired from the original decedent (Harold) by bequest, devise, or inheritance; and

2. the amount of gross income in respect of the original decedent was never includable in computing taxable income of the original decedent (Harold) or the first successor (Maude).

Character of IRD

When IRD is actually received by the decedent's estate or a person who acquires the right to the IRD, the income will have the same character it would have had in the hands of the decedent if he or she had lived to receive the income. This preservation of the character of IRD applies whether the item of IRD is subject to AMT as well. However, if the IRD represents self-employment income to the decedent, it will not be considered self-employment income when paid to others.

Example 1A-5 Character of IRD is preserved.

Andy Phillips, a real estate speculator, died holding various parcels of raw land. Prior to his death, the decedent entered into a legally binding contract of sale covering Parcel A and performed all substantive acts prior to closing that were called for in the executory contract of sale. There were no economically material contingencies as of the date of death that might have prevented the sale from being completed. Andy would have received the sales proceeds if he had lived. Under these conditions, the gain on the sale of Parcel A is IRD.

Andy's brother, Ralph, who was also Andy's executor and sole heir, attended the closing and received the sales proceeds in his capacity as sole heir. Ralph, a dealer in raw land, sold an adjoining parcel of land he owned to the identical buyer at the same closing.

The preparer of Ralph's individual income tax return determines the gain from the sale of Andy's parcel is capital gain to Ralph, notwithstanding Ralph's status as a dealer in raw land. The character of the IRD is determined by the character it would have had if the decedent had received it. Since Andy was an investor in raw land, the income on the sale would have been capital gain in his hands. Therefore, it is capital gain to Ralph, despite his status as a real estate dealer. However, the gain from the sale of the adjoining parcel Ralph owned personally (independently of Andy) is ordinary income earned in his capacity as a dealer in raw land.

Nontaxable Income Excluded from IRD

IRD includes only those items included in gross taxable income. Items excluded from gross income do not fall within the scope of IRC Sec. 691. For this reason, tax-exempt interest income and other types of income excluded from gross income are not IRD. The IRS felt it necessary to add this specific regulation in addition to the Section 691(a)(3) rule discussed above (i.e., that the income retains its character), although at first glance, it might appear the result is the same.

Where to Report IRD

The character of the IRD, which is the same as it would have been in the hands of the decedent if he or she had lived to collect it, determines where it should be reported.

<u>Estate or Trust Entitled to Right to Receive IRD.</u> The estate or trust will report IRD once it is collected, but only to the extent it was entitled to the IRD (i.e., probate assets). The amount will be included in distributable net income (DNI). If IRD is distributed in satisfaction of a pecuniary (i.e., fixed-dollar) amount, gain (or loss for estates, but not trusts) must be recognized by the fiduciary upon the transfer, even if the IRD has not yet been collected, and no income distribution deduction will be available to the estate or trust.

If accrued bond interest is collected, the interest is reported on Line 1 of Form 1041. Unpaid receivables from the decedent's sole proprietorship are reported by the estate on Schedule C when collected, with the net business income reported on Line 3 of Form 1041. If the type of IRD does not specifically relate to amounts reported on Lines 1–7 of Form 1041, it should be reported on Line 8. The decedent's unpaid compensation and distributions from his or her qualified plans and IRAs would also be reported on Line 8 if the estate is entitled to receive these benefits. If more than one item is reported on Line 8, a schedule listing the type and amounts of the items included should be attached to the tax return. Deductions in respect of a decedent would be handled in a similar fashion.

<u>Other Person Entitled to IRD Asset.</u> If the right to receive IRD passes directly to an heir or legatee upon the decedent's death (i.e., nonprobate asset) or if it passes through the estate and is then distributed to the beneficiary as a specific bequest, the IRD is reported by that individual (or entity) when collected, rather than by the estate. Even if the estate collects the IRD on behalf of a beneficiary or legatee, the estate will not report the IRD on its Form 1041 if it did not have a right to it.

If the estate distributes an asset that includes IRD before the IRD is collected (e.g., the right to receive a note receivable or the proceeds of a retirement plan account) to a specific or residuary beneficiary, the beneficiary, rather than the estate, should report the income upon collection.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Define *income in respect of a decedent (IRD)*.

   a. Gross income a decedent was entitled to receive at the time of his or her death but that was not included in his or her final Form 1040 under the decedent's regular method of accounting.

   b. Money or property received by the decedent's estate after his or her death that was attributable to investments of the estate on the behalf of the beneficiaries.

   c. Income that the decedent could have excluded or deducted from his or her Form 1040 if the decedent had received the income while he or she was still alive.

   d. A step-up or step-down in the basis of property's fair market value and all income related to the property that occurs after an individual's death.

2. Which of the following best describes how IRD is taxed?

   a. It is subject to income tax only.

   b. It is subject to estate tax only.

   c. It is subject to double taxation.

   d. It is taxed up to 2% of the adjusted gross income (AGI) limit.

3. Upon her death in March 2009, Grace had earned compensation of $7,000 from her employer that had not yet been paid. Grace's estate is in the 45% federal estate tax bracket and the 35% income tax bracket. The estate receives the income at the end of the employer's payment cycle in April 2009. Calculate the amount that will be owed in taxes.

   a. $2,450.

   b. $3,150.

   c. $5,600.

   d. $7,000.

4. Which of the following scenarios correctly illustrates the tax treatment of IRD?

   a. Malcolm's probate estate acquires the right to receive IRD from the decedent. Malcolm dies in 2008, and the estate reports IRD income in the year of Malcolm's death.

   b. Linda's probate estate distributes the right to receive IRD to Linda's daughter Judy as part of Judy's inheritance. Judy reports income in the year the income is received.

   c. Tom acquires the right to IRD income by reason of the death of his wife, Sally. Income recognition is accelerated and reported by Sally's estate.

   d. Joe receives the right to receive IRD as a bequest from his father's estate. The transfer is taxable to the estate in the year of the transfer.

5. The estate of Tara Turnmill is entitled to receive all of Tara's IRD upon her death. Tara dies in 2009, and is owed both unpaid compensation and a distribution from her qualified retirement plan. These payments are made to her estate by her employer in 2009. Where should the estate report these amounts?

   a. Line 1 of the Form 1041.

   b. Line 3 of the Form 1041.

   c. Line 8 of the Form 1041.

   d. The estate should not report the IRD.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Define *income in respect of a decedent (IRD)*. **(Page 3)**

   a. Gross income a decedent was entitled to receive at the time of his or her death but that was not included in his or her final Form 1040 under the decedent's regular method of accounting. [This answer is correct. IRD is not defined in the Internal Revenue Code, but this definition generally covers what the term IRD refers to.]

   b. Money or property received by the decedent's estate after his or her death that was attributable to investments of the estate on the behalf of the beneficiaries. [This answer is incorrect. Generally, IRD arises when money or property attributable to the activities and efforts of the decedent while he or she was alive is received after the decedent's death.]

   c. Income that the decedent could have excluded or deducted from his or her Form 1040 if the decedent had received the income while he or she was still alive. [This answer is incorrect. IRD is income that would have been taxable to the decedent, if the decedent had lived and received the income personally.]

   d. A step-up or step-down in the basis of property's fair market value and all income related to the property that occurs after an individual's death. [This answer is incorrect. This is not the definition of IRD. However, when an individual dies, the basis of property in the hands of the person acquiring it is generally the fair market value (FMV) at the decedent's date of death. Unless there is a provision to the contrary, this step-up/step-down applies to the underlying property and all associated income.]

2. Which of the following best describes how IRD is taxed? **(Page 3)**

   a. It is subject to income tax only. [This answer is incorrect. This would be true if the decedent were still alive.]

   b. It is subject to estate tax only. [This answer is incorrect. This would be true of amounts in the decedent's estate that are *not* subject to IRD.]

   c. It is subject to double taxation. [This answer is correct. IRD may be subject to both income tax and estate tax (and possibly the generation-skipping transfer {GST} tax). However, this double taxation is mitigated by the IRC Sec. 691(c) deduction.]

   d. It is taxed up to 2% of the adjusted gross income (AGI) limit. [This answer is incorrect. IRC Sec. 691(c) allows an estate to deduct federal estate and GST tax attributable to IRS as a miscellaneous itemized deduction. This deduction is not subject to the 2% of AGI limit.]

3. Upon her death in March 2009, Grace had earned compensation of $7,000 from her employer that had not yet been paid. Grace's estate is in the 45% federal estate tax bracket and the 35% income tax bracket. The estate receives the income at the end of the employer's payment cycle in April 2009. Calculate the amount that will be owed in taxes. **(Page 3)**

   a. $2,450. [This answer is incorrect. This amount was calculated using the 35% income tax bracket for Grace's estate, but that is not the only necessary calculation in this scenario.]

   b. $3,150. [This answer is incorrect. This amount was calculated using the 45% federal estate tax bracket for Grace's estate; however, another calculation is necessary in this scenario.]

   c. $5,600. [This answer is correct. Both the 35% and 45% tax brackets apply to Grace's estate; therefore, the IRD will undergo double taxation. However, the effects of this taxation will be mitigated by IRC Sec. 691(c), which allows federal and GST tax to be deducted as a miscellaneous itemized deduction. This deduction is not subject to the 2% of AGI limit.]

d. $7,000. [This answer is incorrect. The entire IRD amount of $7,000 will not be paid as taxes by Grace's estate. A lesser amount will be determined using the proper calculations.]

4. Which of the following scenarios correctly illustrates the tax treatment of IRD? **(Page 3)**

a. Malcolm's probate estate acquires the right to receive IRD from the decedent. Malcolm dies in 2008, and the estate reports IRD income in the year of Malcolm's death. [This answer is incorrect. Malcolm's estate should report the income in the year of receipt.]

b. Linda's probate estate distributes the right to receive IRD to Linda's daughter Judy as part of Judy's inheritance. Judy reports income in the year the income is received. [This answer is correct. If the probate estate distributes the right to receive IRD from the decedent to another person in satisfaction of a bequest, devise, or inheritance, the distributee (Judy) should report the income in the year that the income is received.]

c. Tom acquires the right to IRD income by reason of the death of his wife, Sally. Income recognition is accelerated and reported by Sally's estate. [This answer is incorrect. The income recognition would be reported in this way if the right to receive IRD was distributed to Tom in satisfaction of a pecuniary bequest. In this scenario, however, Tom would report the income in the year that it is received.]

d. Joe receives the right to receive IRD as a bequest from his father's estate. The transfer is taxable to the estate in the year of the transfer. [This answer is incorrect. The income recognition would be taxable to the transferor if the right to receive IRD was transferred for a reason other than bequest, devise, inheritance, or pursuant to the right of another person to receive the amount as a result of the decedent's death. In this scenario, Joe would report the income in the year received.]

5. The estate of Tara Turnmill is entitled to receive all of Tara's IRD upon her death. Tara dies in 2009, and is owed both unpaid compensation and a distribution from her qualified retirement plan. These payments are made to her estate by her employer in 2009. Where should the estate report these amounts? **(Page 3)**

a. Line 1 of the Form 1041. [This answer is incorrect. IRD from accrued bond interest is reported on this line of the Form 1041 by the estate.]

b. Line 3 of the Form 1041. [This answer is incorrect. If Tara had owned a sole proprietorship, IRD from unpaid receivables from the proprietorship would be reported by the estate on Schedule C when they were collected, and the net business income would be reported by the estate on Line 3 of the Form 1041.]

c. Line 8 of the Form 1041. [This answer is correct. IRD that does not specifically relate to Lines 1–7 on the Form 1041, like unpaid compensation and distributions from qualified plans and IRAs, are reported on Line 8 by the estate, if the estate is entitled to receive those benefits. If more than one item is reported on Line 8, the estate should attach a schedule to the tax return that lists the type and amounts reported.]

d. The estate should not report the IRD. [This answer is incorrect. If another person was entitled to receive the IRD, the estate would not report it even if it collected the IRD and passed it on to the beneficiary. However, in this instance, the estate is entitled to receive the IRD, so it will report them on its Form 1041.]

Income from Compensation, Business, and Farming

Personal Service Income

A common source of income in respect of a decedent is compensation for personal services rendered before the date of the decedent's death. Situations resulting in this type of IRD include accrued but unpaid salary and vacation pay, deferred compensation, and bonuses.

Example 1B-1 Salary payment received after death of decedent.

William, a cash-basis taxpayer, was employed prior to his death by a firm that paid its employees their salaries every two weeks. He died on the way home from work on the seventh day of the fourteen-day pay period. One week after William's death, his surviving spouse, in her capacity as personal representative, received William's final paycheck of $2,216, covering the seven days he worked in that pay period.

The $2,216 should be included on William's Form 706 (if his estate is subject to filing) because the amount was owed to William as of the date of his death even though it was not payable until seven days later. The salary is considered IRD under IRC Sec. 691 and is also subject to income taxes because:

1. the payment is not a part of William's gross income prior to his death since he was a cash-basis taxpayer and had not actually or constructively received the payment;

2. except for his death and with no further action on his part, it would have been included in his gross income at a later date if he had survived until then;

3. the payment represents a right or an expectancy to receive income that arose from William's actions or rights in property, rather than property that itself included no income component; and

4. the entity (i.e., the estate) obtaining William's right to income did so solely because of his death.

At times, the existence of IRD is not as clear-cut as in Example 1B-1. IRC Sec. 691(a) makes reference to the "right to receive" an amount of income. Reg. 1.691(a)-1(b) refers to "those amounts to which a decedent was entitled." It is clear that IRD exists when the employee had a legally enforceable right to receive the income, such as a final salary payment for services rendered prior to the date of death. However, even for voluntary salary or bonus payments to the employee's estate or survivors, when it is substantially certain at the time of decedent's death that the payments would be made (perhaps because of a moral or customary obligation) or if the evidence shows a substantial certainty that the payments are directly related to the decedent's past services performed for the employer, the courts have ruled that the income is IRD even though the employer was under no legal obligation to make the payment. In other words, a substantial likelihood of receipt is enough to make a payment IRD.

Although certain payments may be excluded from the gross estate on Form 706, such payments may be considered IRD and includible on Form 1041. If the death benefit paid by a decedent's employer is discretionary (i.e., the deceased employee had no enforceable right to the payment), the amount is generally excluded from the decedent's gross estate on Form 706 but included on Form 1041. However, if a death benefit paid by a decedent's employer is merely the continuation of the decedent's salary or other compensation to which he or she is legally entitled (i.e., nondiscretionary), the death benefit is included in the decedent's gross estate (Form 706, if required) and on Form 1041.

Example 1B-2 Payments under an employment contract.

Karen negotiated an employment agreement with her employer that, during the period of her employment, she would be paid $20,000 per month for her services and that, in the event of her death, payments would continue to her estate for one year thereafter. Karen died in 2009 while still employed, and her estate received payments for one year as provided in the employment agreement.

The salary payments received by the estate are included in its gross income and are considered IRD.

Example 1B-3 Voluntary payments by decedent's employer.

Assume the same facts as in Example 1B-2, except that the company made the payments voluntarily to Karen's widower. Based on judicial history cited above, the payments are still IRD because they are attributable to services rendered by Karen. However, the payments are not includible in the gross estate for Karen's estate (if subject to Form 706 filing).

The same rationale has also been held to apply to renewal insurance commissions.

Example 1B-4 Insurance commissions paid to estate.

Joe Deal, an insurance salesman, died in 2009. His surviving spouse, Lil, acquired, by bequest from Joe, the right to receive renewal commissions on life insurance sold by him during his lifetime that were contractually payable over a period of years. Lil died before having received all of such commissions, and her son, Ben, inherited the right to receive the balance. The commissions received by Lil were includable in her gross income. The remaining commissions received by Ben are includable in his gross income. In each case, the commissions are IRD.

Example 1B-5 Commissions paid without contractual obligation.

Assume the same facts as in Example 1B-4, except that the insurance company was under no contractual obligation to pay the renewal commissions. However, under company policy, commissions are paid to the estates of deceased agents. In this situation, the commissions will still be IRD, even though the insurance company was not legally obligated to pay the commissions.

Sales of Farm Crops and Livestock

Livestock and farm crops, harvested or unharvested, raised by a cash-basis decedent prior to his or her death and owned at the time of death, are property or inventory of the estate and are not IRD. Therefore, as long as the crops or livestock have not been sold or pledged before a farmer dies, mere ownership of these items does not cause them to be IRD. Such property qualifies for a basis adjustment to fair market value at the decedent's death under the general rule of IRC Sec. 1014.

On the other hand, if the decedent had disposed of the crops or livestock, whether by sale or some other arrangement that put the assets beyond his or her control, and he or she is entitled to only the proceeds from the property, the proceeds are IRD. The determining factor is whether the estate is entitled to receive sales proceeds (IRD) or the actual assets (not IRD).

Example 1B-6 Harvested and unharvested farm crops.

Al owned and operated an apple orchard. Before he died, Al sold and delivered 1,000 bushels of apples to Wolbert Canning Factory, but did not receive payment before his death. Al also entered into negotiations to sell 3,000 bushels of apples to Tyler Canning Company, but did not complete the sale before his death. After Al's death, the executor received payment from Wolbert for the 1,000 bushels. He also completed the sale to Tyler and transferred to it 1,200 bushels of apples on hand at Al's death and harvested and transferred an additional 1,800 bushels.

The gain from the sale of the 1,000 bushels of apples by Al to Wolbert Canning is IRD and taxable when received. On the other hand, none of the gain from the sale of the 3,000 bushels of apples by the executor to Tyler Canning is IRD.

Receipt of Crop-share Rentals

Landowners frequently enter into rental arrangements whereby they agree to be paid in crop shares or livestock for the use of their land but do not materially participate in the farming or ranching operations. Crop shares or livestock received as rent by a cash-basis decedent and owned at the time of death (converted to cash on sale after death), as well as crop shares or livestock owed to the decedent at the date of death (i.e., accrued rent), is IRD included in gross income in the year the crops or livestock are sold and converted to cash. When the decedent dies during a rent period, only the net proceeds (from the eventual sale of the crops or livestock) attributable to the portion of the rent period ending with his or her death are IRD. The proceeds attributable to the portion of the rent period that runs from the day after death to the end of the period are ordinary income to the estate.

Example 1B-7 Proration of crop-share rentals.

A farm owner who used the cash method of accounting leased land to a tenant for one-third of the crop, payable in cash when the crop share is sold at the direction of the lessor. The rental period was for one year, beginning March 1, 2009. The lessor died June 30, 2009. He was alive for 122 days of the rental period. The cash received from the sale of the decedent's share of the crop was paid to the decedent's estate on October 31, 2009. Therefore, 122/365 of the amount received by the estate is IRD.

Insurance Commissions

Because the commissions earned but not yet received by an insurance agent are usually required to be paid to the agent's successors upon the agent's death, the commissions received after death are considered IRD to the person(s) entitled to receive them. However, if the successors in interest do not have an enforceable right to the decedent's commissions, the payments would not be IRD.

Even though the IRD would have been self-employment income to the decedent, it will not be considered self-employment income when paid to others, such as to the agent's estate or beneficiaries.

Exercise or Sale of Stock Options

An individual may die owning stock options received as compensation that were not exercised as of his or her date of death. The options may pass to the decedent's estate or trust where they may be exercised (converted to stock) by the executor or trustee. The income realized upon exercising the options or disposing of the stock may be treated as income in respect of a decedent.

Two basic types of stock options are received as compensation by employees—incentive stock options (ISOs, also referred to as qualified or statutory stock options) and nonqualified stock options (NQSOs). Under each alternative, the employer grants an employee the right to purchase company stock at some time in the future at a specified price. ISOs are governed by IRC Secs. 421 and 422, and nonqualified stock options are governed by IRC Sec. 83.

<u>Incentive Stock Options (ISOs).</u> If an employee dies owning an ISO that is transferable, the option will retain its status as an ISO. However, the decedent must have been an employee of the corporation within three months of death for the option to qualify for ISO treatment. An estate that receives the option due to the decedent's death is generally subject to the same restrictions as in the decedent's hands with two exceptions:

1. The requirement that the option be exercised within three months of termination from employment does not apply.

2. The estate or trust beneficiary is not subject to the holding period requirements.

The tax effects of the exercise of an ISO by an estate are substantially the same as though the option had been exercised by the decedent. Taxable income, for regular tax purposes, is generally not recognized upon the exercise of the ISO for the bargain element of the transaction (i.e., FMV of the stock − option price). Thus, as long as the option is exercised by the estate (or decedent's beneficiary), and it is not otherwise sold or disposed of, there will be no IRD attributable to the ISO for regular tax purposes. For alternative minimum tax purposes, however, income is recognized when an ISO is exercised for the bargain element of the transaction.

If an ISO is sold (rather than exercised) by the estate or trust beneficiary, there is a "disqualifying disposition," and the general rule of IRC Sec. 421(a)(1) (i.e., nontaxability upon exercise) does not apply. In that case, ordinary income must be recognized for the excess of the sales price of the option over the option price. The amount of IRD will be the difference between the FMV of the option on the date of death (or alternate valuation date, if applicable) and the option price.

Upon sale of the stock by the estate or decedent's beneficiary, capital gain treatment will apply even if the executor or trustee disposes of the stock before the end of the applicable holding period. This is because the holding period and employment requirements do not have to be met by the estate or beneficiary in order for IRC Sec. 421(a)(1) to apply. IRD treatment does not apply to capital gains realized on the sale of the stock after the exercise of the ISO.

Nonqualified Stock Options (NQSOs). If an individual dies owning an NQSO that has not been exercised, any income realized on or after the decedent's death is, at least in part, considered IRD and governed by IRC Sec. 691. The IRD will be taxable to the estate or the decedent's beneficiary. The amount of the IRD will be the difference between the FMV of the stock on the date of death (or alternate valuation date, if applicable) and the option's exercise price (the bargain element). Any increase in the FMV of the NQSO between the date of death (or alternate valuation date) and the date of exercise is not IRD. Although post-death appreciation is not IRD, it is still subject to ordinary income recognition by the estate or beneficiary upon exercise if it would have been ordinary income to the decedent had he or she lived to exercise the options. However, if the employee elected to recognize compensation income for the value of the options at the time of grant, as provided by IRC Sec. 83(b)(1), there will be no IRD to the employee's estate at the time of its exercise. There are no AMT consequences for NQSOs as there are for ISOs and ESPPs.

If the FMV of the *option* (not the FMV of the *stock*) is readily ascertainable (e.g., publicly traded), the bargain element is taxed at the date of grant rather than the date of exercise. In that case, there is no IRD because the employee would have been alive on the date of grant. Furthermore, there would be no tax consequences upon the exercise of the options, and the basis in the stock would include the option price and the FMV of the option upon the date of grant. However, most NQSOs do not have a readily ascertainable FMV, so ordinary income recognition is generally postponed until the date of exercise.

Example 1B-8 Exercise of nonqualified stock options.

Bethany was an executive with Priest Lake Bank. On May 16, 2004, she was granted NQSOs to purchase 100 shares of Priest Lake Bank's stock (nonpublicly traded) at $30 per share, the FMV of the stock on that date. Bethany died on October 15, 2008, without having exercised the vested options or elected to recognize income when the options were granted. For estate tax purposes, the stock was valued at $50 per share. When the executor of Bethany's estate exercised the options on August 5, 2009, the price of the stock had risen to $60 per share.

The bargain element of the nonqualified stock options is $3,000 [100 shares × ($60 FMV per share at date of exercise − $30 option price)] and is entirely ordinary income (compensation of the decedent's personal services). Of this amount, $2,000 [100 shares × ($50 FMV per share at date of death − $30 option price)] is IRD because it represents income accrued at the decedent's death that would have been taxable to the decedent if she had lived and received this benefit personally.

Upon subsequent sale of the stock by the executor or beneficiary, capital gain treatment will apply. The amount of the capital gain will be the excess of the FMV of the stock on the date of sale over the FMV of the stock on the date of exercise (i.e., the exercise price plus the amount included in ordinary income).

In private letter rulings, the IRS has held that any income realized upon the exercise of a decedent's NQSOs that were bequeathed to a charitable organization would be IRD and taxable to the charity (not the decedent's estate) when the options were exercised. However, if the stock options had been exercised by the executor rather than the charity, they would be IRD to the estate since it acquired the right to receive the stock from the decedent.

Employee Stock Option Plans (ESSPs). Employee stock option plans (ESPPs) are plans under which employees are given the right to purchase shares of the employer's stock, usually at a discount. Unlike ISOs, however, an ESSP option cannot be transferable during the employee's lifetime, although it can pass at the employee's death by will or by the laws of intestacy. Similar to the ISO tax treatment, if the ESPP meets the requirements of IRC Sec. 423, the employee is not subject to income inclusion for the discount at the time the option is granted or exercised. The employee must recognize ordinary income if he or she sells or disposes of the shares before the end of the holding period, which is the same as for ISOs.

A key difference from the ISO tax treatment, however, is the special rule that applies when an ESPP option is exercised and the shares are subsequently sold or disposed. If, at the time the option was granted, the option price per share was between 85 and 100% of the FMV of the share, and the employee exercises that right and then either— (1) disposes the share after meeting the holding period requirements, or (2) dies while owning the share, the employee must include in gross income as compensation, rather than gain from the sale of a capital asset, the lesser of the:

(a) FMV of the stock when the option was granted, minus item b the option price, *or*,

(b) excess of item a the FMV at the time of the disposition or death (for the taxable year ending with the employee's death) over item b the amount paid for the share under the option.

If the employee dies after receiving the option to purchase stock but before exercising it, the employee's estate or beneficiary may exercise the option, if the plan so permits, and receive the same tax benefits that would have applied to the employee if he or she had survived (i.e., no taxable income upon exercise). However, upon sale or disposition by the estate, the fiduciary must recognize ordinary income if the special rule of IRC Sec. 423(c) applies, as discussed above. This income would be considered IRD and is eligible for the Section 691(c) deduction for any estate tax paid attributable to the income. The remainder of the gain on the disposition of stock that is not taxable as ordinary income is eligible for capital gain treatment. However, any capital gains realized on the sale of the stock after the date of death are not considered IRD.

If the employee had exercised the option before his or her death and held the corresponding stock, which passed to the estate, the estate's disposition of such stock should not trigger ordinary income under the special rule of IRC Sec. 423(c), since it should have already been recognized on the decedent's final income tax return. However, the amount of ordinary income recognized by the decedent does not increase the basis of these shares. Instead, the basis of such shares are determined according to the general step-up (or step-down) in value rules of IRC Sec. 1014.

Income from Investments

Investment income generally is income in respect of a decedent (IRD) to the extent the income has accrued at the date of death but is not included on the decedent's final Form 1040. The most common types of investment income that are IRD include dividends, interest, rents, and royalties.

Dividend Income

Dividends are considered IRD only if the date of the decedent's death occurs on or after the record date but before the payment date. If the shareholder dies after the date the dividends are declared but before the date of record, the dividends are simply gross income of the estate and are not considered IRD. If no date of record is fixed for stock in closely held corporations, the date of declaration should be used to determine the existence of IRD. If the decedent dies before the dividends are declared, the dividends are not IRD because the decedent was not entitled to the income at the time of death.

Example 1C-1 When are dividends IRD?

Lynne Hughes died on June 25, 2009. At the time of her death, she owned 1000 shares of Hitech, Inc. common stock. On June 15, the directors declared a dividend of $100 per share, payable to shareholders of record on June 30, 2009. As of the June 30 record date, Lynne's estate owned the stock. Therefore, the estate will include the dividends in gross income in the year received, and the dividends are not IRD because Lynne had no right to receive the dividends on the day she died.

On the other hand, if Lynne had died on July 2, 2009, and the estate received the payment on July 10, receipt of the dividends would be IRD to the estate since Lynne (and not the estate) would have owned the stock on June 30, the date of record.

Interest Income

Interest income is considered earned on a daily basis, unlike corporate dividends, which must be formally declared by the board of directors. If the interest is credited to the taxpayer's account on a monthly basis, which is often the case, the taxpayer is in constructive receipt of the income, and thus, the only IRD from the interest income would be the portion allocable to the period of time between the last crediting of interest income and the date of the decedent's death (assuming the executor timely notifies the bank of the date of death). However, if the interest is accrued but unpaid at the date of death it is income in respect of the decedent. Although most situations are straightforward, when the decedent owned zero-coupon bonds or other OID instruments, U.S. savings bonds, or tax-exempt bonds, the presence or absence of IRD is not so obvious.

Tax-exempt Interest. IRC Sec. 691 applies only to items included in gross taxable income. Items such as tax-exempt interest that are excluded from gross income do not fall within the scope of IRC Sec. 691.

Example 1C-2 Municipal bond interest does not create IRD.

Harry died on September 29, 2009. At the time of his death, he owned certain municipal bonds with a scheduled interest payment due October 1, 2009, in the amount of $10,000. The accrued interest at the date of death was properly reported on Harry's Form 706.

Although Harry's estate paid estate tax on the accrued interest, the interest is not IRD because the IRD rules apply only to taxable income. Ordinarily, no income tax will be paid on the municipal bond interest, although double taxation could arise if the bonds were private activity bonds, causing AMT to be paid by the estate or beneficiary. Since the interest is not IRD, there is no Section 691(c) deduction available to the recipient.

Original Issue Discount (OID). When an individual purchases debt instruments (e.g., bonds) originally issued at a discount, the OID rules generally cause the discount to be included in interest income on a daily basis over the life of the bond. This rule applies even if the bonds were purchased at a premium in the open market. Since cash-basis taxpayers are effectively placed on the accrual basis for purposes of reporting OID, the interest income attributable to the OID earned up to the date of death will be reported on the decedent's final return, and there will be no IRD. For more information about OID instruments and the calculations required, see IRS Pub. 1212, "List of Original Issue Discount Instruments."

Example 1C-3 Interaction of IRD and OID rules.

Flo died in 2009. At the time of her death, she owned $100,000 of zero-coupon corporate bonds and $50,000 of U.S. Treasury Bills.

As for the corporate bonds, IRC Sec. 1272 requires that the OID be ratably accrued up to the date of death and included on Flo's final Form 1040. Therefore, there will be no IRD associated with the zero-coupon corporate bonds.

On the other hand, debt instruments with a fixed maturity date of not more than one year from the date of issue are exempt from the OID rules. Since T-Bills are issued at a discount and have a fixed maturity date of one year or less, the estate will recognize the interest upon maturity, and the pre-death portion of the interest will be IRD.

U.S. Savings Bonds. The Section 1272 OID rules do not apply to U.S. savings bonds. Instead, all interest is recognized upon maturity or disposition unless a special election is made to recognize interest as it accrues. If the decedent made the election during his or her lifetime, or if the executor made the election on the decedent's final return (as allowed by Rev. Rul. 68-145), accrued interest will be recognized up to the date of death, and there will be no IRD. On the other hand, if no election is made, all interest accrued at the date of death will be IRD and the interest income will be recognized upon maturity or disposition.

Rental and Royalty Income

Rental income accrued at the date of death by a cash-method taxpayer is included in the decedent's gross estate and considered IRD. However, often the accrued rent represents advance payment, which is considered a liability, rather than an asset, and is *not* IRD.

Livestock or crop shares received as rent by a cash-method decedent and owned at the time of death are IRD that will be recognized when converted to cash.

Oil and gas royalties are also IRD to the extent the production was attributed to the period prior to the decedent's death. Since most oil companies make royalty payments one or two months after the oil and gas is produced, the return preparer should examine the check statements or "runs" for several months following the date of death to determine when the oil was produced in relation to the date of death. It would also be prudent to inquire whether any months of production have been "suspensed" (not paid) for any reason as of the date of death since any such production represents IRD.

Example 1C-4 How to determine the amount of IRD from oil and gas royalties.

Max died on June 30, 2009. He received monthly checks from U.S. Exploration for oil royalties on land to which he held the mineral rights. His estate received royalty checks of $3,500 in July, $3,300 in August and $3,200 in September. Upon examination of the monthly statements, the return preparer noticed the checks received in July and August were royalty payments for May and June, respectively, while the September check represented payment for July production.

The payments received in July and August are IRD, while the September payment is not IRD, because it represents production for a period after the date of death.

Royalties received after death that, in substance, are for the sale of property (e.g., book royalties) are IRD. Also, royalties received after death that were earned before death under a license agreement (e.g. a contract between an inventor and a manufacturer) are IRD.

Income from Life Insurance Proceeds

IRD can arise in unexpected ways. The proceeds from a life insurance policy are typically not IRD since life insurance proceeds are not usually included in gross income. However, if life insurance proceeds are includible in gross income, such as a transfer for valuable consideration, that portion comprising gross income could be IRD.

Example 1C-5 Life insurance proceeds included in gross income.

Marjorie Nelson was the owner and beneficiary of a life insurance policy on the life of her uncle, Rod Fresco. Marjorie had purchased the policy from Rod in 2000 for $20,000 and the agreement to continue making the annual premiums. Marjorie died unexpectedly in December 2009 while Rod was still alive, and the ownership of the policy passed to Marjorie's estate. For estate tax purposes, the policy was valued at $100,000 upon Marjorie's death.

Marjorie's tax basis in the $500,000 face-value policy was $30,000, which included the original purchase price of $20,000 plus $10,000 premiums made until her date of death. In June 2010, prior to the termination of Marjorie's estate, Rod died, thus causing the life insurance proceeds to be paid to Marjorie's estate in July 2010. Marjorie's estate had paid $1,250 in premiums before the policy matured.

Of the $500,000 life insurance proceeds, $70,000 represents IRD, which is the value of the policy ($100,000) in excess of her basis ($30,000) upon her death. This is not entitled to a step-up in basis under IRC Sec. 1014(c). However, the total income (including IRD of $70,000) to be included by Marjorie's estate for the insurance proceeds will be $468,750 ($500,000 − $30,000 − $1,250), due to the transfer for value rules of IRC Sec. 101(a)(2). The estate's basis in the policy will include both Marjorie's basis of $30,000 and the $1,250 premiums it paid after Marjorie's death. Thus, although only $100,000 is subject to inclusion for estate tax purposes on Form 706 (if her estate is subject to filing), $468,750 is subject to inclusion for estate income tax purposes, and the IRD portion of such income ($70,000) is eligible for the Section 691(c) deduction.

Annuities

Annuity payments are made under one of three primary options: single life, joint and survivor, and term certain. Although varying forms of these options exist, annuity payments will either stop when the decedent dies or be made to designated beneficiaries according to the selected payment option. When an annuitant dies after the annuity starting date and payments are made to surviving beneficiaries, the payments are taxed in the same manner as if the decedent had received the payment and the taxable portion is treated as IRD. If the annuitant dies before the annuity starting date, payments received in excess of the decedent's investment in the contract are IRD. The result is the same whether the beneficiary receives the death benefit as a lump-sum or as periodic payments.

When a taxpayer invests in an annuity, the cost is considered the investment in the contract. Once payments begin, a percentage of each payment is treated as a return of the investment in the contract and is not taxable. After the investment in the contract has been fully recaptured, all remaining payments are fully taxable. If a person dies before recovering the entire investment in the contract, and no future payments are required under the annuity's terms, any unrecovered investment in the contract can be deducted on the decedent's final income tax return as an itemized deduction not subject to the 2% AGI limitation.

If annuity payments continue after the annuitant dies, the beneficiary will exclude the same percentage of each payment received until the decedent's investment in the contract has been recovered. Once the decedent's investment in the contract has been entirely recaptured, all future payments are fully taxable. The taxable portion of each payment is considered IRD in the hands of the beneficiary. This is the same percentage of the payment that would have been taxed if it had been received by the decedent. If payments stop when the beneficiary dies, and the decedent's investment in the contract has not been fully recovered, the beneficiary may deduct any unrecaptured investment in the contract can be deducted on the beneficiary's final income tax return as an itemized deduction not subject to the 2% AGI limitation.

Example 1C-6 Annuity payments considered IRD.

Jana Barnett was the owner of an annuity with a 15-year term certain payment option. When she began receiving payments, she computed her exclusion ratio to be 35%; therefore, 65% of each payment was taxable as ordinary income on her personal income tax return. At the time of Jana's death, she had received seven payments. A trust created for Jana's nephew was the named beneficiary of Jana's annuity. The trust must include 65% of each payment in its income as IRD.

Property Sales

When appreciated property acquired from a decedent is sold by the decedent's estate, the gain is not income in respect of a decedent (IRD). Such property includes inventory of a decedent who was a dealer in property as well as capital assets owned by the decedent at the time of his or her death.

Example 1D-1 No IRD from buy/sell agreement taking effect at shareholder's death.

During her lifetime, Sharon acquired 10,000 shares of the capital stock of Transco Corporation at a cost of $100 per share. Before she died, Sharon entered into an agreement with Transco whereby the company agreed to purchase and the decedent agreed that her executor would sell the 10,000 shares back to the company at book value on the date of her death. Upon Sharon's death, the shares were sold by her executor for $500 a share pursuant to the agreement. Since the sale of stock was consummated after Sharon's death, there is no IRD for the appreciation in value of her stock to the date of her death. Death of the individual owner is neither a "ministerial act" nor a "contingency" in this buy/sell agreement.

In a similar situation, a decedent owned property near a country club. The country club was granted an option to purchase the property or the right of first refusal. The option to purchase was for three months beginning on the date of death. The option was not a completed sale, and there was no IRD upon the sale of the property.

If, in this example, Sharon had sold the stock during her lifetime but payment had not been received before her death, any gain on the sale would be IRD and taxable when the proceeds were received.

When Are Sales Proceeds IRD?

Occasionally, a decedent will enter into a sale agreement before death but die before the sale is actually closed. When the decedent was in the process of selling property at the time of his or her death, the courts and the IRS generally have focused on whether the decedent had substantially fulfilled the prerequisites to consummating the sale.

When the remaining obligations to be performed after the decedent's death are merely administrative ("ministerial"), the income is IRD. The Court of Appeals for the Fifth Circuit developed the "entitlement test" for determining whether income from the disposition of property owned by a decedent is IRD. Under this test, the income is IRD, and is included in the recipient's gross income if the decedent was entitled to the income at the date of death. In *Trust Company of Georgia v. Ross*, the court held that because the decedent was entitled to the proceeds of a stock sale under a binding contract at the time of death, the proceeds of the contract were IRD. This test goes beyond the determination of whether the income was attributable to the economic efforts and activities of the decedent.

Example 1D-2 Death of seller before sale closes.

In June 2009, Ed Patterson, a cash-method taxpayer, signed a binding contract to sell a tract of land for $700,000. Ed had purchased the property several years ago for $500,000. The closing was scheduled for August 15, 2009. However, Ed died on July 30, after substantial fulfillment of the prerequisites to consummation of the sale. The remaining obligations to be performed were administrative, not substantive. Ed's executor completed the sale pursuant to the contract and transferred title and possession of the land on August 15.

At the time of death, Ed had substantially fulfilled all of the prerequisites to consummation of the sale and was unconditionally entitled to the proceeds of the sale. Accordingly, the proceeds are IRD.

If the decedent had entered into an agreement to sell property, and the sale was subject to a contingency at the time of his or her death, the income to which the decedent had a contingent claim is IRD. However, if there are material contingencies regarding the sale proceeds that are not resolved before the decedent's death, the IRS has held that any gain from the sale will *not* be treated as IRD.

Example 1D-3 Sale of property subject to a contingency.

Lisa entered into a contract to sell a parcel of real estate on June 1, 2009. The sale was contingent on the buyer obtaining financing within 45 days. Lisa died on June 15, before the expiration of the contingency period and before it was known whether the purchaser would obtain the financing. After Lisa's death, the financing was obtained within the 45-day deadline, and the executor closed the sale on behalf of the estate.

The gain on the sale is IRD, even though Lisa died while the contingency was in effect. If the financing had not been obtained until after the 45-day period ended, the sale would have been the result of a new (post-death) contract, and any gain on that sale would not be IRD.

If a buy/sell agreement allocates a portion of the buy-out price to the right to receive income, an allocation must be made to characterize that portion as IRD. In the *Estate of Cartwright*, a law firm shareholders' agreement required life insurance proceeds to be paid to the estate of a deceased partner for the redemption of his or her stock and work-in-process claims. The portion of the payment allocable to work-in-process was deemed to be IRD, whereas the portion allocable to the stock redemption was not.

Sales of Property on Installment Method

When property is sold by the decedent during his or her lifetime on the installment method, any gain unrecognized at the time of his death is IRD and taxable income upon collection. The step-up in basis rules do not apply to installment obligations; the estate's initial basis in the note is the same as the decedent's basis. The decedent's estate or the person entitled to receive the installment sale income by bequest or inheritance from the decedent recognizes income as it is collected, using the same gross profit percentage as the decedent would have if he or she had lived and received the payments himself. Transmission of a pre-death installment note at death generally is not a disposition of an installment obligation that would trigger acceleration of gain recognition.

Example 1D-4 Self-canceling installment obligations.

As part of his estate planning, George Walker sold the stock in his closely held business to his son Ben ten years ago, accepting a cash down payment and a 15-year installment note. The sales agreement and the installment note provided that all sums due on the note were automatically extinguished and canceled upon George's death, and were thus expected to remove the value of the note from his estate. George's life expectancy at the time of the sale was longer than 15 years. He reported the gain on the sale on the installment method of accounting. George died in 2009 and, at the time of his death, the unrecognized installment sale income was $50,000.

George's death canceled the installment obligation with five years of payments outstanding. Any cancellation of the obligation at the death of the decedent is treated as a taxable transfer of the obligation. This causes $50,000 of IRD to be included in the gross income of the estate in the year of cancellation.

The gain on cancellation of the installment obligation upon the decedent's death is taxed to the estate, rather than the decedent's final Form 1040, as IRD.

Example 1D-5 Discounted installment note and IRD.

Two weeks prior to her death, Vicki sold some raw land held as investment property for $1.25 million on December 1, 2008. She collected a 20% cash down-payment and received a note for $1 million (the remaining purchase price). The note required a 10-year term with a stated interest rate of 6%. The total capital gain to be recognized by Vicki over the life of the note if collected in full at 6% interest was $900,000 (i.e., 90% of the proceeds). Her basis in the note was $100,000 ($1 million face value − $900,000 capital gain inherent in the sale). At the time of Vicki's death, the balance of the note was $950,000 and the unrecovered basis was $95,000. For estate tax purposes, the note was valued as its face amount ($950,000).

Several events caused the financial market to decline and by July 2009, the yield on similar notes increased to 8%. The estate, fearing further market declines sold the note in July 2009 at its current fair market value, receiving a cash payment of $850,000. As a result, the IRD amount (the remaining unrecognized gain on the note) of $855,000 ($950,000 − $95,000) was reduced by the amount of the discount on the sale. The gain to be reported is $755,000 ($850,000 discounted sale proceeds − $95,000 unrecovered basis).

Rules for Income from Pass-through Entities

When an estate receives income from a pass-through entity, different rules apply, depending on whether the income is from a partnership, an S corporation, or a fiduciary. This lesson focuses on classification of pass-through income as income in respect of a decedent (IRD).

Partnership Income and Losses When a Partner Dies

The taxable year of the partnership closes with respect to a deceased partner at the time of his or her death. Thus, the decedent will receive a Schedule K-1 from the partnership that reports income through the date of death. This income will be reported on the decedent's final Form 1040 and is not IRD. Partnership income earned *after* the date of death is reported on a separate Schedule K-1 to the estate (or other successor) and is not IRD. In other words, only amounts earned by the partnership during the partner's lifetime but not includable in income until after the partner's death are IRD (e.g., payments received by a cash basis partnership *after* the partner's death for amounts earned *before* his or her death).

When a deceased partner's interest in the partnership is liquidated by a distribution or series of distributions, IRD treatment depends on whether the distributions are:

1. a distributive share of the partnership's income,
2. guaranteed payments to a partner, or
3. payments in exchange for the deceased partner's interest in partnership property.

If the distributions are a distributive share of partnership income or guaranteed payments, they are IRD.

If the distributions are in exchange for the decedent's interest in partnership property, no IRD results except to the extent:

1. the payments are attributable to unrealized receivables (which include only accounts receivable or other unbilled amounts) of the partnership, *or*

2. the payments are attributable to goodwill (unless the partnership agreement calls for goodwill payments), but only if

3. capital is not a material income-producing factor (such as in a personal service partnership), *and*

4. the deceased partner was a general partner.

Although payments made by the partnership in exchange for the decedent's partnership interest are generally not considered IRD (unless the exceptions discussed in the previous paragraph apply), proceeds from the sale of a deceased partner's interest are IRD to the extent of the partner's share of the partnership's zero-basis accounts receivable.

The fair market value (and therefore the basis to the successor-in-interest) of the partnership interest must be reduced by amounts considered IRD. Additionally, a Section 754 election will not entitle the successor-in-interest to a basis step-up for IRD items such as zero-basis accounts receivable.

Example 1E-1 Liquidation of a deceased partner's partnership interest.

Al was a partner in a local law firm. The partnership agreement provided that a deceased partner's estate would continue to receive his distributive share of partnership income for five years following his death. Al died in 2008. Al's estate received $120,000 in 2009, representing his estate's distributive share of the 2009 partnership income. The 2009 Schedule K-1 from the partnership reflected $120,000 of ordinary income.

The partnership income is included in the gross income of the estate for its tax year that includes December 31, 2009. Since the payments made in liquidation of Al's partnership interest represent his distributive share of the partnership's income (and not payments in exchange for his share of partnership property), the income is IRD.

Example 1E-2 Distributions of partnership assets at death.

Deborah was a partner in a local law firm. The partnership agreement provided that a deceased partner would receive his or her share of the value of partnership assets at death. Deborah died in 2009, and her estate received $30,000 (Deborah's share of the value of partnership assets). Deborah's share of unrealized receivables is $10,000.

Since the $30,000 is in exchange for Deborah's interest in the partnership, only $10,000 (payment attributable to unrealized receivables) is IRD.

Pass-through from S Corporations

S corporations generally pass through items of income or loss based on a per-share, per-day allocation method. However, if all shareholders consent, a decedent's pro rata share can be determined by an interim closing of the books. Regardless of the allocation method, a deceased shareholder's share of the income or loss for the period ending with the date of death is included on his or her final return. For the remainder of the corporation's tax year, income or loss will be reported to the new holder(s) of the S stock. Accordingly, neither income nor losses from an S corporation are IRD.

However, a person acquiring stock in an S corporation from a decedent treats as IRD his or her pro rata share of income items that would have been IRD if the items had been acquired directly from the decedent. For example, unrealized receivables at the date of death for a cash-basis S corporation is IRD to the person acquiring the S corporation stock. Likewise, the basis (generally fair market value at date of death) is reduced by the amount of IRD attributable to the S corporation stock.

Example 1E-3 Determining the tax basis of inherited S corporation stock with IRD.

Erin owned a one-half interest in Ross Corp., a cash basis S corporation. Upon her death, the fair market value of her interest was $40,000, which included accounts receivable valued at $6,000. Luke, who inherited Erin's interest in Ross Corp., subsequently sold the shares for $50,000. When determining the gain or loss, the basis of Luke's S corporation shares must be reduced by the IRD attributable to the S corporation interest as of Erin's death. Thus, Luke's gain on the sale of his S corporation stock is $16,000 [$50,000 sale proceeds − ($40,000 stepped-up tax basis − $6,000 IRD)].

Pass-through Income from Fiduciaries

In the year of death of a cash-basis individual beneficiary of an estate or trust, gross income from the fiduciary on the final individual return includes only income actually distributed before the decedent's death. Income required to be distributed as of the date of death, but distributed to the decedent's estate, is included in the estate's gross income and is IRD (and reported on the estate's Schedule K-1). Any income carried out to the estate from an in-kind (property) distribution will also be IRD if the income was required to be distributed as of the date of death, provided the property distribution carries out gross income under the property distribution rules.

Example 1E-4 Reporting pass-through income from a fiduciary to the successor of a decedent-beneficiary's interest.

The Rawlor Family Trust requires that income is to be payable to Ryan, the sole beneficiary, at least annually. For 2009, the trust had $24,000 of accounting income to distribute, of which Ryan had received $18,000 as of the date of his death. The amount of income to which he was entitled, but had not received or been reported as of his death ($6,000), is IRD to the beneficiary who receives his income from the trust. The preparer of the K-1 (1041) from the Rawlor Family Trust should indicate this amount and character of the IRD.

Retirement Plan Distributions

If distributions received by an estate or legatee from a decedent's individual retirement account (IRA) or qualified retirement plan account would have been taxable to the decedent, they are taxable to the recipient. Such amounts are IRD under IRC Sec. 691(a)(1) to the extent of the balance in the account at the date of death less any nondeductible contributions made by the decedent. The IRD amounts are deemed distributed before the retirement plan earnings that are generated after the decedent's death.

Specifically, the portion of a lump-sum distribution that equals the balance in the account at the date of the owner's death, including unrealized appreciation and income accrued to that date, less the owner's nondeductible contributions is included in the recipient's gross income and is IRD.

Amounts received that are IRD have the same character as if the decedent had lived to receive the amounts. Therefore, to the extent the decedent would have received favorable tax treatment on lump-sum distributions under IRC Sec. 402(e)(4)(D), the estate is entitled to receive the same tax treatment.

Proceeds from retirement plans, including IRAs and 401(k) plans, are common IRD items.

Example 1F-1 Distribution of Section 401(k) plan assets as IRD.

Eve was the beneficiary of her father's 401(k) plan when he died unexpectedly in late 2008. The trustee liquidated the account and distributed the $200,000 proceeds to Eve in April 2009. Eve will report the $200,000 as income on her 2009 Form 1040 since she acquired the right to the income by reason of her father's death.

If she itemizes her deductions, Eve will be able to take a Section 691(c) deduction on her 2009 Schedule A for the estate tax attributable to the IRD as a miscellaneous itemized deduction not subject to the 2% of AGI limit. However, the Section 691(c) deduction is subject to the phase-out of itemized deductions if Eve's adjusted gross income exceeds $166,800 ($83,400 if married filing separately).

Any minimum required distribution, determined as if the participant/owner had lived throughout the year, is required for the year of his or her death and must be paid to the designated beneficiary to the extent it was not distributed to the participant/owner.

Any distribution from a decedent's IRA or qualified retirement plan that qualifies for the spousal roll-over provisions defers income recognition by the spouse which, in turn, defers recognition of the IRD associated with those balances. Successors other than spouses are not entitled to rollover treatment and have more limited options for distributions.

Decedent's Contributions

If the decedent made a nondeductible contribution to an IRA or an employee contribution to an employer retirement plan with after-tax dollars, such contributions are subtracted from the total distribution to determine the taxable amount and the amount of IRD. This rule applies whether the distribution is received in a lump sum or in the form of an annuity.

Example 1F-2 Effect of decedent's contributions on amount of IRD recognized.

Merle died in 2009. His estate was named sole beneficiary of his vested balance in his employer's profit-sharing plan. His entire balance in the plan, $100,000, was invested in a money-market fund. Over the years, Merle made after-tax contributions to the plan totaling $10,000.

If the estate receives a lump-sum distribution, the taxable portion is determined without the after-tax employee contributions. Therefore, $90,000 is taxable as IRD under IRC Sec. 691.

Unrealized Appreciation in Employer Securities

When employer securities are distributed from a qualified retirement plan, either to the decedent before his or her death or to his or her estate or other beneficiary after his or her death, any unrealized appreciation associated with the employer securities is not subject to immediate taxation. The unrealized appreciation at the time of the distribution will be taxed upon disposition of the securities. In the year of distribution from the plan, the estate or other distributee is required to include in gross income the plan's cost of the employer securities plus the fair market value of any other assets received, less any employee contributions. This amount included in gross income is IRD.

Example 1F-3 Appreciated employer securities acquired from decedent.

Jane retired from a large oil company in 2003. At that time she received a lump-sum distribution of employer securities that had a basis to the plan of $50,000 and a fair market value (FMV) of $100,000. Jane's contribution to the plan over the years was $10,000. In 2003, Jane included $40,000 in gross income—the $50,000 basis to the plan, less her $10,000 employee contribution. Jane died in 2008 when the FMV of the securities was $120,000. Her estate sold the securities in 2009 for $130,000.

The estate's basis in the securities was $70,000, the FMV at the date of death ($120,000) less the unrealized appreciation of $50,000 ($100,000 − $50,000). The unrealized appreciation is IRD to the estate in 2009 when the securities are sold. Accordingly, the estate received no step-up in basis at death for the unrealized appreciation. The gain on sale of the securities is $60,000, the sales price of $130,000 less the estate's basis of $70,000. The post-death appreciation of $10,000 ($130,000 − $120,000) is not IRD.

IRD from Other Sources

Certain types of income are less common, and thus, must be given careful consideration of the particular facts and circumstances to determine whether they give rise to IRD.

Medical Savings Accounts and Health Savings Accounts

Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs) transferred at death to anyone other than a surviving spouse cease to be MSAs/HSAs. If the estate is the transferee of the former MSA/HSA, the fair market value of the assets in the account is gross income on the decedent's final income tax return. If anyone else (other than the surviving spouse) is the transferee of the former MSA/HSA, the fair market value of the assets in the account is included in the transferee's gross income as IRD when received.

Coverdell Education Savings Accounts

Rules similar to those of Medical Savings and Health Savings Accounts transferred at death also apply when an individual other than a surviving spouse or family member (i.e., a "qualified beneficiary") acquires a decedent's

Coverdell Education Savings Account. In other words, the fair market value of the account assets at the date of death must be included in the acquirer's income as IRD (or in the decedent's income, if the acquirer is the estate).

Medical Expense Reimbursements for Prior Deductions

Amounts received as reimbursements for medical expenses that were previously deducted on the decedent's individual income tax return are considered IRD.

Covenant-Not-to-Compete Payments

Income received after the decedent's death under a covenant-not-to-compete contract entered into by the decedent is IRD.

Litigation Settlements

If an individual dies during the course of a lawsuit, the proceeds from a settlement may or may not be IRD, depending upon the facts. Thus, a factual analysis is necessary to determine whether IRD treatment is appropriate.

If the litigation relates to the performance of the decedent's services or the decedent's impending right to receive income, the IRS and courts have considered the settlement proceeds to be IRD. For example, if a plaintiff settles a lawsuit but dies before collecting some or all of the settlement amount, the payments received after death should be treated as IRD.

Although there is a lack of authoritative guidance on the treatment of litigation settlements occurring after the plaintiff's death, if the settlement more closely resembles a sale of an asset (e.g., damages to goodwill or sales of patents), and the estate (or legatee) is not given an impending right to receive income, in the authors' opinion, the proceeds should not be considered IRD. This issue seems similar to the sale of property that is subject to a contingency in which there are material contingencies that are not resolved before the decedent's death. If the settlement proceeds are not IRD, the claim should be eligible for a step-up in basis under IRC Sec. 1014(c).

Example 1G-1 Litigation settlement proceeds received by the estate.

Craig sold his advertising business to Sherlock, Inc. in February of 2009. Three months later, Craig discovered that Sherlock, Inc. had committed fraud in the sale. In August of 2009, he brought suit against Sherlock to recover additional sale proceeds. Craig died unexpectedly on February 4, 2010. At the time of his death, the outcome of the litigation was uncertain. The estate pursued the claim and recovered an additional $110,000 on November 12, 2010.

Because the claim more closely resembles a sale of a capital asset, the executor reports the settlement proceeds as a capital asset, with no reportable gain, on the estate's Schedule D (1041) for 2010. (The amount received is offset by the basis, which has been stepped up to the fair market value at the decedent's death.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Compensation is one of the most common types of income that can result in IRD. Which of the following is an example of this type of compensation?

   a. Royalties.

   b. Bonuses (not lease bonus).

   c. S-corporation income.

   d. Appreciated property sold by the decedent's estate.

7. In which of the following scenarios, would the payment be considered IRD? (Assume all of the decedents were cash-basis taxpayers.)

   a. Carolyn is an insurance agent. Commissions earned before her death are received by her successor.

   b. Upon Adam's death, all his livestock and crops passed to his son, Alvin. None of these assets had been pledged or sold.

   c. June owned an NQSO at the time of her death. She had elected to recognize compensation income for the value of the option at the time of grant.

   d. Leroy was entitled to accrued rental income at the time of his death. That income represented an advance payment.

8. Upon her death, Lucy owned unexercised incentive stock options (ISOs). Her estate exercises the ISOs for their bargain price. How will this transaction affect the estate's IRD and tax recognition?

   a. For regular tax purposes, no IRD will be attributable to Lucy's estate.

   b. Ordinary income is recognized by the estate on the full value of this transaction.

   c. Any income realized after Lucy's death is considered IRD and governed by IRC Sec. 691.

   d. IRD is recognized only if Lucy's death occurred after the record date but before the payment date.

9. In which of the following scenarios would the investment income be considered IRD upon the decedent's death?

   a. Jane's estate receives interest payments from original issue discount (OID) bonds she purchased at a premium on the open market.

   b. The publishing company pays Erin's estate $100,000 in royalties for her best-selling novel six months after her death.

   c. Michael's estate receives a $50,000 payment from his life insurance policy. The insurance payment is not received in a transfer transaction.

   d. George dies before the start date for his annuity. His son receives the death benefit as a lump-sum, which does not exceed George's original investment in the annuity.

10. Nadia is a partner in Tate, Williams, & Jarvis. After Nadia's death, which of the following types of partnership income would always be considered IRD?

    a. Partnership income through the date of Nadia's death.

    b. Partnership income earned after the date of Nadia's death.

    c. Partnership income earned in her life, but not includable income until after her death.

    d. Payments made in exchange for Nadia's interest in partnership property.

11. The Milton Family Trust requires income be payable annually to Sarah, the sole beneficiary. Sarah's beneficiary is her son, Leo. In 2009, the trust had $30,000 to distribute. Sarah had received $17,000 of the income as of the date of her death. How should the remaining $13,000 be treated?

    a. It is IRD to Leo and is reported on the trust's Form 1041.

    b. Neither income nor losses from a trust are IRD.

    c. If Leo itemizes his deductions, the IRD amount can be deducted.

    d. Only the amount previously deducted by Sarah is IRD.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Compensation is one of the most common types of income that can result in IRD. Which of the following is an example of this type of compensation? **(Page 11)**

   a. Royalties. [This answer is incorrect. To the extent it is accrued at the date of death and not been included on the decedent's final Form 1040, investment income (which includes royalties) is IRD. However, investment income is not considered compensation.]

   b. Bonuses (not lease bonus). [This answer is correct. Other common sources of compensation that result in this type of IRD include unpaid salary and vacation pay, as well as deferred compensation.]

   c. S-corporation income. [This answer is incorrect. S-corporation income is income received from a pass-through entity. When an estate receives this kind of income, different rules apply than those applying to normal compensation.]

   d. Appreciated property sold by the decedent's estate. [This answer is incorrect. If the decedent's estate sells appreciated property that it acquires from the decedent, the gain is not considered IRD. Sales of property are also not considered compensation.]

7. In which of the following scenarios, would the payment be considered IRD? (Assume all of the decedents were cash-basis taxpayers.) **(Page 11)**

   a. Carolyn is an insurance agent. Commissions earned before her death are received by her successor. [This answer is correct. In this scenario, usually such payments would be required to be made to Carolyn's successor; therefore, they would be considered IRD to the successor. Though the commissions would have been self-employment income for Carolyn, it will not be considered as such for her successor.]

   b. Upon Adam's death, all his livestock and crops passed to his son, Alvin. None of these assets had been pledged or sold. [This answer is incorrect. Crops and livestock produced by Adam are not considered IRD unless he had sold, pledged or otherwise put out of Adam's control before his death.]

   c. June owned an NQSO at the time of her death. She had elected to recognize compensation income for the value of the option at the time of grant. [This answer is incorrect. In this scenario, because June elected to receive income at the time of grant, no IRD will be attributed to her estate at the time the NQSO is exercised.]

   d. Leroy was entitled to accrued rental income at the time of his death. That income represented an advance payment. [This answer is incorrect. Rental income representing an advance payment, as in this scenario, is considered a liability, not an asset. Therefore, the payment is not IRD.]

8. Upon her death, Lucy owned unexercised incentive stock options (ISOs). Her estate exercises the ISOs for their bargain price. How will this transaction affect the estate's IRD and tax recognition? **(Page 11)**

   a. For regular tax purposes, no IRD will be attributable to Lucy's estate. [This answer is correct. The tax effects of ISOs being exercised by her estate are substantially the same as if Lucy had exercised them herself. Taxable income is not recognized for regular tax purposes on the exercise of the ISO for the bargain element of the transaction. However, income would be recognized for alternative minimum tax purposes.]

   b. Ordinary income is recognized by the estate on the full value of this transaction. [This answer is incorrect. If the estate sold the ISOs as opposed to exercising them, ordinary income would be recognized for the excess of the sales price of the option over the option price.]

c. Any income realized after Lucy's death is considered IRD and governed by IRC Sec. 691. [This answer is incorrect. If Lucy had died owning unexercised nonqualified stock options (NQSOs), not ISOs, income realized on them on or after her death would (at least in part) be considered IRD and governed by IRC Sec. 691.]

d. IRD is recognized only if Lucy's death occurred after the record date but before the payment date. [This answer is incorrect. If Lucy received dividend income after her death that met these qualifications, it would be considered IRD.]

9. In which of the following scenarios would the investment income be considered IRD upon the decedent's death? **(Page 15)**

   a. Jane's estate receives interest payments from original issue discount (OID) bonds she purchased at a premium on the open market. [This answer is incorrect. Because the bonds were originally issued at a discount, the OID rules cause the discount to be included in interest income on a daily basis over the life of the bond, even though Jane purchased them at a premium on the open market. Income from these bonds would be reported on Jane's final tax return, so it would not be considered IRD.]

   b. The publishing company pays Erin's estate $100,000 in royalties for her best-selling novel six months after her death. [This answer is correct. Royalties received after death that, in substance, are attributed to the sale of property are considered IRD. Royalties received after death that are earned before death under a license agreement would also be considered IRD (e.g., the contract between an inventor and a manufacturer).]

   c. Michael's estate receives a $50,000 payment from his life insurance policy. The insurance payment is not received in a transfer transaction. [This answer is incorrect. Life insurance proceeds are not normally considered IRD as they are not normally included in gross income. If the life insurance was included in gross income (e.g., if it were a transfer for valuable consideration) the portion of the payment comprising gross income could be IRD.]

   d. George dies before the start date for his annuity. His son receives the death benefit as a lump-sum, which does not exceed George's original investment in the annuity. [This answer is incorrect. In this situation, only annuity payments received in excess of George's investment in the contract would be considered IRD. The excess amounts would be considered IRD in that instance no matter if George's son took the benefit as a lump-sum or in periodic payments.]

10. Nadia is a partner in Tate, Williams, & Jarvis. After Nadia's death, which of the following types of partnership income would be always considered IRD? **(Page 20)**

   a. Partnership income through the date of Nadia's death. [This answer is incorrect. Nadia will receive a Schedule K-1 from Tate, Williams, & Jarvis that reports this income. Because this income will be reported on Nadia's final Form 1040, it is not IRD per the Internal Revenue Code.]

   b. Partnership income earned after the date of Nadia's death. [This answer is incorrect. This type of income is reported on a separate Schedule K-1 and sent to the estate or Nadia's successor. It is not IRD according to the Internal Revenue Code.]

   c. Partnership income earned in her life, but not includable income until after her death. [This answer is correct. An example of this type of income would be payments received by Tate, Williams, & Jarvis, a cash basis partnership, after Nadia's death for amounts earned before her death.]

   d. Payments made in exchange for Nadia's interest in partnership property. [This answer is incorrect. Except in a few circumstances, no IRD results from distributions in exchange for the decedent's interest in partnership property. Other payments made to liquidate Nadia's interest in the partnership, such as guaranteed payments, would be considered IRD.]

11. The Milton Family Trust requires income be payable annually to Sarah, the sole beneficiary. Sarah's beneficiary is her son, Leo. In 2009, the trust had $30,000 to distribute. Sarah had received $17,000 of the income as of the date of her death. How should the remaining $13,000 be treated? **(Page 22)**

    a. It is IRD to Leo and is reported on the trust's Form 1041. [This answer is correct. The amount of income to which Sarah was entitled but had not received and that had not been reported as of her death is IRD to the beneficiary, Leo, who receives her income from the trust. The preparer of the trust's Schedule K-1 should indicate the amount and character of the IRD.]

    b. Neither income nor losses from a trust are IRD. [This answer is incorrect. Neither income nor losses of income from an S corporation would be considered IRD, but as the Milton Family Trust is a fiduciary, not an S corporation, that does not apply in this scenario.]

    c. If Leo itemizes his deductions, the IRD amount can be deducted. [This answer is incorrect. If Leo were dealing with IRD from a retirement plan distribution, that would be correct; however, this does not apply to the situation above.]

    d. Only the amount previously deducted by Sarah is IRD. [This answer is incorrect. Amounts received as reimbursements for medical expenses that Sarah had deducted previously on her individual income tax return would be considered IRD. However, that does not apply to the above scenario.]

Transferring and Distributing IRD Assets

The receipt of a right to receive IRD by a person entitled to receive such a right (e.g., the decedent's estate) is not a taxable event for income tax purposes. IRD is taxed when the income itself is received. If a right to IRD is transferred by an estate to a legatee, the legatee generally steps into the estate's shoes and must include the income in gross income when actually or constructively received. In this situation, there are no tax consequences to the estate or the distributee (legatee) at the time of the transfer. If a trust owning the right to receive IRD terminates and transfers the right to a beneficiary, the beneficiary will similarly include the IRD in gross income when it is collected.

Transfer of a Right to Receive IRD to Specific or Residuary Legatee

If a right to receive IRD is transferred by an estate or trust to a specific or residuary legatee and the transfer is not a pecuniary (fixed-dollar) bequest, the legatee rather than the estate, includes the income in gross income when it is actually or constructively received. When an estate assigned the right to receive IRD (from retirement plans for which there were no designated beneficiaries) to a residuary beneficiary, the IRS has held that the assignment was not a "transfer" under IRC Sec. 691(a)(2). Similarly, the IRS has ruled that a personal representative's assignment of a decedent's individual retirement accounts (IRAs) in satisfaction of residuary bequests to charities would not be taxable to the estate. The estates (and in one case, a resulting pour-over trust) did not receive any distributions from the IRAs that were assigned. Instead, the IRA distributions were made directly to the charitable beneficiaries. The IRS ruled that only the charitable beneficiaries would include the income from the IRA distributions and only when such distributions were received (Ltr. Ruls. 200633009 and 200826028).

Thus, only the specific or residuary beneficiary must include such income in gross income when received. Similarly, if a trust that owns the right to receive IRD terminates and transfers the right to a beneficiary, the IRD should be included in the beneficiary's gross income when it is collected.

A specific bequest under IRC Sec. 663(a) exists when the will gives the beneficiary a stated asset or sum that can be determined from the document and paid in three installments or less. When the will specifically gives a particular asset, excluding cash, to a beneficiary, the beneficiary, rather than the estate, reports all income and expenses associated with the asset on the beneficiary's tax return beginning immediately after the decedent's death.

If the right to IRD is specifically bequeathed in the will, the beneficiary will report all income as collected on the beneficiary's Form 1040. Similarly, if the will provides for a residuary bequest in which the amount to be distributed is ascertainable as of the date of the decedent's death, the distribution will not carry out DNI to the beneficiary (no distribution deduction at the fiduciary level and no income recognition by the beneficiary until the income is collected).

Example 1H-1 IRD transferred to a specific legatee.

Harry's will provided that his daughter, Susan, was to receive his XYZ bonds. At Harry's death, the bonds had accrued interest of $500. Because the bonds were specifically bequeathed to Susan, the interest income thereon should be reported on her Form 1040 in the year the $500 is received. Even if the estate collects the interest, no interest from the XYZ bonds will be reported on the estate's Form 1041. The executor should give Susan a statement showing when the interest was collected and how to properly report it on her Form 1040. However, the estate should not report the interest on its Form 1041 or give Susan a Schedule K-1 for the interest income from the XYZ bonds since the distribution will not carry out DNI.

Transfer of a Right to Receive IRD to a Nonspecific or Nonresiduary Legatee

If an estate or trust transfers a right to receive IRD to nonspecific or nonresiduary legatees for any reason other than due to the decedent's death, the estate or trust must recognize income at the time of the transfer in an amount equal to the fair market value (FMV) of the claim plus any amount received in excess of the claim's FMV. Transfers, for this purpose, include sales, exchanges, gifts, or other dispositions. Transfers also include satisfaction of installment obligations having IRD at less than face value.

Although IRC Sec. 691(a)(2) provides exceptions to the term *transfer* (and thus gain recognition treatment) for certain transfers, a sale is not among the exceptions.

If the executor has a choice of assets with which to fund a pecuniary formula bequest and funds the amount with IRD, the Second Circuit has held that the transfer is considered a sale. The Court reasoned that the beneficiary of a pecuniary formula bequest assumes none of the risk of an individual who receives a specific or residuary bequest because he or she is entitled to receive a fixed dollar amount, payable either in cash or other property of that value.

Furthermore, the estate's transfer of the right to receive IRD in fulfillment of a pecuniary formula bequest is not excluded from taxable transfer treatment, since it is omitted from the second illustration of Reg. 1.691(a)-4(b), while transfers to a specific or residuary beneficiary are specifically exempted from being taxable to the estate.

Satisfying a Pecuniary Bequest with IRD

A pecuniary bequest is a fixed-dollar bequest. It can either be stated as a certain dollar amount (e.g., "I bequeath Tim $500,000") or based on a formula (e.g., "transfer to my bypass trust an amount necessary to avoid all death taxes"). If non-cash property is transferred to satisfy the bequest, the estate or trust is treated as if it has sold the property and must report any gain (or loss for estates, but not trusts) attributed to the sale. The gain/loss is the difference between the FMV of the property on the date of distribution and the property's basis.

When the non-cash property transferred consists of a right to receive IRD, the IRD becomes fully taxable to the estate (since the IRD has a zero tax basis) even though the IRD has not been collected. The beneficiary will take the claim to the IRD with a basis equal to the income recognized by the estate and will not have to recognize income when the IRD is actually collected. The same result would occur if the executor uses IRD to pay a creditor or the executor's fee, since both are considered fixed-dollar obligations.

Example 1H-2 Transfer of IRD in satisfaction of a pecuniary bequest.

Ron Thornburgh was a partner in a large law firm. The firm had a partnership agreement whereby, upon the death of a partner, his share of the value of work-in-process and accounts receivable would be payable to his designated beneficiary over five years. When completing the firm's paperwork several years ago, Ron designated his estate as beneficiary of the payout from the firm. Ron died in 2009.

Ron's will provided that $300,000 "in cash or in kind or partly in each, to be determined by the executor" be distributed to his wife, with the residue of the estate held in trust for his children. At the time of his death, the present value of his share of the firm's receivables and work-in-process was $300,000. In satisfaction of the bequest to his wife, the executor distributed, and the widow agreed to receive, the right to the income from the firm in a 2009 transfer.

The transfer of the right to the future income from the firm is a transfer of IRD in satisfaction of a pecuniary bequest. As such, the estate must recognize the entire $300,000 as ordinary income on the 2009 Form 1041.

The distribution of the IRD claim is considered a bequest of a specific sum of money under IRC Sec. 663(a) since the monetary value of the bequest is ascertainable as of the date of death under the terms of Ron's will. Therefore, the estate is not allowed a distribution deduction, and Ron's widow will not include any amount in gross income. If the estate owes estate tax, the estate is allowed a Section 691(c) deduction for income tax purposes for estate tax paid on the $300,000 included in the gross estate.

Ron's will did not provide a specific bequest of the buyout proceeds to Ron's widow. If it had specified that his share of the partnership's receivables and work-in-process were to be distributed to her, the estate would not have recognized the $300,000 of income, and Ron's widow would have recognized the IRD as the claim was collected over the five-year period. She would also be entitled to the Section 691(c) deduction for estate tax paid on the inclusion of the IRD claim in the gross estate.

Unless the "fairly representative" method of funding is used for pecuniary formula bequests funded with IRD, the proper tax treatment of transfers of IRD is unclear as to whether income recognition is actually required by IRC Sec. 691. The issue revolves on whether IRC Sec. 402(a) or 408(d)(1), which specifically provides that IRAs and qualified plan proceeds are taxed when actually (i.e., not constructively) distributed, trumps IRC Sec. 691(a)(2). This is a controversial issue among tax commentators, with some believing that IRC Sec. 691(a)(2) does not apply, while others believe it does. Many believe caution is still called for in this area.

In the early 1990s, the IRS issued three private letter rulings that applied the "sale" principle of Reg. 1.661(a)-2(f) for pecuniary bequests of installment sale notes and savings bonds (IRD assets). However, in subsequent letter rulings, the IRS made no reference to the IRD accelerated income issue when IRA or qualified plan benefits (i.e., IRD) payable to an estate or trust were to be paid directly to a surviving spouse in fulfillment of a pecuniary spousal share.

More recently, the IRS held that IRD assets transferred to beneficiaries in fulfillment of the trust's pecuniary bequest would trigger income realization at the trust level under IRC Sec. 691(a)(2). In this situation, although the trustee had discretion to use other assets to fulfill the trust's obligation, the IRD assets were selected.

However, in a different ruling, when the governing instrument required the use of IRD assets for funding (i.e., a marital trust named as beneficiary of a retirement plan), the IRS held that there was no acceleration of IRD at the time a decedent participant's retirement assets passed to the marital trust and that the IRD would be includable in the gross income of the surviving spouse as she received trust distributions. Although it is not clear from this letter ruling whether the transfer of the retirement plan benefits to the marital trust was in satisfaction of a pecuniary bequest, the ruling did not distinguish between types of bequests (e.g., pecuniary or specific) when, based upon the decedent's death, the recipient had a right to receive such amount and the IRD assets were required to be transferred (i.e., other assets could not be used to fulfill the obligation for funding). The IRS applied the exception in the last sentence of IRC Sec. 691(a)(2), which exempts from IRD acceleration treatment transfers at death to the decedent's estate or to "a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent."

It is unclear whether the IRS (a) simply overlooked the IRD issue in some of the earlier rulings and would not give those same rulings currently, (b) applies a more lenient standard to funding a marital pecuniary bequest, or (c) will only apply the "sale" principle if the fiduciary has discretion to choose which assets are used for funding the pecuniary bequest and other estate or trust assets are available. (Earlier letter rulings either required the fiduciary to use the IRD assets to fulfill the pecuniary bequests, or the fiduciary had discretion to choose among assets, but there were no other assets with which to fund the bequest.) Until the IRS provides more authoritative guidance, if the executor is funding a pecuniary formula bequest (based on date of distribution values) with IRD assets of a material amount, a letter ruling should be considered to determine whether income (gain) must be recognized by the estate or trust upon transfer.

Transfer of a Right to Receive IRD to a Charity

When an estate or trust transfers the right to receive IRD, the fair market value of the IRD asset plus any consideration received must be included in the fiduciary's income. However, if the IRD is transferred to a charity and the amount is included in gross taxable income, the fiduciary will be entitled to a charitable deduction if the requirements of IRC Sec. 642 are otherwise met.

The IRS privately ruled, citing Reg. 1.691(a)-4(b), that an estate's assignment of a decedent's retirement account to a charity that was entitled to a specific percentage of the estate residue under decedent's will would not cause any income inclusion by the estate. The IRS also ruled that, although the charity would be required to recognize the IRD on the assigned retirement income, it would not be taxable on the income due to its tax-exempt status.

Transfer of IRD Right for Reasons Other Than Death

If the transfer occurs for any reason other than death, the income associated with the IRD right is gross income to the transferor, even if the transfer otherwise would not be taxable. The income recognized equals the greater of the amount received for the right or the fair market value of the right.

Example 1H-3 Transfers of right to IRD for reasons other than death.

Sheila Miller died in 2008. Her will provided that the right to receive $25,000 (face amount) of a particular IRD item would pass to her daughter, Robin. This transfer (from Sheila's estate to Robin) is a specific bequest, which does not trigger income recognition to the estate or to Robin. In 2009, Robin retransfers the claim to her 15-year-old daughter, Elsa, as a gift, and Elsa promptly collects the $25,000.

The preparer of Robin's 2009 Form 709 determines that Robin has $25,000 gross income to be reported on her 2009 Form 1040 because the transfer of the IRD did not take place on account of Robin's (or Sheila's) death. The fair market value of the claim was determined to be $25,000 since Elsa collected the face value promptly. Robin is not pleased since she did not know the rules and assumed she had shifted the income tax burden associated with the $25,000 to her daughter at her lower marginal income tax rate.

IRD and the DNI Rules

IRC Sec. 691 overrides the distribution rules of IRC Sec. 661. Therefore, distribution of an IRD asset to a person entitled to receive the asset (i.e., an heir or legatee) before the income is collected does not carry out any distributable net income to the beneficiary of the trust or estate. If the trust or estate collects the IRD and makes distributions to the beneficiaries, the availability of a distribution deduction to the fiduciary is determined under the usual rules.

Example 1H-4 No distribution deduction upon distribution of the right to collect IRD to legatee.

Janet Jones, a cash-basis taxpayer, died in October 2009. One of the assets of her estate was the right to receive fees of $75,000 on January 31, 2010, for referrals she had made during 2009. The executrix, in her discretion, distributed the right to receive the $75,000 to Frank, the sole beneficiary, in December 2009 since he was short of funds. Frank immediately located a purchaser for the claim and sold it for $65,000 to an unrelated party after determining that was the highest price he could get.

The distribution of the claim to Frank during the estate's short 2009 tax year does not generate a distribution deduction for the estate, since distribution of a right to receive IRD to a person entitled to receive the asset does not carry out distributable net income to the distributee.

IRD versus Election to Recognize Gain on In-kind Distributions

The Section 643(e) election to recognize gain on distribution of appreciated property is not believed to be available for distributions of IRD claims because IRD claims are not part of distributable net income until collected. The election is presumably unavailable even though a claim to IRD is "appreciated property" (tax basis less than fair market value) since the income is not recognized until the IRD claim is collected. The *Rollert Residuary Trust* court determined that distributions of IRD are controlled by IRC Sec. 691, rather than IRC Sec. 661. However, there are no rulings or judicial decisions directly on point.

Example 1H-5 Election to accelerate recognition of IRD not available.

Bob Smith died on December 15, 2009, three weeks before he was scheduled to receive a substantial bonus based on his 2009 performance review. In his discretion, the executor of his estate considers distributing the claim to Bob's sole heir, his grandson, Tim, and making a Section 643(e) election to recognize the distribution of the bonus claim as a deemed sale of appreciated property. This strategy seems beneficial since Tim has a substantial NOL carryforward that will expire unused in 2009 unless the bonus is included in taxable income for the year. However, no Section 643(e) election is available for IRD items. IRD is not a component of distributable net income until collected, so no appreciated property distribution election is available.

The practitioner devises an alternative plan. The *claim* to the bonus is distributed to Tim several days before year-end as originally planned, but no Section 643(e) election is made. The distribution produces no distribution deduction for the estate and no income in Tim's hands because he has merely received the IRD claim to which he is entitled.

As an accommodation to its employee's heir, Bob's employer settles the bonus claim in cash at a small discount prior to the end of 2009, which generates gross income in Tim's hands from the collection of an IRD claim (sheltered by his expiring NOL).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Marlowe dies in 2009, and his estate makes the following transfers. IRD would be included in the estate's gross income for which transfer?

    a. The estate transfers the right to receive IRD for amounts in Marlowe's retirement account to Marlowe's daughter, Christine, as specified in the will.

    b. The estate gifts the right to receive IRD for bonds owned by Marlowe to his niece, Josephine, at Christine's request.

    c. Marlowe's will specifically bequeaths a rental house to Kendrick, Marlowe's brother.

13. Hannah dies in 2008, and her will states that the right to an IRD item will pass to her daughter, Joy. The asset's face amount is $5,000. In 2009, Joy gifts the claim to her 12-year-old son, Leo. Leo collects the $5,000 as soon as the transfer is concluded. Who will assume the tax burden of the IRD?

    a. Hannah's estate.

    b. Joy.

    c. Leo.

14. Gloria dies in August 2009. Georgia is her sole beneficiary. One of the assets included in Gloria's estate is the right to receive fees of $50,000 on January 1, 2010 for a consulting assignment that she completed in 2009, just before her death. The executor of Gloria's estate, at his discretion, distributes the right to receive the $50,000 to Georgia, who is in need of the funds. Georgia sells the claim to a purchaser for $45,000 in November of 2009. What are the consequences of these transfers?

    a. The estate elects to recognize gain on the distribution of appreciated property under IRC Sec. 643(e).

    b. Gloria's estate is entitled to claim a deduction of $50,000 under IRC Sec. 642.

    c. Because DNI is generated, Gloria's estate is entitled to a distribution deduction of $50,000.

    d. IRC Sec. 691 overrides the DNI rules and Gloria's estate is not allowed a distribution deduction.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. Marlowe dies in 2009, and his estate makes the following transfers. IRD would be included in the estate's gross income for which transfer? **(Page 30)**

    a. The estate transfers the right to receive IRD for amounts in Marlowe's retirement account to Marlowe's daughter, Christine, as specified in the will. [This answer is incorrect. When an estate transfers the right to receive IRD and the transaction is not a pecuniary bequest, the legatee, not the estate, includes the income in gross income when it is actively or constructively received.]

    b. The estate gifts the right to receive IRD for bonds owned by Marlowe to his niece, Josephine, at Christine's request. [This answer is correct. When an estate transfers the right to receive IRD to nonspecific or nonresiduary legatees for any reason other than due to the decedent's death (e.g., sales, gifts, or other dispositions) the estate must recognized the income at the time of the transfer in an amount that equals the fair market value (FMV) of the claim plus any amount received in excess of the claim's FMV.]

    c. Marlowe's will specifically bequeaths a rental house to Kendrick, Marlowe's brother. [This answer is incorrect. When the will specifically gives a particular asset, excluding cash, to a beneficiary, the beneficiary reports all income and expenses on his or her individual income tax return.]

13. Hannah dies in 2008, and her will states that the right to an IRD item will pass to her daughter, Joy. The asset's face amount is $5,000. In 2009, Joy gifts the claim to her 12-year-old son, Leo. Leo collects the $5,000 as soon as the transfer is concluded. Who will assume the tax burden of the IRD? **(Page 30)**

    a. Hannah's estate. [This answer is incorrect. Because Hannah bequeathed the item to Joy in a specific bequest, income recognition is not triggered for the estate.]

    b. Joy. [This answer is correct. Because the transfer of the funds to Leo was not the result of either Joy or Hannah's death, Joy will bear the tax burden of the IRD. The $5,000 should be reported on Joy's Form 1040.]

    c. Leo. [This answer is incorrect. Though Leo would have the lowest marginal income tax rate, he cannot bear the tax burden of the IRD in this scenario.]

14. Gloria dies in August 2009. Georgia is her sole beneficiary. One of the assets included in Gloria's estate is the right to receive fees of $50,000 on January 1, 2010 for a consulting assignment that she completed in 2009, just before her death. The executor of Gloria's estate, at his discretion, distributes the right to receive the $50,000 to Georgia, who is in need of the funds. Georgia sells the claim to a purchaser for $45,000 in November of 2009. What are the consequences of these transfers? **(Page 30)**

    a. The estate elects to recognize gain on the distribution of appreciated property under IRC Sec. 643(e). [This answer is incorrect. Because IRD claims are not part of DNI until collected, the Section 643(e) election is not believed available for such transfers.]

    b. Gloria's estate is entitled to claim a deduction of $50,000 under IRC Sec. 642. [This answer is incorrect. IRC Sec. 642 covers charitable deductions, which would not be available to Gloria's estate under these circumstances. However, if the estate did transfer IRD to a charity and that amount was included in the estate's gross income, the estate would be entitled to a charitable deduction if the requirements of IRC Sec. 642 are otherwise met.]

c. Because DNI is generated, Gloria's estate is entitled to a distribution deduction of $50,000. [This answer is incorrect. The distribution was made before the income was collected so there was no DNI to deduct.]

d. IRC Sec. 691 overrides the DNI rules and Gloria's estate is not allowed a distribution deduction. [This answer is correct. The distribution of IRD to a person entitled to receive that asset (Georgia, as Gloria's heir) before the income is collected does not carry DNI; therefore, Gloria's estate is not allowed a distribution deduction.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T41TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following are commonly included in income in respect of a decedent (IRD)?

    i. Amounts included on the decedent's final Form 1040

    ii. Survivor payments under employment contracts

    iii. Amounts received after the decedent's death as compensation for the decedent's personal services

    iv. Income received after the decedent's death from pass-through entities

    a. i. and iii.

    b. ii. and iv.

    c. ii., iii., and iv.

    d. i., ii., iii., and iv.

2. Upon his death in September 2009, Larry had earned compensation of $5,000 from his employer that had not yet been paid. Larry's estate is in the 45% federal estate tax bracket and the 35% income tax bracket. The estate receives the income at the end of the employer's payment cycle in October 2009. Calculate the amount that will be owed in taxes.

    a. $0.

    b. $1,750.

    c. $2,250.

    d. $4,000.

3. Which of the following would typically report IRD?

    i. The decedent

    ii. A trust established under the decedent's will

    iii. A trust that is a will substitute

    iv. A surviving joint tenant

    v. The decedent's estate

    vi. The decedent's employer

    vii. The beneficiary of a pension

    a. i., ii., and iii.

    b. v., vi., and vii.

    c. i., iv., v., and vi.

    d. ii., iii., iv., v., and vii.

4. Upon her death in June 2009, Sally owned Series EE United States savings bonds, and her nephew, Ray, was listed as the co-owner. The bonds are scheduled to mature in 2010. All interest has been deferred from inception. How will this interest be taxed?

   a. All bond interest will be taxed to Ray.

   b. All bond interest will be taxed to Sally's estate.

   c. IRD interest will be taxed to Sally's estate, and all remaining interest will be taxed to Ray.

   d. IRD interest will be taxed to Ray, and all remaining interest will be taxed to Sally's estate.

5. Which statement correctly describes the character of IRD?

   a. The IRD has the same character as it would have in the hands of the decedent when IRD is received by the person who acquires the right to the IRD or by the decedent's estate.

   b. If IRD is made up of self-employment income that was due to the decedent, the income will be considered self-employment income when it is paid to the beneficiary.

   c. IRD received by a beneficiary or the decedent's estate will never be subject to the alternative minimum tax (AMT).

   d. Tax-exempt income and other types of income excluded from gross income are considered IRD under IRC Sec. 691.

6. Upon Richard's death, his wife, Rachel, receives a discretionary payment of $5,000 from his employer. The payment is a death benefit that Richard had no enforceable right to. How will this payment be reported?

   a. On the estate's Form 1041.

   b. On the estate's Form 706.

   c. On both Form 1041 and Form 706.

   d. On Rachel's Form 1040.

7. Under his employment contract with MegaCo, James is paid $10,000 per month for services rendered. After James's death, MegaCo voluntarily continued making the payments to his widow, Laura, for one year. Are these payments considered IRD?

   a. No, only payments for services actually rendered by James before his death would be included in IRD.

   b. Yes, these payments are attributed to services rendered by James, so they are considered IRD.

   c. No, because the payments are not includible in James's gross estate, they are not considered IRD.

   d. Yes, the payments are both considered IRD and includible in James's gross estate.

8. Harvey owned and operated a farm that grows wheat, corn, and spelt. At the time of Harvey's death, he had sold and delivered the year's wheat crop to the Butterfield Bread Company. Harvey had begun negotiations with Millstone Grains for the purchase of that year's corn crop. The payment from Butterfield is received by the estate after Harvey's death; also, the executor of the estate completes the transaction with Millstone. Finally, the executor sells the year's spelt crop to Millstone, as well. Income from which crops would be considered IRD?

   a. Wheat.

   b. Wheat and corn.

   c. Corn and spelt.

   d. Wheat, corn, and spelt.

9. What type of investment income is considered earned on a daily basis and, therefore, if accrued by the date of the decedent's death but unpaid, would generally be considered IRD?

   a. Dividend income.

   b. Interest income.

   c. Advance rent payments.

   d. Annuities.

10. In which of the following scenarios would the gain **not** be considered IRD?

    a. In January 2009, Mary signs a binding contract to sell her vacation home for $250,000 (she purchased the home for $175,000 in 2006). The closing date is set for May 15, 2009. Mary dies in April 2009, but only administrative obligations remain on the sale. Her executor completed the sale on May 15.

    b. On May 1, 2009, Clem entered into a contract to sell a piece of real estate contingent on the buyer obtaining financing within 30 days. Clem died on May 14, before the buyer obtained financing. The buyer obtained financing on May 20 and the executor closed the sale on behalf of Clem's estate.

    c. Grace sells the stock in her closely held business to her daughter Julie in 2000 for a cash down payment and a 10-year installment note with an agreement that all sums due on the note were cancelled at her death. Grace dies in 2009, leaving unrecognized installment sale income of $25,000.

    d. Miles purchased a property near a company's office complex for $400,000. The company was granted an option to purchase the property. The option lasts for two months from Miles's date of death but was substantially fulfilled before his death. When Miles dies, the company purchases the property from his estate for $500,000.

11. Landon's balance in his employer's 401(k) plan is $125,000, $25,000 of which was after-tax contributions made by Landon to the plan. The entire balance was invested in a money-market fund. When Landon dies in 2009, his estate is the sole beneficiary of the entire balance. Landon also had $5,000 in a medical savings account (MSA) that is transferred to his sister, Hilda, at Landon's death. Calculate the total amount of Landon's holdings that will be considered IRD.

    a. $5,000.

    b. $105,000.

    c. $125,000.

    d. $130,000.

12. Which of the following is a taxable event?

    a. The receipt of the right to receive IRD.

    b. The receipt of income attributed to IRD.

    c. The transfer of the right to IRD from an estate to a legatee.

    d. The transfer of the right to IRD from a trust to a beneficiary.

13. Tom's will specifically bequeaths three bonds to his daughter Lucy. At Tom's death, the bonds had accrued $1,000 in interest. Tom's estate collects the interest on the bonds and distributes it to Lucy. How should the interest be reported?

    a. On the estate's Form 1041.

    b. On the estate's Form 706.

    c. On Lucy's Form 1040.

    d. On the Schedule K-1 provided to Lucy by the estate.

14. Harlan dies in 2008, and his will provides that the right to an IRD item with a face amount of $10,000 will pass to his son, James. In 2009, James gifts the claim to his daughter, Samantha. Samantha collects the $10,000 as soon as the transfer is concluded. Which family member will assume the tax burden of the IRD?

    a. Harlan's estate.

    b. James.

    c. Samantha.

    d. His transfer is not taxable.

Lesson 2: Deductions—Interaction with Form 706

Introduction

To properly prepare an estate's Form 1041, the practitioner should obtain a copy of the completed Form 706 (the federal estate tax return) if a Form 706 filing was required. As discussed in this lesson, certain items can be deducted either on Form 1041 or on Form 706, but not both. It may be necessary for the estate to file an election statement to claim those deductions on Form 1041.

In contrast, other expenses are deductible on both Form 706 and Form 1041. These items are referred to as deductions in respect of the decedent (DRD).

When an estate (or beneficiary) reports income in respect of the decedent (IRD), an income tax deduction may be available for the estate tax paid on the IRD. See Lesson 1 for detailed coverage of IRD.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the rules for determining where administration expenses can be deducted.
- Recognize deductions in respect of a decedent (DRD) and assess related issues.
- Determine how to claim a deduction for estate tax paid on IRD.

Deducting Administration Expenses

General Rules

Estates, and sometimes trusts, will often pay certain types of expenses that appear to be deductible for both estate tax and fiduciary income tax purposes. For example, executor fees are deductible on Schedule J of Form 706 and in the deductions section of Form 1041. However, amounts allowable as estate tax deductions under IRC Sec. 2053(a)(2) (pertaining to estate administration expenses) or IRC Sec. 2054 (pertaining to casualty and theft losses during the period of estate administration) cannot be deducted on both returns. A portion of administration expenses can be deducted on Form 1041 and the balance on Form 706, but the full amount cannot be deducted on both. Similar restrictions apply to expenses incurred in connection with generation-skipping transfers.

Without a special election, these types of expenses are allowable on Form 706. However, the executor or administrator may elect to claim the deductions on Form 1041. Applicable expenses include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, investment advisor fees, and other administration expenses reasonably and necessarily incurred for the collection, management, and preservation of the estate. For example, interest expense on a loan reasonably and necessarily obtained to preserve the decedent's estate is deductible as an administration expense under IRC Sec. 2053(a)(2). Statutory interest expense (i.e., required by the governing instrument or local law) may also be considered an administration expense in certain jurisdictions. Expenses related to assets that were once the decedent's personal assets (such as a residence) can be deducted as administration expenses in connection with the management of estate assets.

Selling Expenses

Selling expenses, such as commissions and other items that normally offset the sales price in determining gain or loss upon the sale of an asset, generally are also subject to the Section 642(g) prohibition against double deductions.

Example 2A-1 No double deduction for selling expenses.

In accordance with the terms of Jon White's will, the executor sold a parcel of raw land held as investment property in 2009, incurring brokerage commissions of $17,000, and distributed the proceeds to Jon's heirs.

Expenses for selling property of the estate are included as administration expenses if the sale is necessary to pay the decedent's debts, expenses of administration, or taxes; to preserve the estate's assets; or to effect the distribution of assets. Therefore, the brokerage commissions incurred by the estate are considered administration expenses.

However, the brokerage commissions are not deductible as estate administration expenses on both Form 706 and Form 1041, even though they were incurred in the administration of Jon's estate. Administration expenses allowed as estate tax deductions under IRC Sec. 2053 cannot also be claimed as an income tax deduction. Included among administration expenses are those expenses that would be treated as an offset against the sales price of property when determining gain or loss.

Therefore, the commissions can be claimed on Schedule J, Form 706 or as a reduction in the sales price on Schedule D, Form 1041 (assuming the required election is properly made, as described later in this lesson), but not on both returns.

To be deductible, selling expenses must be incurred to sell property to pay debts, administration expenses, or taxes; to preserve or maintain estate property; or to make a distribution of estate property. Generally, this means that selling expenses that are reasonably necessary to preserve the assets of the estate or to make them productive are deductible. However, in the *Estate of Marguerite S. Millikin*, the Sixth Circuit denied the estate's administration expense deductions for maintaining and selling a decedent's residence because there were sufficient other liquid assets that could have been used. Thus, the expenditures were not considered reasonably necessary.

A capital loss on the sale of a decedent's personal residence (for example, due to selling costs or a market decline since the Form 706 valuation date) should be deductible as a loss on the sale of a capital asset by the estate on Form 1041 subject to the usual capital loss limitation rules if the residence is no longer used as a personal residence by a beneficiary after the decedent's death. Also, a loss on the sale of a residence after an immediate attempt to sell the decedent's residence upon his or her death is deductible.

Treatment of Accrued Expenses

The prohibition against double deductions does not apply to deductions in respect of a decedent (DRD) pursuant to IRC Sec. 691. Therefore, taxes, interest, and business expenses accrued at the date of death are allowable on Form 706 as claims against the estate (i.e., debts of the decedent) under IRC Sec. 2053(a)(3) and as DRD on Form 1041 in the year paid. However, if the decedent was not legally liable for these expenses at the date of death, they are not DRD. Instead, they may be administration expenses deductible on Form 706 or on Form 1041, but not both.

Example 2A-2 Expenses not accrued at date of death cannot be deducted twice.

Mildred Lovelace was in the cattle-raising business and regularly incurred breeding fees to produce prize-winning cattle. In January 2009, she entered into a contract with Bar X Ranch to have one of her heifers mated with a prize-winning bull. A breeding fee of $1,100 was payable when the heifer became pregnant. Mildred died on March 5, 2009. In July 2009, the heifer became pregnant and Mildred's estate paid the breeding fee to the Bar X Ranch.

Since Mildred was not legally liable for the breeding fee at the time of her death, the fee is not a claim against the estate. However, it may properly be classified as an administration expense (as a management or asset preservation expense) in the year paid, and can be deducted either on Form 706 or on Form 1041, but not on both returns.

Example 2A-3 Property taxes accrue when liability becomes enforceable.

John Adams owned a personal residence in Birmingham, AL, where property taxes legally accrue October 1 of each year. John died in September 2009, at which time all of his property passed to his estate. The executor paid $3,000 of property taxes on the residence on October 10, 2009.

To be a claim against the estate, property taxes must accrue before the decedent's death. To be considered accrued, the taxes must be an enforceable obligation of the decedent at the time of death. They are not a claim merely because they have ratably accrued in an accounting sense.

Since the taxes had not legally accrued at the date of John's death, they are not a claim against the estate, and thus are not deductions in respect of a decedent. The taxes are deducted on Form 1041 under IRC Sec. 164 without apportionment between pre-death and post-death periods.

Allocating Administration Expenses to Optimize Tax Benefits

When the executor has the flexibility to choose between deducting the expenses on Form 706 or Form 1041, the usual strategy is to deduct the expenses on the return with the higher marginal tax rate. Thus, a federal income tax deduction on Form 1041 is preferable when the estate is sheltered from estate tax by the applicable credit amount and/or the unlimited marital deduction. When the estate is subject to estate tax, the deducting expenses on Form 706 is preferable since the minimum 2009 marginal estate tax rate (45%) exceeds the maximum 2009 marginal federal income tax rate (35%).

The effects of any net incremental fiduciary state income tax rate and any net incremental state inheritance tax rate should also be considered when deciding where to deduct estate administration expenses.

The decision to deduct administration expenses on Form 1041 or on Form 706 may create conflicts between the surviving spouse and nonspousal beneficiaries, or between current income beneficiaries and remaindermen. Fiduciaries and return preparers must proceed with caution because litigation by a disappointed beneficiary is a possibility.

Example 2A-4 Current income beneficiary receives tax benefit of expenses borne by remainder beneficiary when expenses are charged to principal.

The Len Barnes Estate was valued at $3.6 million before administration expenses of $50,000. Len left a life estate to his son, Greg, with the remainder to his grandchildren. Under state law, estate administration expenses are chargeable to principal. In 2009, the estate's gross income was $175,000.

If the expenses are deducted on Form 1041, Greg will receive an income tax benefit of $17,500 ($50,000 × 35%) from the deduction. Although the expenses will be paid from principal (i.e., the remainder beneficiary's share), they reduce the 2009 distributable net income (DNI) carried out to Greg. Therefore, Greg will be taxed on only $125,000 of DNI, even though he will receive the full $175,000 of gross income (assuming there are no other expenses).

If the expenses are deducted on Form 706, the estate tax would be reduced by $22,500, based on a marginal estate tax rate of 45%, and Greg would be taxed on the full $175,000 of 2009 gross income.

Without considering state taxation, deducting the administration expenses of $50,000 on Form 706 reduces overall federal taxes by at least $5,000 ($22,500 − $17,500), which benefits the grandchildren (remainder beneficiaries).

Estate Transmission Expenses. Expenses of transferring the estate from the decedent to his or her beneficiaries, referred to as estate transmission expenses, will generally reduce the marital or charitable deduction if paid out of the marital or charitable property (regardless of whether paid from income or principal or deducted on the estate tax return or on the estate income tax return). However, no reduction of the marital or charitable deduction is necessary for estate transmission expenses paid from income on a pecuniary bequest to a surviving spouse or charity that, according to the governing instrument or local law, has no right to participate in income during estate administration.

Estate transmission expenses are those that would not have been incurred except for the decedent's death. They result from collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property. Examples of estate transmission expenses are executor commissions and attorney fees (other than those related to investment, preservation, or maintenance of assets), probate fees, expenses incurred in proceedings to interpret the will or defend against a will contest, and appraisal fees.

Estate Management Expenses. Estate management expenses are costs incurred in connection with the investment of estate assets or with their preservation or maintenance during the estate administration. These expenses normally do not reduce the marital or charitable deduction, whether they are paid from the principal or income of such property. However, if the management expenses are claimed on the estate tax return as Section 2053 administration expenses, the marital or charitable deduction must be reduced accordingly, thus preventing a double deduction. Additionally, estate management expenses paid from the marital or charitable interest, but attributable to property being distributed to someone other than the marital or charitable interest (i.e., a bypass trust), will reduce the marital or charitable deduction. Examples of estate management expenses include ongoing investment advisory fees, stock brokerage commissions, custodial fees, and interest.

Explicit Election Statement Is Required for Form 1041 Deduction

Without a special election, estate administration expenses are claimed as an estate tax deduction on Schedule J of Form 706. However, if the executor determines a deduction on Form 1041 is preferable, the estate must file a statement, in duplicate, to the effect that the items have not been allowed as deductions for estate tax purposes. The statement irrevocably waives the right to claim the deduction on the estate tax return. The statement is necessary to support the Form 1041 deduction, even if no Form 706 is required.

Example 2A-5 Waiver is irrevocable.

Martha Morrison died on January 27, 2009, leaving a will that provided the following:

1. one-third of her residual estate will be divided equally among her three children,
2. one-third of her residual estate will be left to the local zoo, and
3. one-third of her residual estate will be used to care for a rain forest.

The children brought suit against the estate, claiming their mother was not of sound mind when executing the will; they claimed they were entitled to the entire residual estate. A court battle followed and $65,000 in legal fees was spent by the estate to litigate the will contest. On the 2009 Form 1041, the executor deducted the legal fees and properly filed the waiver required by IRC Sec. 642(g). However, he later determined it would be more advantageous to deduct the legal expenses on Form 706; therefore, he deducted these same expenses on the estate return and filed an amended Form 1041 to remove the expenses from the income tax return. The $65,000 in legal fees deducted on Form 706 will not be allowed because the waiver of the right to claim the fees on the estate tax return had been filed by the executor and is irrevocable. Amending the Form 1041 to remove the deduction does not permit the legal fees to be deducted on Form 706.

The election statement, or waiver, can be filed with Form 1041 for the year in which the expenses are claimed as deductions, or later with the appropriate Case Processing Site for "association" with the return. (Sec. 5 of IRS Notice 2003-19 lists the addresses of the Case Processing Sites according to the state in which the trust is located.) The election statement generally can be filed at any time before the expiration of the statute of limitations for the tax year the deduction is allowed.

It is not necessary that all of the deductions for administration expenses be claimed on the estate tax return (Form 706) or on the income tax return (Form 1041). One deduction, or a portion of a deduction, can be claimed for income tax purposes, assuming the appropriate statement is filed, while another deduction or portion thereof can be claimed for estate tax purposes, as long as there is no deduction duplicated. If an estate pays administration expenses in more than one year, the waiver must be filed, in duplicate, for each year in which expenses are claimed for income tax purposes if they could have also been claimed on Form 706.

Example 2A-6 Splitting deductions between Form 1041 and Form 706.

Tom Lewis died in 2008. The executor determined that $50,000 of attorney and accountant fees should be deducted on Form 706, which was filed in March 2009. No administration expenses were deducted on the initial Form 1041. In late 2009, the estate sold a parcel of real estate and incurred $9,000 in real estate commissions. It also paid $4,000 of additional professional fees and distributed the remaining assets to the heirs.

Since both the real estate commissions and the additional professional fees could also have been deducted on Form 706 as administration expenses, a formal election must be filed, in duplicate, to claim the expenses on Form 1041. The election irrevocably waives the estate's right to claim the expenses on Form 706, even if the estate is later audited by the IRS and additional estate tax assessed. The waiver must be filed before the deduction is "finally allowed," as discussed below.

Practical Considerations

In practice, many fiduciaries prefer not to file a statement waiving the Form 706 deduction with Form 1041. Instead, they wait until Form 706 is audited by the IRS to determine where the deductions will provide the most benefit. Claiming the deductions on both Form 706 and Form 1041, with adequate disclosure, is not uncommon, since the income tax deduction is not precluded by claiming the same item on Form 706, as long as the estate tax deduction is not finally allowed and the waiver statement is filed. Therefore, the waiver should be filed before the statute of limitations expires and before any closing agreement is reached with the IRS. Once the waiver is filed, however, it is irrevocable. If a waiver is not filed, the deduction is an estate tax deduction on Form 706. If both an estate and trust are utilized, some expenses must be classified as estate expenses on Form 706, and some must be classified as trust expenses, with no option to deduct them elsewhere.

Example 2A-7 Form 706 estate expense versus Form 1041 trust expense.

Mary Jones died in 2008, having a power of appointment over a trust which held title to her personal residence. After her death, her estate maintained her residence, which housed a substantial art collection. In March of 2009, the art collection was removed, and the residence listed for sale. The residence was eventually sold in April 2010. The estate claimed deductions for the costs of maintaining the residence until it was sold, as well as the selling expenses.

In a similar situation, the Tax Court held that the estate could only claim the residential maintenance costs for the period in which it stored the decedent's art collection. Following the removal of the art collection, the maintenance of the residence became an expense of the trust and was no longer allowable as an estate administration expense. Furthermore, the residential selling expenses were disallowed because the estate was under no compulsion to sell the residence (i.e., other liquid assets were sufficient to pay a potential tax liability). The selling expenses were held to be an expense of the trust and were not allowed as a Form 706 administration deduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. The executor of Donna's estate sells a retail building held as an investment, per instructions in Donna's will. The building sells for $250,000, incurring brokerage commissions of $25,000. The estate incurs additional administrative expenses of $4,000. The proceeds are distributed to Donna's heirs. How much can the estate deduct on both the Form 1041 and the Form 706 as administrative expenses?

    a. $4,000.

    b. $25,000.

    c. $29,000.

    d. No administrative expenses are eligible for the double deduction.

16. In which of the following scenarios is the deduction treated appropriately?

    a. After Gillian's death, her personal residence, a single-family home in Fort Worth, Texas, was unoccupied. Her son and sole beneficiary, Tom, lives in Houston, Texas. The residence is sold by the estate, and, due to market decline, the sale results in a loss on the capital asset. The loss is deductible by Tom on his Form 1040.

    b. Holden breeds beagles and enters a contract to have one of his females mated with another breeder's prize male in March 2008. Holden dies in May 2009, and the female becomes pregnant in June 2009. His estate pays the breeder and deducts the fee as claims against the estate on Form 706 and as deductions in respect of a decedent (DRD) on Form 1041.

    c. Property taxes legally accrue on Bernard's personal residence, a single family home in Flagstaff, Arizona, annually on October 1. Bernard dies on August 30, 2009, and all of his property, including his residence, passes to his estate. The executor pays $4,500 of property taxes on October 12, 2009, and deducts them on the Form 1041.

17. The Carla Billings Estate incurs administration expenses of $5,000. Under state law, administration expenses are chargeable to principal. Carla left a life estate to her son, Joe, with the remainder of the estate going to her grandchildren. The marginal estate tax rate is 45%, and the maximum 2009 marginal federal income tax rate is 35%. Calculate the income tax benefits if the expenses are deducted on Form 1041.

    a. $1,750.

    b. $2,250.

    c. $4,000.

18. Executor commissions and attorney fees (other than fees related to investment, preservation, and maintenance of estate assets), expenses incurred in proceedings to interpret the will or defend the will if it is contested, probate fees, and appraisal fees are examples of what?

    a. Deductions in respect of a decedent (DRD).

    b. Expenses not considered DRD.

    c. Estate transmission expenses.

    d. Estate management expenses.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. The executor of Donna's estate sells a retail building held as an investment, per instructions in Donna's will. The building sells for $250,000, incurring brokerage commissions of $25,000. The estate incurs additional administrative expenses of $4,000. The proceeds are distributed to Donna's heirs. How much can the estate deduct on both the Form 1041 and the Form 706 as administrative expenses? **(Page 43)**

    a. $4,000. [This answer is incorrect. Administration expenses can be deducted either entirely on Form 1041 or on Form 706, or partially on each.]

    b. $25,000. [This answer is incorrect. The $25,000 brokerage commissions can be deducted on Schedule J, Form 706, or on Schedule D, Form 1041.]

    c. $29,000. [This answer is incorrect. The brokerage fees cannot be added to the other administration expenses and deducted on Form 1041 and Form 706.]

    d. No administrative expenses are eligible for the double deduction. [This answer is correct. Amounts allowable as estate tax deductions under IRC Sec. 2053(a)(2) cannot be deducted on both returns. A portion of administration expenses can be deducted on Form 1041 and the balance on Form 706, but the full amount cannot be deducted on both.]

16. In which of the following scenarios is the deduction treated appropriately? **(Page 43)**

    a. After Gillian's death, her personal residence, a single-family home in Fort Worth, Texas, was unoccupied. Her son and sole beneficiary, Tom, lives in Houston, Texas. The residence is sold by the estate, and, due to market decline, the sale results in a loss on the capital asset. The loss is deductible by Tom on his Form 1040. [This answer is incorrect. The loss should be deducted by the estate on the Form 1041, not by Tom on his Form 1040.]

    b. Holden breeds beagles and enters a contract to have one of his females mated with another breeder's prize male in March 2008. Holden dies in May 2009, and the female becomes pregnant in June 2009. His estate pays the breeder and deducts the fee as claims against the estate on Form 706 and as deductions in respect of a decedent (DRD) on Form 1041. [This answer is incorrect. Holden was not legally liable for the breeding fee at the time of his death; therefore, the fee is not a claim against the estate. It could, however, be classified as an administration expense in the year paid and deducted on either Form 706 or Form 1041. It cannot be deducted on both returns.]

    c. Property taxes legally accrue on Bernard's personal residence, a single family home in Flagstaff, Arizona, annually on October 1. Bernard dies on August 30, 2009, and all of his property, including his residence, passes to his estate. The executor pays $4,500 of property taxes on October 12, 2009, and deducts them on the Form 1041. [This answer is correct. The taxes had not legally accrued as of Bernard's death; therefore, they were not a claim against the estate that could be deducted on the Form 706. They are deducted by Bernard's estate on the Form 1041 under IRC Sec. 164 without any apportionment between pre-death and post-death periods.]

17. The Carla Billings Estate incurs administration expenses of $5,000. Under state law, administration expenses are chargeable to principal. Carla left a life estate to her son, Joe, with the remainder of the estate going to her grandchildren. The marginal estate tax rate is 45%, and the maximum 2009 marginal federal income tax rate is 35%. Calculate the income tax benefits if the expenses are deducted on Form 1041. **(Page 43)**

    a. $1,750. [This answer is correct. The tax benefit for the Form 1041 deduction is calculated as $5,000 x .35. However, the estate would receive a greater tax benefit if it deducted the expenses on the Form 706 instead.]

b. $2,250. [This answer is incorrect. $5,000 × .45 is the calculation for deducting the expenses on the Form 706, not the Form 1041.]

c. $4,000. [This answer is incorrect. The administration expenses are not deductible for both estate taxes and income taxes; thus, ($5,000 x .45) + ($5,000 x .35) is not the correct calculation.]

18. Executor commissions and attorney fees (other than fees related to investment, preservation, and maintenance of estate assets), expenses incurred in proceedings to interpret the will or defend the will if it is contested, probate fees, and appraisal fees are examples of what? **(Page 43)**

a. Deductions in respect of a decedent (DRD). [This answer is incorrect. DRD consists of certain expenses that a decedent was liable for at the date of his or her death.]

b. Expenses not considered DRD. [This answer is incorrect. The fees and expenses listed above are not examples of expenses that are not considered DRD. An example of expenses not considered DRD is a decedent's unpaid medical expenses.]

c. Estate transmission expenses. [This answer is correct. Estate transmission expenses, such as those listed above, would not have been incurred except for the decedent's death. They result from paying the decedent's debts and death taxes, collecting his or her assets, and distributing his or her property.]

d. Estate management expenses. [This answer is incorrect. Estate management expenses are costs incurred in connection with investing estate assets preserving or maintaining estate assets during estate administration. Examples include ongoing investment advisory fees, custodial fees, stock brokerage commissions, and interest.]

An Overview of Deductions in Respect of a Decedent (DRD)

General Rules

When an individual dies, certain expenses for which he or she was liable at the date of death are referred to as deductions in respect of the decedent (DRD). These expenses generally are deductible when paid, either by the decedent's estate or by the person who acquires property subject to liability from the decedent.

The practical effect of classification of an expense as DRD is that the item is deductible on *both* Schedule K of Form 706 (for estate tax purposes) and on Form 1041 (for income tax purposes). In addition, DRD is netted against IRD in computing the deduction for estate tax paid. If the decedent was not liable for the expense at the time of death, it is not a DRD item and instead is an administration expense, deductible on either the Form 706 or the Form 1041, but not on both.

Expenses That Qualify as Deductions in Respect of a Decedent

Unlike income in respect of a decedent, which is controlled by IRC Sec. 691(a), only certain specified items can be deductions in respect of a decedent (DRD). These are:

1. business expenses,
2. interest expense,
3. taxes,
4. investment expenses, and
5. depletion.

To be deductible as DRD, the expense must be a deduction for which the decedent (or a prior decedent) was liable. This course takes the position that expenses that have not "matured" to the point of accrual at the decedent's date of death (i.e., the exact value has not yet been determined) should be considered DRD when later paid by the estate.

When reporting DRD on Form 1041, it should be reported similarly to the way it would have appeared on the decedent's Form 1040. For example, business expenses should be reported on Schedule C, rental expenses on Schedule E, and investment expenses that are miscellaneous itemized deductions subject to the 2% limitation on page 1 of the Form 1041.

Example 2B-1 Decedent unaware of liability at time of death.

Dr. Joel Feinstein, M.D., an unincorporated physician, died suddenly in March 2009. In June 2009, a former patient brought a malpractice claim against Dr. Feinstein's estate. The insurance company and the estate's executor reached an out-of-court settlement with the patient, and the estate paid an insurance deductible of $50,000 in November.

Business expenses for which the decedent was liable at the date of death are DRD in the year paid. Since the malpractice claim arose because of actions of Dr. Feinstein before his death, the claim is a liability of the decedent at the time of his death and deductible on Form 706, even though the validity and amount of the liability were not determined until after he died.

In the year of payment, $50,000 would also be deductible on Form 1041 as DRD. Some commentators believe that Section 162 business expenses which are DRD are deductible only as miscellaneous itemized deductions, subject to the 2% of AGI limit. In this course's opinion, the expenses should be deductible as a business expense on Form 1041 (by attaching a Schedule C, Form 1040). The expenses would then offset income from the medical practice received after Dr. Feinstein died, such as cash-basis receivables. If expenses exceed the income, a net operating loss (NOL) could result.

Section 212 expenses include the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Thus, to be DRD under IRC Sec. 212, the expenses must relate to an income-producing property or activity.

Example 2B-2 Fees paid to trustees of decedent's grantor trust.

Elizabeth Smith died in July 2009. In September, the executor received and paid an invoice for services rendered before the date of death by the trustee of a grantor trust Elizabeth had established during her lifetime. The trust property consisted of both income-producing assets and certain real property not held for the production of income.

Since the grantor of a grantor trust is treated as the owner of the trust, Elizabeth would have been treated as being liable for the fees if she had lived. Accordingly, she would have been allowed a deduction under IRC Sec. 212 for the trustee fees to the extent they were attributable to the management of income-producing assets. Thus, if the trustee fees were attributable to income-producing assets and represent services rendered prior to the date of death, they are deductible as DRD under IRC Sec. 691(b) and reportable on the "Fiduciary fees" line of Form 1041. Presumably, these expenses would be subject to the 2% of AGI limit at the fiduciary level, as they would have been subject to the 2% of AGI limit if deducted on the grantor's Form 1040. Because the real property in the trust was not held for the production of income, the portion of the fees attributable to the real estate is not deductible for income tax purposes.

The trustee fees (including those attributable to the nonincome-producing real estate) are also deductible on Form 706 as a liability of Elizabeth at the time of her death.

<u>Expenses Not Considered DRD.</u> A decedent's unpaid medical expenses at date of death do not qualify as DRD. For estates required to file Form 706, such expenses are treated as claims against the estate. They are reported on Schedule K of the Form 706 or, if so elected by the executor and paid within one year of death, on the decedent's final Form 1040.

Unused income tax loss carryovers do not qualify as DRD. The decedent's unused net operating loss carryover and capital loss carryover are deductible only on the decedent's final Form 1040 and do not carry over from the decedent to the estate. Suspended passive activity losses (PALs) are deductible on the final Form 1040 to the extent they exceed the basis step-up under IRC Sec. 1014 that occurs at death. Any remaining PALs expire unused at the decedent's date of death.

Similarly, the decedent's remaining excess charitable contributions are lost, thus highlighting the importance of careful planning when making substantial gifts during lifetime.

Do Deductions in Respect of a Decedent (DRD) Retain Their Character?

When an estate receives income in respect of a decedent (IRD), income in the hands of the estate has the same character it would have had in the hands of the decedent if the decedent had lived and received the income directly. Although no such provision exists for deductions in respect of a decedent (DRD). This course maintains that these deductions should also retain their character. If so, classification of interest expense as investment, personal, or qualified residence interest under IRC Sec. 163 should apply to interest that is DRD.

Example 2B-3 DRD retains its character.

Jason Roberts died December 30, 2009. Before his death, Jason actively bought and sold stocks and securities. While reviewing the year-end documents from banks and brokerage firms, the return preparer noticed that Jason's account at Capital Securities was charged with $3,000 of margin interest on December 31, representing interest charges for the fourth quarter of 2009. The preparer also noted that the executor had made a car payment on behalf of the estate that included $400 interest for the month of December 2009. The car had been Jason's personal automobile and had been used entirely for personal purposes.

Based on the opinion that DRD retains its character, the margin interest is investment interest expense, subject to the investment interest rules of IRC Sec. 163(d). The estate would include a Form 4952 (Investment

Interest Expense Deduction) with Form 1041 to compute the deductible portion of the margin interest. The interest on the car loan is personal interest and is not deductible for income tax purposes. However, all of the interest expense (including the personal interest expense) is deductible on Form 706 as a liability of Jason at the time of his death.

Allocating the DRD Deductions among Beneficiaries

The taxpayer who pays the obligation is entitled to the deduction in respect of the decedent. Thus, if the decedent's property passes to an heir either directly (non-probate asset) or by specific or residuary bequest, and the property is subject to a liability that is DRD, the heir claims the deduction in the year the obligation is paid. He or she does not need to receive the right to any IRD to be able to claim the deduction.

Example 2B-4 Property passing to beneficiary.

When Joe Schmo died, his real property passed directly to his daughter, Sally, under state law and thus did not become part of his probate estate. The property was subject to delinquent property taxes that had become a lien on the property. Sally paid the taxes in 2010.

Upon payment of the taxes, Sally is entitled to a DRD under IRC Sec. 691(b). The deduction is treated in the same manner as if Joe had made the payment while alive.

Multiple Beneficiaries. If there is more than one IRD recipient, the Section 691(c) deduction is allocated to the beneficiaries in the proportion to which they are deemed to receive the Section 691 income. Even if the governing instrument includes provisions imposing the estate tax on persons other than the IRD recipients, the deduction is allocated only to the IRD recipients. Although the 1997 Revised Uniform Principal and Income Act authorizes fiduciaries to make adjustments between principal and income to shift the tax benefits as needed for equitable treatment among income and remainder beneficiaries, this provision only applies to adjustments between principal and income.

If the governing instrument (or state statute) authorizes *nonprorata distributions* of property, and the fiduciary distributes Section 691 property in a manner other than prorata, the Section 691(c) deduction should be allocated to the recipients who collect the IRD.

When Is DRD Reported?

Deductions in respect of a decedent are allowable in the year the expenses are paid, regardless of the accounting method used by the estate or other person entitled to the deduction.

Deduction for Percentage Depletion

The deduction for percentage depletion is allowable only to the person who receives the IRD, regardless of whether that person receives the property from which the income is derived. If the decedent used cost depletion instead of percentage depletion, there would be no DRD for depletion because the cost depletion would have been computed through the date of death and reported on the final Form 1040. However, this does not preclude the beneficiary from claiming cost depletion on mineral production from the property occurring after death of the decedent.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following occurs when an expense is classified as DRD?

    a. It is added to IRD when the deduction for estate tax paid is computed.

    b. The expense is deductible when billed and only by the estate.

    c. It is deductible on either the Form 706 or Form 1041 as an administration expense.

    d. The expense is deductible on both Schedule K of form 706 and on Form 1041.

20. Hillary dies, and her real property passes directly to Kyle, her son and only heir, as required by state law. Hillary owed delinquent property taxes that were originally due in 2008, which Kyle paid in 2009, after receiving the property. What is the effect of this transaction?

    a. Hillary's estate is entitled to a DRD.

    b. Kyle is entitled to a DRD.

    c. Sally is entitled to a deduction on her final Form 1040.

    d. DRD will be reported in 2008.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following occurs when an expense is classified as DRD? **(Page 52)**

    a. It is added to IRD when the deduction for estate tax paid is computed. [This answer is incorrect. DRD is netted against IRD for the purposes of computing the deduction for estate tax paid. If the decedent was not liable for the expense at the time of death, it is not a DRD item but rather an administrative expense.]

    b. The expense is deductible when billed and only by the estate. [This answer is incorrect. Generally, expenses are deductible when paid, either by the person who acquires property subject to liability from the decedent or by the decedent's estate per IRS Code.]

    c. It is deductible on either the Form 706 or Form 1041 as an administration expense. [This answer is incorrect. This would be true if the decedent was not liable for the expense at the time of his or her death. Then it would be an administration expense, not a DRD item.]

    d. The expense is deductible on both Schedule K of form 706 and on Form 1041. [This answer is correct. A DRD item is deductible on both Schedule K of Form 706 and on Form 1041 per IRS Code.]

20. Hillary dies, and her real property passes directly to Kyle, her son and only heir, as required by state law. Hillary owed delinquent property taxes that were originally due in 2008, which Kyle paid in 2009, after receiving the property. What is the effect of this transaction? **(Page 52)**

    a. Hillary's estate is entitled to a DRD. [This answer is incorrect. Because the property passed to Kyle under state law, it was never part of the probate estate; therefore, the estate would not be eligible to claim a DRD.]

    b. Kyle is entitled to a DRD. [This answer is correct. Under IRC Sec. 691(b), Kyle would be entitled to the DRD because he was the only heir and the one who made the payment. His deduction is treated in the same manner as it would have been if Hillary had made the payment while alive.]

    c. Hillary is entitled to a deduction on her final Form 1040. [This answer is incorrect. Any deduction allowed for this transaction would not be claimed on Hillary's Form 1040, as Hillary did not make the payment while she was still alive.]

    d. DRD will be reported in 2008. [This answer is incorrect. Regardless of the accounting method used by Hillary's estate or Kyle, the deduction will be reported in the year paid (2009), not in the year that the taxes first came due (2008).]

Deducting Estate Tax Paid on IRD

General Rules

To mitigate the effect of double taxation, IRC Sec. 691(c) allows the estate (or successor who collects the IRD) to deduct the federal (not state) estate and GST tax attributable to the IRD as a miscellaneous itemized deduction, not subject to the 2% of AGI limit. However, like certain other itemized deductions, the Section 691(c) deduction is reduced by 3% (1% for 2009) of the amount by which an individual's adjusted gross income exceeds threshold amounts.

IRD is reduced by DRD, and a calculation is performed to determine the estate tax after all credits "with and without" the amount of net IRD included in the gross estate. The difference is referred to as the Section 691(c) deduction. IRD is discussed in Lesson 1.

If IRD is received periodically in the form of a joint and survivor annuity, the timing of the Section 691(c) deduction is determined under the annuity method. Other than annuity amounts covered in IRC Sec. 691(d), the proration of the Section 691(c) deduction related to installment income is based on the amount received currently to the total IRD to be received.

How to Calculate the Section 691(c) Deduction

The Section 691(c) deduction is computed as follows:

1. Determine the total amount of IRD includible on the income tax returns of the estate and beneficiaries.
2. Reduce this amount by the total DRD reported on the income tax returns of the estate and beneficiaries to arrive at the *net* IRD.
3. Recalculate the estate tax by reducing the total taxable estate by the net IRD (the "without" calculation).
4. Subtract the "as if" estate tax calculated in Step 3 from the actual estate tax per the Form 706.
5. Allocate the deduction between the estate and the beneficiaries based on the amount of net IRD reportable by each.

Amount Collected Different from Estate Tax Value of IRD

If the amount ultimately collected is greater than the estate tax value of the IRD claim, the payee must include in gross income the amount actually received, but the IRD deduction allocable to him is based on the lower estate tax value for the IRD claim.

Example 2C-1 Calculation of the estate tax deduction.

In November 2009, Bill Smith received a distribution of $302,287, representing the entire balance of his deceased father's IRA. Bill is his father's sole heir and the designated beneficiary of his IRA. Bill's father died in February 2009.

As requested, Bill provided his return preparer with (1) a copy of his father's Form 706, (2) Form 1099-R reporting the IRA distribution, and (3) a copy of his father's will. All estate and inheritance taxes are to be paid out of the residuary estate.

The value of the IRA included in Bill's father's estate tax return was $299,175 (based on date of death values and excluding $3,112 of income and appreciation between the date of death and the date of distribution to Bill). The IRA was the only item with IRD on Form 706, and there were no deductions in respect of a decedent.

The preparer confirmed through Bill that the IRA was a "regular" IRA to which Bill's father had contributed $2,000 a year for some years on a fully deductible basis. Since the decedent's basis in his IRA was zero, the entire Form 706 value of the IRA is IRD, fully taxable to Bill when he collects the proceeds.

Per Form 706, Bill's father had never made any taxable gifts, nor did his estate qualify for the credit on prior transfers or the credit for foreign death taxes. In addition, there was no generation-skipping transfer tax.

The Form 706 reflected a total taxable estate equal to $3,950,000. Estate tax, net of the applicable credit, amounted to $202,500 (representing a 45% marginal bracket).

Excluding the $299,175 IRA date-of-death value from the estate, the preparer of Bill's 2009 Form 1040 calculated the following *pro forma* Form 706 amounts:

Recomputed taxable estate ("without" IRA)	$ 3,650,825
Recomputed estate tax, net of applicable credit amount	$ 67,871
Net estate tax per Form 706	$ 202,500
Less: Net estate tax "without" IRA	(67,871)
Section 691(c) Form 1040 deduction	$ 134,629

Since the marginal estate tax bracket (45%) did not change when the IRA Form 706 amount was deleted from the Form 706, Bill's preparer performed a simple reconciliation to confirm the Section 691(c) amount:

IRA amount on Form 706	$ 299,175
Net marginal bracket	× 45 %
Estate tax on IRD	$ 134,629

In this example, Bill, as sole heir, bears the burden of all the estate and inheritance taxes since they are imposed on the residuary estate. However, Bill's Section 691(c) deduction would remain the same as long as he collected the IRA, even if 100% of the associated estate tax burden was borne by someone else. Bill can roll over his father's IRA balance to an IRA of his own even though he is not a surviving spouse. (This is because tax-free rollovers of direct trustee-to-trustee transfers from a deceased person's qualified retirement plan account can be made to a nonspousal beneficiary's IRA.)

The $134,629 Section 691(c) deduction in this example is not subject to the 2% of AGI limitation on miscellaneous itemized deductions. It is claimed on Form 1040, Schedule A, under "Other Miscellaneous Deductions" and is described as "Federal Estate Tax on Income in Respect of a Decedent."

As indicated in Example 2C-1, when computing the estate tax differential created by comparing the estate tax, after credits, owed with the net IRD amount (per Form 706) to the estate tax computed without the net IRD amounts, estate tax values are used unless the net amount collected is less than the Form 706 values. In other words, the amount of IRD to be used to compute the Section 691(c) deduction is the amount subject to both income tax and estate tax.

Example 2C-2 Actual IRD received is less than the value reported on Form 706.

Assume the same facts as in Example 2C-1, except the IRA decreased in value between the date of death ($299,175) and the date of distribution, to $294,210. The Section 691(c) deduction is computed in the same manner as in Example 2C-1, but the "without calculation" uses the date-of-distribution value of $294,210 since the value collected by Bill was less than the estate tax value. The Section 691(c) deduction therefore is $42,394, a decrease of $2,235 ($4,965 decrease in the IRA value × 45% net marginal tax rate).

Special Considerations in Computing the Deduction

The calculation of the estate tax without all net IRD items is as encompassing as the "with calculation" performed for the Form 706 itself. For example, if the marital deduction changes in the "without calculation" because a bequest of IRD to a surviving spouse is eliminated, the tax calculation must take the decrease in the marital deduction amount into account.

However, a surviving spouse does not bear the burden of a change in estate tax resulting from a change in the marital deduction. The Section 691(c) deduction is allocated on a pro rata basis among those who collect the claim and is not affected by deductions attributable to specific beneficiaries.

When Form 706 includes a marital and/or charitable deduction, the estate tax must be recomputed with and without the IRD to compute the Section 691(c) deduction. For example, if a charity were the beneficiary of an IRA, the IRA value would be included in the decedent's gross estate on Form 706 along with a corresponding deduction for the charitable deduction. To the extent that the IRA inclusion in the gross estate does not result in estate tax (i.e., due to the charitable deduction), there is no Section 691(c) deduction. Similarly, if the full amount of IRD passes to the surviving spouse, resulting in a marital deduction, no Section 691(c) deduction is available for the IRD. However, if only a portion of the IRD results in a marital or charitable deduction, then a Section 691(c) deduction is available for that portion of estate tax attributable to the IRD included in the gross estate.

Example 2C-3 Interaction with the marital deduction.

Assume the same facts as Example 2C-1 except:

1. the gross estate is $5.5 million;
2. one-third of the decedent's residuary estate was left to his surviving spouse in a way that qualified for the marital deduction, with two-thirds (instead of 100%) being left to the decedent's son, Bill; and
3. the decedent's IRA beneficiary designation specified that his surviving spouse and his son Bill, respectively, would receive outright one-third and two-thirds of his IRA balance.

Using the IRA date-of-death value in Example 2C-1, Bill receives $199,450 (two-thirds of the $299,175 IRA balance), and the surviving spouse receives the remainder, $99,725. The taxable estate per Form 706 is reduced by the marital deduction and now equals $3,696,079 (including Bill's two-thirds of the value of the IRA included in the estate). The estate tax after the federal applicable credit is $88,236. The Section 691(c) deduction is computed as follows:

Adjusted gross estate	$ 5,500,000	
Less: Marital deduction (one-third of residuary estate plus one-third of IRA)	(1,803,921)	
Taxable estate	$ 3,696,079	
Federal estate tax (net of credits)		$ 88,236
Recomputed taxable estate ($5,500,000 − $299,175 IRD − $1,733,608 marital deduction)	$ 3,467,217	
Recomputed federal estate tax		(-0-)
Decrease in federal estate tax		$ 88,236
Bill's Section 691(c) deduction (two-thirds)		$ 58,824

Therefore, Bill will report the $58,824 Section 691(c) deduction as a miscellaneous itemized deduction, not subject to the 2% of AGI limit, on Schedule A of his 2009 Form 1040. The Section 691(c) deduction on the surviving spouse's portion of the IRA is $29,412 (one-third of $88,236), even though the IRA funds she received were sheltered from estate tax by the marital deduction.

The deduction is available only in the year(s) the IRD is included in income. For example, a surviving spouse rolling over a decedent spouse's IRA may not recognize the underlying income for many years, and thus the deduction would be deferred until the income is recognized.

There is no requirement that the estate tax be paid at the time the recipient of the IRD files a return claiming a Section 691(c) deduction. Upon inheriting the right to receive the remaining payments from a decedent's annuity, a taxpayer reported the annuity payments on her income tax return as the payments were received and claimed the Section 691(c) deduction. The deduction was allowed even though the estate tax had not yet been paid.

If all the net IRD items in an estate are included in a specific bequest to a surviving spouse, no beneficiary is entitled to a Section 691(c) deduction on Form 1040. Since the unlimited marital deduction will completely shelter the specific bequest, no additional estate tax is owed as a result of the inclusion of IRD in the gross estate. If a formula marital bequest is used requiring the minimal marital deduction necessary to reduce decedent's federal estate tax to zero, there will be no Section 691(c) deduction because both the "with" and the "without" calculations result in zero estate tax.

Stock Options and the Section 691(c) Deduction

If the person holding nonqualified stock options (NQSOs) that were not taxed at the date they were granted dies, income realized from the exercise of the NQSOs on or after the option holder's death is, at least in part, income in respect of a decedent. Thus, nonqualified stock options, when exercised by an estate, trust, or other beneficiary, trigger IRD equal to the income that would have been recognized on their exercise by the decedent if he had lived and exercised the NQSOs on the valuation date used on Form 706.

The increase in the value of the NQSO between the date of death (or alternate valuation date, if applicable) and the date of exercise is not IRD. The person exercising the NQSO includes the increase in gross income upon exercise, but does not obtain a Section 691(c) deduction for the increase. The amount of IRD used to compute the Section 691(c) deduction is the amount subject to both income and estate taxation.

An incentive stock option (governed by IRC Secs. 421 and 422) does not produce IRD, provided it is exercised by the estate or another entity that acquired it by bequest or inheritance and the option itself was not sold or otherwise disposed of. Incentive stock options qualify for a step-up in basis. The estate or other beneficiary's holding period for stock acquired by exercise of an incentive stock option begins with the date of exercise.

Example 2C-4 Section 691(c) deduction for exercise of nonqualified stock options.

On October 12, 2009, the executor of Joe Turk's estate exercised nonqualified stock options for 10,000 shares of JET Industries, a closely held company, that were valued at $50 per share upon Joe's death and included on the estate tax return (Form 706). Joe received the options several years before his death with an option price of $40 per share. The value of the shares upon exercise had risen to $60 per share. Thus, the estate will recognize ordinary income of $200,000 [($60 FMV − $40 option price) × 10,000 shares] upon exercise of the options, of which $100,000 is IRD [($50 value at date of death − $40 option price) × 10,000 shares].

The executor can claim the Section 691(c) deduction for the additional estate tax attributable to the IRD of $100,000. If the estate tax on the IRD was $45,000 and the estate marginal income tax rate is 35%, the Section 691(c) deduction will result in a tax savings to the estate of $15,750 ($45,000 × 35%).

Distribution of IRD to Beneficiaries

If an estate collects some items of IRD and beneficiaries collect other items of IRD, the related Section 691(c) deduction is allocated between the estate and the beneficiaries. The deduction is carried out to the beneficiaries to the extent IRD items are paid, credited, or required to be distributed to the beneficiaries. If an item of IRD passes through more than one estate before it is collected, the "with" and "without" calculation includes each estate through which an item of IRD has passed.

Example 2C-5 Allocation of Section 691(c) deduction between estate and beneficiaries.

Andy Bailey was an attorney who used the cash method of accounting. On the date of his death in 2008, Andy was entitled to $37,000 of fees for professional services rendered, $10,000 of dividends payable to shareholders of record as of a date before his death, and $12,000 of accrued bond interest. These items were valued in the gross estate at $36,000, $10,000, and $12,000, respectively. The executor deducted for estate tax purposes (Form 706), as claims against the estate, $8,000 in business expenses for which the estate was liable and $10,000 in taxes accrued on certain real property the decedent owned.

The right to the fees for professional services rendered, along with certain other properties totaling $164,000 was specifically bequeathed by Andy to his surviving spouse, Betty. During 2009, the right to those fees was distributed by the executor to Betty, who collected the fees and included them in her gross income on Form 1040. The remaining IRD, the dividends and accrued bond interest, were received by the estate and properly included in its gross income on Form 1041.

The gross estate is valued at $4 million with deductions of $15,000 and a marital deduction of $200,000. The combined Section 691(c) deduction for the surviving spouse and the estate is computed as follows:

IRD included in the gross estate ($36,000 + $10,000 + $12,000)	$ 58,000
Less deductions in respect of the decedent ($8,000 + $10,000)	(18,000)
Value of net IRD included in gross estate	$ 40,000

	Form 706 as Filed	$40,000 Net IRD Excluded from Gross Estate
Value of gross estate	$ 4,000,000	$ 3,960,000
Less:		
Deductions	(15,000)	(15,000)
Marital deduction per Form 706	(200,000)	
Marital deduction reduced by value in gross estate of IRD ($36,000 fees for professional services rendered) included in gross income of spouse and in marital deduction of estate		(164,000)
Taxable estate	$ 3,785,000	$ 3,781,000
Gross estate tax (45% marginal rate)	$ 1,584,050	$ 1,585,250
Less:		
Applicable credit amount for 2009	(1,455,800)	(1,455,800)
Net federal estate tax	128,250	$ 126,450
Less: Recomputed federal estate tax	(126,450)	
Federal estate tax attributable to net value in the gross estate of all items of IRD	$ 1,800	

Betty's Section 691(c) deduction for the $36,000 (professional fees) of IRD she received and included in her gross income on Form 1040 in 2009 is computed as follows:

Total federal estate tax attributable to net IRD included on Form 706	$ 1,800	
Value in the gross estate of all items of IRD	58,000	
Value in the gross estate of item of IRD (professional fees) included in Betty's gross income	36,000	
Portion of estate tax deductible by Betty ($36,000 ÷ $58,000) × $1,800		$ 1,117

The Section 691(c) deduction allowed the estate is computed as follows:

The value in the gross estate of the items of IRD ($10,000 dividends, $12,000 bond interest) received and included in the gross income of the estate	$ 22,000	
Portion of estate tax deductible by the estate for federal income tax purposes ($22,000 ÷ $58,000) × $1,800		$ 683

The estate tax deduction for the estate is reported on page 1, line 19, of Form 1041.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Sarah is calculating the Section 691(d) deduction on her mother's estate. She has determined the total amount of IRD includable on the income tax returns of the estate and beneficiaries. What should she do next?

    a. Allocate the deduction between the beneficiaries and the estate.

    b. Reduce total IRD by the total DRD.

    c. Recalculate the estate tax (the "without" calculation).

22. In which of the scenarios below has the deduction for estate tax paid on IRD been handled correctly?

    a. Stella receives IRD from the estate of her sister, Jill. She files her return claiming the Section 961(c) deduction on March 30, 2009, which becomes the due date for the estate taxes.

    b. Nonqualified stock options (NQSOs) increase in value between the date of Jill's death and the date her estate exercises them. The resulting IRD is included in the calculation of net IRD for the deduction.

    c. The Helping Hands charity is the beneficiary of an IRA held by Jill. The IRA's value is included in the gross estate on From 706 as is the corresponding charitable deduction. There is no Section 691(c) deduction.

    d. Upon Stella's death, an item of IRD that she inherited from Jill is passed to Stella's son, Cal, before it is collected. The "with" and "without" collection on Cal's inheritance only includes Stella's estate.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Sarah is calculating the Section 691(d) deduction on her mother's estate. She has determined the total amount of IRD includable on the income tax returns of the estate and beneficiaries. What should she do next? **(Page 57)**

    a. Allocate the deduction between the beneficiaries and the estate. [This answer is incorrect. This is the final step in the process. The allocation is based on the amount of IRD reported by each.]

    b. Reduce total IRD by the total DRD. [This answer is correct. This is the second step in the process. The total amount of IRD is reduced by the total amount of DRD reported on the income tax returns of the beneficiaries and the estate. This is the net IRD amount.]

    c. Recalculate the estate tax (the "without" calculation). [This answer is incorrect. This is the third step in the process. The "without" calculation is when the estate tax is recalculated by reducing the total taxable estate by the amount of net IRD.]

22. In which of the scenarios below has the deduction for estate tax paid on IRD been handled correctly? **(Page 57)**

    a. Stella receives IRD from the estate of her sister, Jill. She files her return claiming the Section 961(c) deduction on March 30, 2009, which becomes the due date for the estate taxes. [This answer is incorrect. There is no requirement that estate tax must be paid at the time the recipient (Stella) of the IRD files a return claiming the Section 961(c) deduction.]

    b. Nonqualified stock options (NQSOs) increase in value between the date of Jill's death and the date her estate exercises them. The resulting IRD is included in the calculation of net IRD for the deduction. [This answer is incorrect. This increase is not IRD—it would be included in gross income upon being exercised, but there would not be a corresponding Section 961(c) deduction.]

    c. The Helping Hands charity is the beneficiary of an IRA held by Jill. The IRA's value is included in the gross estate on From 706 as is the corresponding charitable deduction. There is no Section 691(c) deduction. [This answer is correct. When the Form 706 includes either a marital or a charitable deduction, the estate tax must be recomputed with and without the IRD for computation of the Section 691(c) deduction. Because no estate tax is attributable to the IRA included in the gross estate, there is no Section 691(c) deduction.]

    d. Upon Stella's death, an item of IRD that she inherited from Jill is passed to Stella's son, Cal, before it is collected. The "with" and "without" collection on Cal's inheritance only includes Stella's estate. [This answer is incorrect. When an item of IRD passes through more than one estate before it is collected, the calculation will include each estate through which that item of IRD has passed.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T41TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

15. How can an estate deduct amounts classified as administration expenses under IRC Sec. 2053(a)(2) or IRC Sec. 2054?

    a. The full amount can be deducted on both the Form 706 and the Form 1041.

    b. A portion can be deducted on the Form 1041 and the balance on the Form 706.

    c. The executor can make a special election and deduct all expenses on the Form 706.

    d. Only expenses related to statutory interest can be deducted on the Form 1041.

16. The Mildred O'Connel Estate incurs administration expenses of $15,000. Under state law, administration expenses are chargeable to principal. The gross income of the estate in 2009 is $75,000. Mildred left a life estate to her son, Paul, with the remainder of the estate going to her grandchildren. The minimum 2009 marginal estate tax rate is 45%, and the maximum 2009 marginal federal income tax rate is 35%. Calculate the income tax benefits if the expenses are deducted on Form 706 rather than on Form 1041.

    a. $1,500.

    b. $5,250.

    c. $6,750.

    d. $46,250.

17. Irene, the executor of an estate, determines that it would be preferable to deduct $5,000 of administration expenses on the Form 1041 instead of the Form 706. How should she proceed?

    a. Irene must file a statement that irrevocably waives the right to deduct the expenses on the estate tax form.

    b. If it is later discovered that deducting the expenses on the Form 706 is more beneficial, Irene should file amended Forms 706 and 1041.

    c. If Irene chooses to use the Form 1041, all administration expenses related to the estate must be deducted on the Form 1041.

    d. Irene must inform the beneficiaries that any deductions made on the Form 1041 will reduce any applicable marital or charitable deduction.

18. Define *deductions in respect of a decedent* (DRD).

    a. Unused income tax loss carryovers as of the date of the decedent's death.

    b. Deductions a decedent's estate is allowed under IRC Sec. 691(c).

    c. Certain expenses for which the decedent was liable at the date of his or her death.

    d. Gross income a decedent was entitled to receive at the time of his or her death.

19. List all of the expenses that are considered DRD.

   i. Business expenses
   ii. Taxes
   iii. Net operating loss carryover
   iv. Investment expenses
   v. Depletion
   vi. Interest expense
   vii. Unpaid medical expenses
   viii. Capital loss carryover
   ix. Suspended passive activity losses
   x. Excess charitable contributions

   a. ii., iii., and viii.
   b. iii., vii., viii., and ix.
   c. i., iv., vi., and x.
   d. i., ii., iv. v., and vi.

20. Which of the following statements most accurately describes DRD?

   a. According to the Internal Revenue Code, DRD retains the character it would have had before the decedent's death.
   b. The taxpayer who pays the obligation, such as the decedent's heir, is entitled to claim any associated DRD.
   c. When cost depletion is used instead of percentage depletion, the decedent will benefit by receiving more DRD.
   d. When the Section 691(c) deduction is calculated, estate tax is determined by reducing the DRD amount by the IRD amount.

21. Along with any generation-skipping transfer (GST) tax, which of the following can be deducted as a miscellaneous itemized deduction under IRC Sec. 691(c) to mitigate double taxation to IRD?

   a. Federal estate tax.
   b. State estate tax.
   c. Alternative minimum tax.
   d. Decedent's income tax.

22. In which of the following scenarios has the estate tax deduction for IRD been handled correctly?

   a. Upon her mother's death, Lacey receives $50,000 of IRD, but the estate tax value of the IRD claim is $35,000. The IRD deduction allocable to Lacey is based on the full $50,000.
   b. Upon his death, Harold leaves an investment portfolio worth $1 million to his wife, Esther. The IRD from the portfolio must be included when calculating the deduction.
   c. Martha rolls her deceased spouse's IRA over into her own and underlying income is not recognized for five years. The deduction is deferred until the income is realized.
   d. Harrison's estate collects some items of IRD and his children collect other IRD items. The estate tax deduction is fully taken by the beneficiaries.

Lesson 3: Other Deductions

Introduction

Trusts and estates are allowed deductions for various administration expenses, which typically are allowed in full without limitations. Examples of these deductions are trustee fees, accounting and legal fees, and tax return preparation fees. However, investment advisory fees incurred by a trust or estate are generally subject to the 2% AGI floor. Casualty losses incurred during estate or trust administration may also be deductible.

Certain expenses incurred by trusts and estates are classified as miscellaneous itemized deductions. These deductions are allowed only to the extent they exceed 2% of adjusted gross income.

A portion of administration expenses, including Section 212 expenses, must be allocated to any tax-exempt income generated by the estate or trust. The portion allocated to tax-exempt income is nondeductible.

Expenses incurred to preserve and maintain the assets of an estate generally are deductible.

Learning Objectives:

Completion of this lesson will enable you to:

- Assess issues related to deducting investment advisory fees, casualty and theft losses, and other deductions not subject to the 2% of AGI floor.
- Identify the rules for miscellaneous itemized deductions subject to the 2% of AGI floor, indirect expenses, and expenses for maintaining estate property.

Investment Advisory Fees

When the 2% AGI Limitation Applies

Investment advisor fees incurred in administering the estate or trust are generally treated as miscellaneous itemized deductions reduced by 2% of the adjusted gross income. However, if such fees would not have been incurred if the property had been held outside the estate or trust, the 2% floor limitation does not apply. Unfortunately, this test is not easy to qualify and quantify because it requires that an expense would *not* be incurred if the property had *not* been held in trust (i.e., the expense is "unique" to trusts) If an expense would be incurred regardless of whether the property is held in trust, it fails the "not incurred" test and is subject to the 2% AGI limitation.

In the Sixth Circuit (KY, MI, OH, TN), those fees were held to be fully deductible when the trustee lacked financial management experience and incurred investment advisory fees in fulfilling fiduciary obligations. However, three consecutive more recent cases in the Second, Fourth, and Federal Circuits have all held that such fees are subject to the 2% floor, regardless of the fiduciary's financial management experience. The courts in *Scott* and *Mellon Bank* concluded that a trust expense is subject to the 2% floor if it is an expense "commonly" or "customarily" incurred by individuals; and the court in *Rudkin* looked to whether such an expense was "peculiar to trusts" and "could not" be incurred by an individual. In all three cases, the courts believed that investment management fees are commonly incurred outside of trusts and that individual taxpayers are likely to incur such expenses when managing a large sum of money. In other words, only trust-related expenses that are unique to trust administration and not customarily incurred outside of trusts are eligible to be fully deductible in these circuits.

Losses from Casualties and Theft

Deducting Casualty and Theft Losses

An estate or trust suffering a casualty or theft loss may claim a deduction for the loss by completing Form 4684 (Casualties and Thefts). To be deductible by an estate, the casualty loss must occur or the theft loss must be discovered during the settlement of the estate. Theft losses on nonbusiness or not-for-profit property that are discovered during the settlement of an estate may be deducted by the estate even though the theft occurred during the decedent's tax year.

Without a special election, casualty losses occurring and theft losses discovered during an estate's administration are claimed as an estate tax deduction on Form 706. However, if an estate claims a deduction on Form 1041, it must also file a statement irrevocably relinquishing the right to claim a deduction on the estate tax return (Form 706).

Personal-use Property Losses

Personal property losses resulting from a casualty or theft are deductible under IRC Sec. 165(h). A personal-use casualty loss is a loss of property not connected with a trade or business or a transaction entered into for profit. Generally, casualty losses are deductible in the year incurred, while theft losses are deductible in the year discovered. A casualty is the damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event. Losses caused by fires, storms, and floods are deductible casualty losses. A deductible theft loss is the result of illegal activity with criminal intent.

The amount of the loss is the lesser of the adjusted basis of the property or the decrease in fair market value (FMV) due to the casualty or theft. The amount of the decrease in FMV should be provided by the fiduciary and documented in the preparer's workpaper, and may require the use of a professional appraiser.

Once the amount of the loss is established, the deductible portion is determined by subtracting the following amounts from the amount of the total loss:

1. $500 (for 2009);
2. 10% of adjusted gross income (AGI); and
3. the amount of expected reimbursement (e.g., insurance).

AGI for this purpose is computed by subtracting the administration expenses of the estate or trust from the "total income" line of the Form 1041.

The $100 per-casualty is increased to $500 for losses incurred in 2009.

Example 3B-1 Claiming a casualty loss for personal use property.

The Estate of David Jones owned a condominium that was completely destroyed by a fire soon after David's death in 2009. At the time, his daughter, who was the sole heir, was residing there rent-free pending the distribution of the condominium to her. The unit had an adjusted basis of $350,000 before the fire, but the estate received only $230,000 in proceeds from the insurance policy. The estate's AGI for 2009 was $300,000.

The amount of the deductible casualty loss is $89,500, as computed in Section A of Form 4684. (The 10% of AGI and $500 limitations apply.) The $89,500 deduction is reported on the "Other deductions not subject to the 2% floor" line on page 1 of Form 1041. The estate must also file a statement with Form 1041 or with the appropriate Case Processing Site waiving the right to deduct the loss on the estate tax return (Form 706).

Variation: If David's daughter had not been residing in the condominium rent-free at the time of the fire pending its distribution to her, the condominium would likely (depending on intended use) have been income-producing property in the hands of the estate instead of personal use property, in which case, the entire $120,000 loss ($350,000 − $230,000) would have been deductible on Form 4684 Section B.

Business and Income-producing Property Losses

A deduction is also allowed for losses resulting from a casualty, or a theft of business or income-producing property. The method of determining the deductible portion of the loss is the same as discussed for personal-use property, except the deduction is not reduced by the $500 (for 2009) or 10% of AGI. The amount of the loss is computed in Section B of Form 4684.

Affirmative Election by Estate Required for Form 1041 Deduction

Without a special election, casualty and theft losses occurring during the administration of an estate are claimed as an estate tax deduction on Form 706. However, if the executor or administrator prefers to claim an income tax deduction on Form 1041, the estate may file a statement, in duplicate, indicating that the items have not been and will not be deducted for estate tax purposes. The statement irrevocably relinquishes the right to claim a deduction for the expenses on the estate tax return (Form 706). The statement is necessary to support the Form 1041 deduction, even if no Form 706 is required.

The election statement or waiver can either be filed with Form 1041 or later for the year in which the expenses are claimed as deductions with the appropriate Case Processing Site (see IRS Notice 2003-19). The election generally can be filed at any time before the statute of limitations expires for the tax year for which the deduction is allowed.

More Deductions That Are Not Subject to the 2% of AGI Floor

Expenses Other than Casualty and Theft Losses

In addition to casualty and theft losses discussed previously, the following items are examples of expenses that should be reported on the "Other deductions not subject to the 2% floor" line on page 1 of Form 1041:

1. Amortization of bond premiums for taxable bonds acquired before October 23, 1986.

2. Net operating loss deduction.

3. Fiduciary's share of amortization, depreciation, and depletion not related to investments and not claimed elsewhere on the return (i.e., on Schedules C, C-EZ, E, or F). The fiduciary's share of these deductions should be reported on an attached sheet and included on line 15(a). The beneficiary's share of such deductions should be reported in the appropriate box of Schedule K-1 (Form 1041).

4. Interest expenses, taxes, and estate taxes attributable to income in respect of a decedent (IRD).

5. Fiduciary, attorney, accountant, and return-preparer fees are deductible in arriving at adjusted gross income and are not subject to the 2% of AGI floor if the expenses would not have been incurred if the property was held outside the estate or trust. (See Lesson Two for additional coverage of administration expenses.)

Qualified Production Activities Income Deduction

In addition to the various other expenses described previously, the fiduciary's share of qualified production activities income deduction (QPAI) is not subject to the 2% of AGI floor and should be reported on the "Other deductions not subject to the 2% floor" line on page 1 of Form 1041. The deduction must be attributable to the following activities [IRC Sec. 199(a)(1), (c)(4), and (d)(1)]:

1. Construction performed in the United States.

2. Engineering or architectural services performed in the United States for construction projects in the United States.

3. Any lease, rental, license, sale, exchange, or other disposition of:

   a. Tangible personal property, computer software, and sound recordings that the estate or trust manufactured, produced, grew, or extracted in whole or in significant part within the United States;

   b. Any qualified film the estate or trust produced; or

   c. Electricity, natural gas, or potable water the estate or trust produced in the United States.

The QPAI deduction cannot exceed 6% (for 2007–2009) of the taxpayer's adjusted gross income or 50% of Form W-2 wages. The fiduciary's QPAI, as well as Form W-2 wages, must be allocated among the trust or estate (line 15a of Form 1041) and its beneficiaries [Schedule K-1 (1041), box 14].

An estate or trust distributes QPAI (whether positive or negative) and W-2 wages based on the relative proportion of the trust's or estate's DNI that is distributed, or required to be distributed in the case of a simple trust, to the beneficiary or that is retained by the estate or trust. The QPAI deduction is allowed for AMT as well as for the regular income tax.

If the estate or trust has no DNI for the tax year, QPAI and W-2 wages are allocated entirely to the estate or trust. The QPAI will be negative if the cost of goods sold and deductions allocated and apportioned to domestic production gross receipts (DPGR) is more than the estate's or trust's DPGR.

Relatively few estates or trusts will have QPAI since the great majority are neither engaged in a trade or business nor pay W-2 wages.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Blaine, a decedent's trustee, lacks financial management experience. Due to his inexperience, he incurs $4,000 of investment advisory fees while fulfilling his fiduciary obligations. Based on the decisions in majority of court cases, are these fees fully deductible?

    a. Yes.

    b. No.

    c. Only if the investment fees are peculiar to trusts.

24. Select the term that matches the following definition:

    > Damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event.

    a. Casualty.

    b. Theft.

    c. Personal-use casualty loss.

    d. Business property loss.

25. Calculate the personal-use property casualty loss deduction using the following:

Adjusted basis of the property:	$500,000
Insurance settlement:	$325,000
Estate's adjusted gross income (AGI):	$750,000

    a. $99,500.

    b. $100,000.

    c. $175,000.

    d. $500,000.

26. Which activities are eligible for a qualified production activities income (QPAI) deduction?

    a. A skyscraper constructed in Asia.

    b. A building designed in Chicago, IL, that will be located there.

    c. A lease agreement for an oil lease located in Houston, TX.

    d. A qualified film starred in by the decedent.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Blaine, a decedent's trustee, lacks financial management experience. Due to his inexperience, he incurs $4,000 of investment advisory fees while fulfilling his fiduciary obligations. Based on the decisions in majority of court cases, are these fees fully deductible? **(Page 67)**

    a. Yes. [This answer is incorrect. Though the Sixth Circuit found such fees to be fully deductible in a similar situation, that view is not the same held in the majority of other similar cases.]

    b. No. [This answer is correct. In the majority of court cases, it was found that investment management fees are commonly incurred outside of trusts. It was also found that individual taxpayers are likely to incur such expenses when managing a large sum of money. Since these expenses are not unique to trust administration, they are not eligible to be fully deductible in those circuits.]

    c. Only if the investment fees are peculiar to trusts. [This answer is incorrect. This was considered by the court in *Rudkin*, but it is not a deciding factor as to whether advisory fees incurred by an inexperienced trustee are deductible.]

24. Select the term that matches the following definition: **(Page 67)**

    Damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event.

    a. Casualty. [This answer is correct. This is the definition of a casualty. Deductible casualty losses include losses caused by fires, storms, and floods.]

    b. Theft. [This answer is incorrect. Loss from theft is the result of illegal activity with criminal intent.]

    c. Personal-use casualty loss. [This answer is incorrect. This is the loss of a property that is not connected with a trade or business or a transaction entered into for profit.]

    d. Business property loss. [This answer is incorrect. A deduction is allowed for losses that are the result of a casualty or the theft of business or income-producing property.]

25. Calculate the personal-use property casualty loss deduction using the following: **(Page 67)**

Adjusted basis of the property:	$500,000
Insurance settlement:	$325,000
Estate's adjusted gross income (AGI):	$750,000

    a. $99,500. [This answer is correct. The amount of total loss ($500,000) must be reduced by (1) $500 (for 2009), (2) 10% of AGI ($75,000), and (3) the amount of expected reimbursement ($325,000).]

    b. $100,000. [This answer is incorrect. To get this amount, the adjusted basis of the property was reduced by the insurance settlement and 10% of AGI.]

    c. $175,000. [This answer is incorrect. For this amount, the adjusted basis of the property was reduced by the insurance settlement.]

    d. $500,000. [This answer is incorrect. The full amount of the adjusted basis of the property would not be allowed as the personal-use property casualty loss deduction. The full amount must be reduced.]

26. Which activities are eligible for a qualified production activities income (QPAI) deduction? **(Page 69)**

    a. A skyscraper constructed in Asia. [This answer is incorrect. Only construction performed in the United States qualifies for a QPAI deduction.]

    b. A building designed in Chicago, IL, that will be located there. [This answer is correct. Architectural services (and engineering services) performed in the United States for construction projects that are in the United States are eligible for the QPAI deduction.]

    c. A lease agreement for an oil lease located in Houston, TX. [This answer is incorrect. The lease, rental, sale, license, exchange or other disposition of natural gas, potable water, or electricity an estate or trust produced in the United States would qualify for the QPAI deduction, but oil is not included on that list.]

    d. A qualified film starred in by the decedent. [This answer is incorrect. The rental, lease, license, exchange, sale, or other disposition of a qualified film that the estate or trust produced is eligible for the QPAI deduction.]

Miscellaneous Deductions That Are Itemized and Subject to the 2% Floor

General Rules

As is the case with individuals, miscellaneous itemized deductions of estates and trusts are allowed only to the extent they exceed 2% of adjusted gross income (AGI). The determining factor for applying the 2% of AGI limitation is whether such costs or expenses would otherwise have been incurred if the property had been held outside the estate or trust. In other words, if the costs or expenses are commonly incurred by individuals in the absence of an estate or trust, the 2% limitation applies. The IRS issued proposed regulations providing guidance on the types of fiduciary costs that it considers unique to estates and trusts, and, thus, fully deductible.

Miscellaneous itemized deductions received indirectly from a pass-through entity, such as a partnership or S corporation, are subject to the 2% floor. Miscellaneous itemized deductions also include the excess deductions upon termination of an estate that pass through to a trust (or another estate) that is a residuary beneficiary of the estate.

Deductions (including miscellaneous itemized deductions) for costs of administration of an estate or trust that would not have been incurred if the property were held outside an estate or trust are fully deductible without regard to the 2% floor limitation. Presumably, this same principle applies to miscellaneous itemized deductions such as investment custodial expenses (e.g., investment advisory subscriptions).

Computing AGI

The AGI of an estate or trust is computed by subtracting the following items from the "Total income" line of the Form 1041:

1. The administration costs of the estate or trust.
2. The income distribution deduction.
3. The personal exemption.
4. Deductions not included in the "Total income" line of Form 1041 that were incurred in the conduct of a trade or business or the production of income.

Computing Allowable Miscellaneous Deductions and Distributable Net Income

The amount of the actual distribution, rather than the distributable net income (DNI), should be used to compute AGI for an estate or trust when the income distribution deduction is limited to the actual distribution (i.e., the income distribution is less than the DNI).

However, for an estate or trust with an income distribution deduction limited to DNI (i.e., the actual distribution is greater than or equal to DNI), the DNI must be computed taking into account the allowable miscellaneous itemized deductions (AMID) after applying the 2% floor limitation. This means the estate or trust must simultaneously solve for two unknowns: (1) the AMID and (2) the DNI.

Example 3D-1 Simultaneous equations when distributions equal or exceed DNI.

The Bernard P. Aloof Trust had the following activity for the year:

Interest income	$ 30,000
Capital gains	30,000
Deductible loss from partnership	(10,000)
Fiduciary fees	2,000
Accounting fees	1,000
Miscellaneous itemized deductions subject to the 2% floor	2,500
Distribution to beneficiary	20,500
Personal exemption	100

Based on these facts, the actual amount distributed can reasonably be expected to equal or exceed the DNI. Thus, the DNI must be computed taking into account the AMID after applying the 2% floor limitation.

The equation for computing the AMID is: AMID = total miscellaneous itemized deductions − [.02(AGI)]

Using the above facts: AMID = \$2,500 − [.02(AGI)]

The equation for computing the AGI is:

$$\text{AGI} = \begin{array}{c}\text{total income}\\\text{from Form 1041}\end{array} - \begin{array}{c}\text{costs incurred in the}\\\text{administration of the trust}\end{array} - \text{DNI} - \text{personal exemption}$$

Using Example 3D-1 facts:

AGI = (\$30,000 + \$30,000 − \$10,000) − (\$2,000 + \$1,000) − DNI − \$100
AGI = \$46,900 − DNI

This formula is then substituted for the value of AGI in the AMID formula above as follows:

AMID = \$2,500 − [.02(\$46,900 − DNI)]

This equation cannot be solved without determining the amount of DNI. However, DNI can be expressed in terms of the AMID. The equation for computing DNI is:

$$\text{DNI} = \begin{array}{c}\text{total income}\\\text{from Form 1041}\end{array} - \begin{array}{c}\text{capital gains}\\\text{allocated to corpus}\end{array} - \begin{array}{c}\text{total deductions without}\\\text{regard to miscellaneous}\\\text{itemized deductions}\end{array} - \text{AMID}$$

Using the above facts:

DNI = \$50,000 − \$30,000 − \$3,000 − AMID
DNI = \$17,000 − AMID

This formula is then substituted for the value of DNI in the AMID formula as follows:

AMID = \$2,500 − {.02[\$46,900 − (\$17,000 − AMID)]}
AMID = \$2,500 − [.02(\$29,900 + AMID)]
AMID = \$2,500 − [\$598 + .02(AMID)]
AMID = \$1,902 − .02(AMID)
1.02(AMID) = \$1,902
AMID = \$1,902 ÷ 1.02
AMID = \$1,865

Therefore: DNI = \$15,135 (i.e., \$17,000 − \$1,865)
AGI = \$31,765 (i.e., \$46,900 − \$15,135)

Proof: AMID is limited to the excess of miscellaneous itemized deductions over 2% of AGI.

AMID = \$2,500 − [.02(\$31,765)]

AMID = \$2,500 − \$635

AMID = \$1,865

The \$1,865 is reported on the "Allowable miscellaneous itemized deductions subject to the 2% floor" line on page 1 of the trust's Form 1041.

Miscellaneous Deductions for Grantor Trusts

For grantor trusts, miscellaneous itemized deductions (determined under the rules for individuals) pass through to the grantor/owner, and the trust as a separate entity is disregarded. Thus, all of the administration expenses for a grantor trust are subject to the 2% floor limitation at the grantor/owner level.

In the case of *Susan L. Bay*, a taxpayer who was both the grantor and beneficiary of a grantor trust argued that deductions paid or incurred in connection with the administration of the trust, which was created to manage the grantors' investments, should be fully deductible in arriving at AGI. The taxpayer contended that the trust should not be considered a grantor trust with respect to the investment expenses. Thus, these expenses would be fully deductible in arriving at AGI under IRC Sec. 67(e). However, the Tax Court held that IRC Sec. 67(e) does not apply to grantor trusts, and thus, the deduction for investment expenses must be reduced by the 2% floor.

Example 3D-2 Application of 2% floor to grantor trust.

In 2009, Bill Williams transferred \$300,000 to a trust in which he retained the right to receive annual payments of 6% of the fair market value of the trust principal (determined on an annual basis). The payments are to continue for 10 years. After the 10-year period, the trust terminates and all assets are distributed to Bill's daughter, Laura. This is a grantor retained unitrust (GRUT). (This example assumes the grantor is treated as the owner of all of the income of a GRUT, so all items of income, deduction, and credit are attributed to the grantor.) During 2009, the trust incurred \$3,000 in trustee fees and \$3,000 in appraisal fees. The trust must pass the \$6,000 in deductions through to Bill, the grantor of the trust. Bill may then deduct these expenses on his personal income tax return to the extent they exceed 2% of his AGI.

Indirect Expenses

General Rule

Deductions not directly attributable to a specific class of income, also referred to as indirect expenses, such as trustee fees, may be allocated to any item of income included in DNI, as long as a "reasonable portion" is allocated to nontaxable income.

Tax-exempt Income

When a taxpayer has tax-exempt income, a reasonable allocation of expenses not directly attributable to any certain class of income must be made to the tax-exempt income. Tax-exempt income includes tax-exempt interest, compensation for illness or injury, debt forgiveness income (Chapter 11 bankruptcy), and death benefits. All indirect expenses allocated to tax-exempt income other than tax-exempt interest (the regulations distinguish between the two) are nondeductible. Section 212 indirect expenses (e.g., trustee fees, accounting and legal expenses, safe deposit box rentals, and similar administration expenses) that are allocated to tax-exempt interest are nondeductible. However, other indirect expenses allocated to tax-exempt interest are deductible if allowable by other sections of the Code [e.g., IRC Secs. 167(a)(2) (depreciation on property held in the production of income) and 164 (taxes)]. Thus, indirect property taxes deductible under IRC Sec. 164 are deductible in full when the only tax-exempt income is tax-exempt interest.

Example 3E-1 Tax-exempt income causes administration expenses to be partially nondeductible.

During the current year, the Estate of Henry White has the following activity:

Ordinary dividend income	$ 15,000
Tax-exempt interest	5,000
Rental income	20,000
Trustee fees	4,000

Thus, total fiduciary accounting gross income is $40,000. Tax-exempt income is 12.5% of the income ($5,000 ÷ $40,000). Therefore, 12.5% of the trustee fees ($500) are allocated to the tax-exempt income and are nondeductible. The estate may claim a deduction of $3,500 ($4,000 − $500) for the trustee fees on page 1 of Form 1041.

Direct and Indirect Expenses. The allocation of expenses to tax-exempt income becomes more complicated when the trust or estate has both direct and indirect expenses. A reasonable allocation must be made and the regulations provide two basic methods of allocating expenses in this situation:

1. *Net Income Method.* Under this method, fiduciary accounting gross income is first reduced by direct expenses before allocation of indirect expenses.

2. *Gross Income Method.* Under this method, indirect expenses are allocated before reducing gross income by direct expenses.

Example 3E-2 Allocation of indirect expenses using the net income method.

Assume the same facts as in Example 3E-1. In addition, the estate has depreciation and maintenance expenses of $5,000 that are directly attributable to the rental income. Under the net income method, the rental income of $20,000 must first be reduced by the $5,000 of direct expenses before the trustee fees are allocated.

Thus, the allocation of trustee fees is based on the following income amounts:

Ordinary dividend income	$ 15,000
Tax-exempt interest	5,000
Rental income	15,000
	$ 35,000

The allocation of the $4,000 of trustee fees to the various income categories is computed as follows:

$15,000 ordinary dividend income	÷ $35,000 total income	× $4,000	=	$ 1,714
$ 5,000 tax-exempt interest	÷ $35,000 total income	× $4,000	=	572
$15,000 rental income	÷ $35,000 total income	× $4,000	=	1,714
Total				$ 4,000

Page 1 of the Form 1041 will show a $3,428 ($4,000 − $572) deduction for trustee fees. The $5,000 of tax-exempt interest will be disclosed on page 2 (and the appropriate box checked). A schedule showing the calculation of the deduction for the trustee fees should also be attached to the return.

Example 3E-3 Allocation of indirect expenses using the gross income method.

Assume the same facts as Example 3E-2. Under the gross income method, the rental income of $20,000 is not reduced by the $5,000 of direct rental expenses before the trustee fees are allocated.

Thus, the allocation of trustee fees is based on the following income amounts:

Ordinary dividend income	$ 15,000
Tax-exempt interest	5,000
Rental income	20,000
	$ 40,000

The allocation of the $4,000 of trustee fees to the various income categories is as follows:

$15,000 ordinary dividend income	÷ $40,000 total income	× $4,000	=	$ 1,500
$ 5,000 tax-exempt interest	÷ $40,000 total income	× $4,000	=	500
$20,000 rental income	÷ $40,000 total income	× $4,000	=	2,000
Total				$ 4,000

Page 1 of the Form 1041 will show a $3,500 ($4,000 − $500) deduction for trustee fees. The $5,000 of tax-exempt interest will be disclosed on page 2 (and the appropriate box checked). A schedule showing the calculation of the deduction for trustee fees must also be attached to the return. (See Example 3E-2.)

In the case of administration expenses incurred by an estate, the amount allocated to tax-exempt income (and therefore nondeductible) on Form 1041 may nevertheless be deducted on Form 706 pursuant to Rev. Rul. 63-27.

Example 3E-4 Expenses not deductible on Form 1041 can be deducted on Form 706.

Assume the same facts as Example 3E-3. The fiduciary cannot claim a deduction on Form 1041 for the $500 allocated to tax-exempt interest. However, a deduction for the $500 fiduciary fees can be claimed on the estate tax return, Form 706.

Indirect expenses may be allocated to any item of income included in the computation of DNI. Typically, capital gains are not included in the computation of DNI if they are allocable to principal under the trust instrument or state law. Thus, a simple trust that does not distribute capital gains because they are allocable to principal under the trust agreement or state law may not include them in the formula for allocating indirect expenses to tax-exempt income. However, when a trust terminates, capital gains are included in the formula for allocating indirect expenses to tax-exempt income, since DNI includes capital gains in the year of termination.

Example 3E-5 Effect of capital gains on the allocation of indirect expenses.

The Charlie Cook Trust has the following activity for the year:

Ordinary dividend income	$ 8,000
Tax-exempt interest	10,000
Capital gains	5,000
Trustee fees	2,000

The trust instrument is silent with regard to special provisions for capital gains. However, state law specifies that capital gains are allocated to principal (as opposed to income).

Since the capital gains are allocated to principal under state law, they do not receive an allocation of the trustee fees. Thus, the trustee fees are allocated as follows:

$ 8,000 ordinary dividend income	÷ $18,000 total income	× $2,000	=	$ 889
$10,000 tax-exempt interest	÷ $18,000 total income	× $2,000	=	1,111
Total				$ 2,000

Trustee Fees Paid on Termination of a Trust

Trustee fees paid on termination of a trust or estate for trustee or executor services performed during the entire term of the trust or estate (termination fees) may not be allocated solely on the basis of the income in the year of termination. Rather, the fees must be allocated based on a "reasonable method" such as the ratio of tax-exempt income realized over the life of the trust or estate to all income (including taxable income, tax-exempt income, net realized gains, and net unrealized appreciation on assets) over the life of the trust or estate.

The allocation may be expressed as the following formula:

$$\frac{\text{Tax-exempt income over the life of trust or estate}}{\text{All income + net unrealized appreciation}} \times \text{termination fee}$$

Example 3E-6 Special allocation for termination fees.

The John P. Doe Trust terminates in 2009. The value of trust assets on the date of termination is $500,000. The trustee is paid a termination fee of 10% of the assets' value, or $50,000. The trust's total income during its existence was $200,000, including $10,000 of tax-exempt interest that it earned its first year. The trust had no tax-exempt interest income other than in its first year. The net unrealized appreciation of the trust's assets is $40,000.

Even though there is no tax-exempt interest in the year of termination, a portion of the termination fee must be allocated to the tax-exempt interest earned during the life of the trust, as follows:

$$[\text{Tax-exempt income} \div (\text{total income} + \text{unrealized appreciation})] \times \text{termination fee}$$

$$[\$10{,}000 \div (\$200{,}000 + \$40{,}000)] \times \$50{,}000 = \$2{,}083$$

Thus, $2,083 of the termination fee is allocated to tax-exempt income and is therefore not deductible on the 2009 Form 1041. The trust may deduct a termination fee of $47,917 ($50,000 − $2,083).

Expenses Incurred to Maintain Estate or Trust Property

Deductible Expenses

Expenses that are necessary to preserve and distribute the estate property are deductible, including the cost of storing or maintaining estate property, if it is impossible to distribute the property to the beneficiaries immediately. For the expenses to be deductible, the property should come under the executor or trustee's control as specified in the will or in accordance with state law. Allowable expenses do not include outlays for additions and improvements to estate property.

Thus, expenses to maintain and preserve property of an estate are deductible as administration expenses. Such expenses may be claimed on either the income tax return of the estate (Form 1041) or the estate tax return (Form 706).

Example 3F-1 Deducting expenses to maintain property for eventual distribution.

John Brown died on January 15, 2009, leaving his personal residence to his sole beneficiary, Jake Brown. Jake is on safari and cannot be reached to be informed of his inheritance. He is scheduled to return to the United States on December 10, 2009. The estate incurs expenses, including utilities and insurance, to maintain the residence until it can be distributed to Jake. These fees may be deducted by the estate as administration expenses on Form 1041 or Form 706 (but not both).

Likewise, expenses for maintaining property to be sold by the estate are deductible as administration expenses.

Example 3F-2 Deducting expenses to maintain property for sale.

John Brown died on January 16, 2009. Included in his estate is a personal residence. Because of the depressed real estate market, the residence is not sold by the estate until February 15, 2010. Expenses of maintaining the property such as utilities, yard maintenance, etc. are deductible by the estate as administration expenses.

Beneficiary's Rent-free Use of Property

When a beneficiary occupies a residence rent-free that is held by an estate or trust, the fiduciary's expenses of maintaining and preserving such residence (other than taxes and qualified personal residence interest) are not deductible. In that case, the expenses relate to assets that are held for personal use, which are not deductible by an estate or trust (or an individual).

Expenses to maintain a residence held in an estate or trust that is occupied rent-free by a beneficiary are not considered indirect distributions to the beneficiary.

If a beneficiary occupies a residence rent-free only for a reasonable period of time pending the sale or other disposition of the residence, the facts and circumstances determine whether the estate's or trust's expenses are deductible. When the expenses are for maintenance and storage, serious attempts are made to dispose of the residence, and facts indicate that the expenses are not personal in nature, the expenses may be deductible.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Martin is the executor of an estate for which the income distribution deduction is less than distributable net income (DNI). What should he use to compute the estate's AGI?

    a. The DNI.

    b. The allowable miscellaneous itemized deductions (AMID).

    c. The actual distribution amount.

28. Which of the following statements about deductions is most accurate?

    a. Deductions for estate administration costs are always subject to the 2% floor limitation.

    b. Miscellaneous itemized deductions for a grantor trust are passed through to the grantor/owner.

    c. If there is nontaxable income, deductions for indirect expenses cannot be allocated to DNI.

    d. Expenses made to improve estate property can be deducted by the estate.

29. Calculate the AMID for an estate with a total of $5,000 of miscellaneous itemized deductions and AGI of $42,500.

    a. $850.

    b. $4,150.

    c. $5,000.

    d. $37,500.

30. What type of indirect expenses would be deductible if allocated to tax-exempt interest?

    a. Compensation for illness or injury.

    b. Accounting and legal expenses.

    c. Safe deposit box rentals and trustee fees.

    d. Depreciation on property held in the production of income.

31. Calculate the amount of trustee fees that the estate can deduct based on the following amounts of activity:

Ordinary dividend income:	$ 30,000
Tax-exempt interest:	10,000
Rental income:	40,000
Trustee fees:	8,000

    a. $1,000.

    b. $1,250.

    c. $7,000.

    d. $8,000.

32. The Desmond Trust is a simple trust. The trust instrument requires that capital gains be allocated to principle, and in 2009 the trust had $3,200 of capital gains. Which of the following is true?

    a. The capital gains will never be included in the trust's DNI.

    b. The trust will distribute at least a portion of the capital gains.

    c. Capital gains are not included in the formula for allocating indirect expenses.

33. The Carmichael Trust terminates in 2009, and the trustee is paid a termination fee equal to 5% of the trust's value for services performed for the entire amount of time the trust was in existence. How must the termination fee be allocated?

    a. Based on the trust's income in 2009.

    b. Based on the trust's income in 2009 and in the three prior years.

    c. Based on income over the entire life of the trust.

34. Hilda dies on March 17, 2009. Her estate includes her personal residence, but due to a down-turn in the real estate market, the residence is not sold until November 22, 2009. During this time, Hilda's son and beneficiary, Steve, lives in the residence rent free. The estate incurs administration fees for maintenance during the intervening months, including charges for utilities and lawn care. Which of the following is true in this scenario?

    a. All of the maintenance fees are deductible by the estate.

    b. Depending on the facts and circumstances, the expenses could be deductible by the estate.

    c. The expenses must be considered indirect distributions to Steve.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Martin is the executor of an estate for which the income distribution deduction is less than distributable net income (DNI). What should he use to compute the estate's AGI? **(Page 74)**

    a. The DNI. [This answer is incorrect. The DNI would be a factor if the actual distribution was equal to or greater than the DNI, which is not the case in this scenario.]

    b. The allowable miscellaneous itemized deductions (AMID). [This answer is incorrect. The AMID must be calculated along with the DNI if the actual distribution is greater than or equal to the DNI; however, that is not the case in Martin's scenario.]

    c. The actual distribution amount. [This answer is correct. When an estate's income distribution is less than the DNI, the amount of the actual distribution would be used to compute the estate's AGI per the IRS Code.]

28. Which of the following statements about deductions is most accurate? **(Page 74)**

    a. Deductions for estate administration costs are always subject to the 2% floor limitation. [This answer is incorrect. If such deductions would not have been incurred on property held outside the estate, the amounts would be fully deductible, not subject to the 2% floor limitation.]

    b. Miscellaneous itemized deductions for a grantor trust are passed through to the grantor/owner. [This answer is correct. In this situation, the trust would be disregarded as a separate entity, and the 2% floor limitation would be applied at the grantor level.]

    c. If there is nontaxable income, deductions for indirect expenses cannot be allocated to DNI. [This answer is incorrect. Such expenses (e.g., trustee fees) can be allocated to any item of DNI; however, a reasonable portion of the expenses must be allocated to the nontaxable income.]

    d. Expenses made to improve estate property can be deducted by the estate. [This answer is incorrect. Expenses incurred to preserve or distribute the property can be deducted if it is impossible to distribute the property to the beneficiary immediately. However, expenses allowed do not include the costs of additions or improvements to the estate property.]

29. Calculate the AMID for an estate with a total of $5,000 of miscellaneous itemized deductions and AGI of $42,500. **(Page 76)**

    a. $850. [This answer is incorrect. This is 2% of the AGI, but that is not all of the AMID equation.]

    b. $4,150. [This answer is correct. The correct equation for AMID is the total of miscellaneous itemized deductions ($5,000) minus 2% of AGI ($850).]

    c. $5,000. [This answer is incorrect. The entire amount of the miscellaneous itemized deductions does not qualify for AMID.]

    d. $37,500. [This answer is incorrect. $37,500 is not the allowable miscellaneous itemized deductions amount.]

30. What type of indirect expenses would be deductible if allocated to tax-exempt interest? **(Page 76)**

    a. Compensation for illness or injury. [This answer is incorrect. Compensation for illness or injury, like tax-exempt interest, is an example of tax-exempt income, not an example of indirect expenses.]

b. Accounting and legal expenses. [This answer is incorrect. This type of indirect expense would be nondeductible if allocated to tax-exempt interest. They would also be nondeductible if allocated to another kind of indirect income.]

c. Safe deposit box rentals and trustee fees. [This answer is incorrect. These are Section 212 indirect expenses and are nondeductible if allocated to tax-exempt interest.]

d. Depreciation on property held in the production of income. [This answer is correct. This is one type of indirect expense that is deductible when allocated to tax-exempt interest, because it is allowable by IRC Sec. 167(a)(2). Another example would be taxes, which is allowable by IRC Sec. 164.]

31. Calculate the amount of trustee fees that the estate can deduct based on the following amounts of activity: **(Page 76)**

Ordinary dividend income	$ 30,000
Tax-exempt interest	10,000
Rental income	40,000
Trustee fees	8,000

a. $1,000. [This answer is incorrect. This is 12.5% of the trustee fees, which is the amount that would be allocated to the tax-exempt interest. This amount is important in the calculation of how much of the trustee fees the estate can deduct, but it is not the final answer.]

b. $1,250. [This answer is incorrect. This is 12.5% of the tax-exempt interest, which is not the amount of trustee fees that the estate can deduct.]

c. $7,000. [This answer is correct. Because the tax-exempt interest equals 12.5% of the total fiduciary accounting gross income, 12.5% of the trustee fees ($1,000) are allocated to that income and are, therefore, nondeductible. The remainder of the trustee fees ($7,000) are allocable to the taxed income and are deductible on the first page of Form 1041.]

d. $8,000. [This answer is incorrect. The estate is not allowed to deduct 100% of the trustee fees because 12.5% of the total fiduciary accounting gross income is tax-exempt.]

32. The Desmond Trust is a simple trust. The trust instrument requires that capital gains be allocated to principle, and in 2009 the trust had $3,200 of capital gains. Which of the following is true? **(Page 76)**

a. The capital gains will never be included in the trust's DNI. [This answer is incorrect. In the year the trust terminates, capital gains will be included in the trust's DNI.]

b. The trust will distribute at least a portion of the capital gains. [This answer is incorrect. When capital gains are allocable to principal under either state law or the trust instrument, they will not be distributed by the trust.]

c. Capital gains are not included in the formula for allocating indirect expenses. [This answer is correct. If the trust instrument allocates capital gains to principal, they will not be included when calculating the allocation of indirect expenses to tax-exempt income.]

33. The Carmichael Trust terminates in 2009, and the trustee is paid a termination fee equal to 5% of the trust's value for services performed for the entire amount of time the trust was in existence. How must the termination fee be allocated? **(Page 79)**

a. Based on the trust's income in 2009. [This answer is incorrect. In this scenario, the fee cannot be allocated solely based on the Carmichael Trust's income in the year of termination, because the fee is payment for services performed during the entire life of the trust.]

b. Based on the trust's income in 2009 and in the three prior years. [This answer is incorrect. Because the services were provided by the trustee over the life of the trust, this allocation method would not be considered reasonable in these circumstances.]

c. Based on income over the entire life of the trust. [This answer is correct. Any "reasonable method" could be used. One such method would be a ratio of tax-exempt income realized over the trust's life to all income over the life of the trust.]

34. Hilda dies on March 17, 2009. Her estate includes her personal residence, but due to a down-turn in the real estate market, the residence is not sold until November 22, 2009. During this time, Hilda's son and beneficiary, Steve, lives in the residence rent free. The estate incurs administration fees for maintenance during the intervening months, including charges for utilities and lawn care. Which of the following is true in this scenario? **(Page 79)**

a. All of the maintenance fees are deductible by the estate. [This answer is incorrect. In general, this would be correct; however, in this scenario, the rent-free occupation of the residence by Hilda's beneficiary adds a wrinkle to the treatment of the expenses.]

b. Depending on the facts and circumstances, the expenses could be deductible by the estate. [This answer is correct. Generally, Steve's rent-free occupation of the residence would mean the maintenance expenses could not be deducted; however, the expenses could be deductible depending on the facts and circumstances of the case. If Steve occupied the residence for a reasonable amount of time only, pending sale or disposal of the residence, if the expenses are for maintenance and storage (not personal in nature to Steve), and if serious attempts are made to dispose of the residence, it is possible that the estate could be allowed to deduct the maintenance fees.]

c. The expenses must be considered indirect distributions to Steve. [This answer is incorrect. Expenses incurred by an estate owning a residence that is occupied rent-free by a beneficiary will not be considered indirect distributions to that beneficiary.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (T41TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. If investment advisor fees are incurred while administering an estate, will they qualify for a deduction?

    a. They can be fully deducted on the estate tax return.

    b. They are reduced by 2% of adjusted gross income, then deducted.

    c. Investment advisor fees would never be eligible for a deduction.

    d. It depends on the results of the "not incurred" test.

24. In which of the following scenarios could the casualty and theft losses be deducted by the estate?

    a. A tornado destroys the primary residence of Matilda, the decedent, during the settlement of the estate.

    b. During the settlement of the estate, it is discovered that $5,000 was stolen from MAC-2, Matilda's business, during her final tax year.

    c. Larry, Matilda's son, inherits her vacation home. During the time between the bequest and Larry's first visit to the property, it is damaged by a hurricane.

    d. Larry bequeaths his car to John. Upon Larry's death, the executor of his estate elects an alternate valuation date. Between the date of death and the valuation, the car is stolen.

25. Dahlia owned a home that she shared with her sister, Marie. Dahlia left the house to Marie in her will, and upon Dahlia's death, Marie was living in the house rent free. Before the house was distributed to Marie, the house was destroyed in a fire. The house had an adjusted basis of $200,000 before the fire, but Dahlia's estate only received $150,000 from the insurance company. The estate's adjusted gross income (AGI) for 2009 was $175,000. Calculate the amount that Dahlia's estate can deduct.

    a. $32,000.

    b. $50,000.

    c. $182,500.

    d. $199,900.

26. Which of the following is reported on the "Other deductions not subject to the 2% floor" line on the first page of the Form 1041?

    a. Amortization of all bond premiums.

    b. Net operating loss deduction.

    c. Amortization and depreciation deductible by the beneficiary.

    d. Interest expenses and estate taxes not attributable to IRD.

27. What is the determining factor for determining if the 2% of AGI limitation applies to an estate's deductions?

    a. Whether the deductions amount to more or less than 2% of AGI.

    b. Whether the deductions are indirectly received from a pass-through entity.

    c. Whether the decedent died before or after those costs or expenses occurred.

    d. Whether the costs or expenses would have occurred outside of the estate.

28. Linda transfers $500,000 into a grantor trust in 2009. She retains the right to receive annual payments of 5% of the fair market value of the trust principal, which will be determined annually. The payments will continue for 10 years, at which point the trust will terminate and the assets will be distributed to Linda's son, Mike. During 2009, the trust incurred $2,000 in appraisal fees and $5,000 in trustee fees. How will these fees be deducted?

    a. The trust will deduct $7,000.

    b. Linda will deduct $7,000.

    c. Mike will deduct $7,000.

    d. Linda will deduct $3,500 and the trust will deduct $3,500.

29. Match the following terms with the correct definitions.

1. Indirect expenses	i. Indirect expenses are allocated before gross income is reduced by direct expenses.
2. Net income method	ii. Tax-exempt interest, compensation for illness and injury, death benefits, and debt forgiveness income (Chapter 11 bankruptcy).
3. Gross income method	iii. Fiduciary accounting gross income is reduced by direct expenses first and then indirect expenses are allocated.
4. Tax-exempt income	iv. Deductions that cannot be directly attributed to a specific class of income.

    a. 1., i.; 2., iv.; 3., ii.; 4., iii.

    b. 1., iii.; 2., ii.; 3., iv.; 4., i.

    c. 1., iv.; 2., iii.; 3., i.; 4., ii.

    d. 1., ii.; 2., i.; 3., iii.; 4., iv.

30. What is the general rule for allocating indirect expenses?

    a. All indirect expenses must be allocated to nontaxable income and none of the indirect expenses can be allocated to taxable income.

    b. All indirect expenses must be allocated to taxable income and none of the indirect expenses can be allocated to nontaxable income.

    c. Indirect expenses can be allocated to any item of income included in DNI if a "reasonable portion" is allocated to nontaxable income.

    d. Indirect expenses can only be deducted in full if they are subject to the 2% of AGI floor and a "reasonable portion" is allocated to taxable income.

31. The Estate of Glenda Goode has the following activity in 2009:

Ordinary dividend income:	$10,000
Tax-exempt interest:	3,000
Rental income:	7,000
Trustee fees:	2,000

Calculate the deduction the estate can claim on page 1 of Form 1041 for the trustee fees.

a. $300.

b. $1,000.

c. $1,700.

d. $2,000.

32. Jane is the executrix of an estate. Jane uses the gross income method to allocate the estate's direct and indirect expenses. Under this method, $700 of estate administration expenses is allocated to tax-exempt income. How should Jane proceed?

a. She should deduct the $700 on Form 1041.

b. She should deduct the $700 on Form 706.

c. She should split the deduction between Form 1041 and Form 706.

d. None of the $700 can be deducted on either form.

33. The Meyers Trust does not include special provisions for capital gains in the trust instrument, but state law specifies that capital gains are allocated to principal. Calculate the correct allocation of trustee fees based on the following trust activity.

Ordinary dividend income:	$ 16,000
Tax-exempt interest:	20,000
Capital gains:	10,000
Trustee fees:	4,000

a. $1,778 allocated to ordinary dividend income; $2,222 allocated to tax-exempt interest.

b. $1,778 allocated to ordinary dividend income; $1,111 allocated to tax exempt interest; $1,111 allocated to capital gains.

c. $667 allocated to ordinary dividend income; $2,222 allocated to tax exempt interest; $1,111 allocated to capital gains.

d. All $4,000 should be allocated to ordinary dividend income.

34. Jake dies on February 12, 2009, and leaves his estate, including his personal residence, to his daughter, Lisa. Lisa is on a research trip in the rainforest and cannot be reached. She is scheduled to return in June of 2009. The estate incurs $5,000 of maintenance expenses on the residence. How should the estate deal with these expenses?

    a. They can be deducted on the Form 1041.

    b. The can be deducted on the Form 706.

    c. They can be deducted on both forms.

    d. They can be deducted on either Form 1041 or 706, but not on both.

Lesson 4: Net Operating Losses

Introduction

The net operating loss (NOL) deduction is available to estates and trusts much like it is to individuals when deductible business expenses and losses exceed gross income from that business plus taxable income earned from all other sources. As a practical matter, NOLs tend to be fairly uncommon for estates and trusts since they result only (1) when business activities are conducted within the fiduciary entity or through activities of flow-through entities (e.g., partnerships, LLCs, S Corporations) and/or (2) the estate or trust incurred casualty or theft losses. These losses may first be affected by at-risk limitations and the passive activity rules before they are eligible for NOL treatment. Estates and trusts are more likely to hold portfolio and passive activity investments rather than active engagement in an ongoing trade or business.

A trust or estate that has an NOL for regular income tax purposes might also have an NOL for alternative minimum tax (AMT) purposes, which may not be the same.

NOLs may generally be carried back two years and forward 20 years unless they were created in a taxable year prior to August 6, 1997. In that case, they may be carried back three years and carried forward 15 years. The estate or trust can elect to forgo the carryback of the NOL. Any unused NOLs pass through to the beneficiaries upon the termination of the estate or trust.

Learning Objectives:

Completion of this lesson will enable you to:

- Explain net operating losses (NOLs), recompute them in carryback and carryforward years, and summarize the related rules.
- Assess issues related to filing a refund claim for NOL carryback, electing to forgo NOL carryback, and unused NOLs that pass through to beneficiaries.

NOL Computations

General Rules

Because of the way NOLs are computed, it is important to recognize that negative taxable income does not necessarily result in an NOL. Thus, practitioners should always perform an NOL computation before advising a client about the existence of an NOL.

Casualty and theft losses incurred by the estate or trust are considered business deductions even if they involved nonbusiness property. Thus, all deductions for nonbusiness casualty and theft losses can be included when computing an NOL. However, the Section 199 domestic producer deduction is not allowed in computing an NOL and must be treated as a nonbusiness loss.

The following items are deductible for purposes of taxable income, but not for the NOL computation. They must be added back to the estate or trust's negative taxable income when computing the NOL generated in a tax year:

1. Personal exemption.

2. NOL carryover from another year.

3. Excess of nonbusiness capital losses over nonbusiness capital gains.

4. Section 1202 exclusion (i.e., the exclusion for 50% of the gain realized on the sale of qualified small business stock).

5. Excess of nonbusiness deductions over nonbusiness income.

   a. Nonbusiness income includes:

      (1) Investment income (e.g. dividends, interest).

      (2) Nonbusiness capital gains in excess of nonbusiness capital losses.

      (3) Annuities.

      (4) Oil and gas royalties.

   b. Nonbusiness deductions are not attributable to, or derived from, a trust's or estate's trade or business, such as administration fees not allocable to trade or business income.

6. Excess of business capital losses over the total of (a) business capital gains and (b) any nonbusiness capital gains remaining after deducting nonbusiness capital losses and other nonbusiness deductions in excess of nonbusiness ordinary income. In other words, the trust or estate cannot take a deduction for a net capital loss when computing the NOL. A net Section 1231 loss is treated as an ordinary loss, which is included in the NOL. However, Section 1231 gains may not offset the excess of nonbusiness capital losses over nonbusiness capital gains. For example, if an estate or trust had a net Section 1231 gain of $100,000 and a nonbusiness capital loss of $70,000, the $100,000 of Section 1231 gain would be added back to the NOL computation (thus, reducing the NOL), whereas the nonbusiness capital loss of $70,000 would be disregarded.

7. Charitable contribution deductions allowed by IRC Sec. 642(c).

8. Income distribution deductions allowed by IRC Secs. 651 and 661.

9. For trusts that are partially grantor trusts, that portion of income and deductions attributable to the grantor or another person under IRC Secs. 671 through 678 (relating to grantors and others treated as owners).

10. The Section 199 domestic production activities deduction.

An NOL cannot be generated by excess fiduciary's fees. This is because a fiduciary's administrative responsibilities to the estate or trust is not an active trade or business for purposes of IRC Sec. 172.

Example 4A-1 Computing the NOL for the current year.

The taxable income of the Estate of John Jones for 2009 is computed as follows:

Taxable interest income	$ 3,000
Business income	20,000
Business expenses (including administration expenses allocable to business income)	(25,000)
Administration expenses and commissions not allocable to business income	(4,000)
Personal exemption	(600)
Taxable income (loss) of fiduciary	$ (6,600)

The estate's 2009 NOL is $5,000, as computed below.

1. Taxable income—Form 1041, page 1 (must be a negative number)		(6,600)
2. NOL carryover from 2006 (included in taxable income; enter as a positive number)		—
3. Personal exemption—Form 1041, page 1		600
4. Excess nonbusiness capital gains	—	
5. Excess nonbusiness capital losses	—	

6.	Nonbusiness income (other than capital gains)	3,000	
7.	Nonbusiness deductions	4,000	
8.	Line 4 + line 6	3,000	
9.	Line 7 − line 8 (if negative, enter zero)		1,000
10.	Line 8 − line 7 but not more than line 4 (if negative, enter zero)	—	
11.	Business capital gains without regard to any Section 1202 exclusion	—	
12.	Business capital losses (enter as a positive number)	—	
13.	Line 10 + line 11	—	
14.	Line 12 − line 13 (if negative, enter zero)	—	
15.	Line 5 + line 14	—	
16.	Net capital loss, if any, before limitation (entered as a positive number)	—	
17.	Net capital loss allowed, after limitation (entered as a positive number)	—	
18.	Line 16 − line 17	—	
19.	Line 15 − line 17		—
20.	Charitable contribution deduction allowed under IRC Sec. 642(c)		—
21.	Distribution deduction—Form 1041, page 1		—
22.	**NOL Incurred in 2009 (lines 1 + 2 + 3 + 9 + 19 + 20 + 21)** (If positive, no NOL was generated in 2009.)		(5,000)

For alternative minimum tax (AMT) purposes, the regular tax NOL is modified by adding or subtracting the AMT adjustments and preference items, resulting in the AMT NOL.

Carryback and Carryforward Rules

Carryback Period

An NOL is generally carried back to the second tax year preceding the loss year. However, there are exceptions to the standard two-year carryback period that allow a three-year carryback (eligible losses) or a five-year carryback. If the loss is not completely used in that year, the unused amount is carried to the tax year immediately preceding the loss year.

There are various exceptions to the standard two-year carryback period—those allowing a three-year carryback and those allowing a five-year carryback. Certain NOLs are subject to specific carryback period rules (e.g., product liability loss may be carried back 10 years). Some NOLs cannot be carried back [e.g., real estate investment trust (REIT) NOLs cannot be carried back to any year in which the trust qualifies as a REIT]. Generally, the NOL must be carried back before it can be carried forward.

<u>Three-year Carryback for Eligible Losses.</u> A three-year carryback period applies to the portion of an NOL attributable to eligible losses, which includes (1) losses arising from fire, storm, shipwreck, other casualty, or theft and (2) losses incurred in presidentially declared disaster areas by taxpayers (a) engaged in the trade or business of farming and not eligible for the five-year carryback, or (b) engaged in any trade or business whose average annual gross receipts for the three-tax-year period ending with the prior tax year is $5 million or less. The IRS periodically publishes a list of presidentially declared disaster areas. Also, see the Federal Emergency Management Agency's website at **www.fema.gov**. Eligible losses are treated as separate NOLs taken into account and carried back after the remaining portion of the NOL.

<u>Five-year Carryback for Farming Losses.</u> The carryback period of an NOL or a portion thereof attributable to a farming loss is five years. A farming loss is the amount of the NOL attributed to income and deductions from farming businesses, as defined in IRC Sec. 263A(e)(4). An irrevocable election can be made under IRC Sec. 172(i)(3) to forgo the five-year carryback period, in which case the two-year carryback period applies or, if the loss is attributed to a presidentially-declared disaster (as previously defined), a three-year carryback period applies. The election must be made by the due date (including extensions) of the return generating the farming loss. There is no guidance on how to make the election. Presumably, it is made by attaching a statement to the return stating that the taxpayer elects to forgo the five-year carryback period and be subject to the two-year (or three-year) period. An

NOL attributable to a farming loss is treated as a separate NOL and is taken into account after the remaining portion of the NOL for the taxable year.

Five-year Carryback for Qualified Disaster Losses. A five-year carryback is available for *qualified disaster losses*, which are defined as the lesser of:

1. The sum of (a) the casualty losses attributable to a federally declared disaster occurring and (b) the deduction for qualified disaster expenses (or what would be allowable if not otherwise treated as an expense), or

2. The NOL for the year.

The five-year carryback for qualified disaster losses applies to losses attributable to disasters occurring after December 31, 2007 and before January 1, 2010. If the taxpayer elects not to apply the five-year carryback, the loss is carried back two years.

Three, Four, or Five Year Carryback for 2008 NOLs. The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) created a special carryback period for 2008 NOLs for eligible small businesses (ESBs) , exclusive of the previously discussed special carryback periods for certain casualties, disasters, or farmers. ESBs could elect a carryback period (increased carryback) of three, four, or five years instead of the general two-year carryback. For calendar year taxpayers (e.g., trusts), the election was only available for 2008 NOLs. However, fiscal year taxpayers (e.g., estates) whose year ends in 2008 can elect the extended carryback for its fiscal year ending in 2008 or its fiscal year beginning in 2008 and ending in 2009, but not both.

Summary of Applicable Carryback Periods. Determining the applicable NOL carrybacks is complicated by the fact that an estate's or trust's NOL may actually consist of two (or more) different types of NOLs, depending on items causing the NOL. For 2008 NOLs, the carryback periods for the different types of NOLs consist of the following:

	Carryback Period (Years)		
NOL Attributed to:	**2**	**3**	**5**
Regular (nonfarm) loss	X		
Nonfarm casualty loss (eligible loss)		X	
Small business disaster loss (eligible loss)		X	
Farm disaster loss (eligible loss)		X	X[a]
Farming loss	X		X[a]
GO Zone loss	X		X[b]

Notes:

[a] The five-year carryback period applies first. A taxpayer that elects to forgo the five-year carryback period becomes eligible for the three-/two-year carryback period. To only carry the NOL forward, a taxpayer must elect to forgo both the five and three-/two-year carryback periods.

[b] The five-year qualified disaster loss is considered separate and apart from all other NOLs and is applied after the remainder of the NOL for that year is applied. If the taxpayer elects to forego the five-year carryback period, then the regular two-year period only applies (it is not eligible for the special three-year eligible loss carryback period).

Effect of NOL Carryback on Beneficiaries

NOL carrybacks may have the effect of reducing distributable net income (DNI) previously reported by income beneficiaries. Income beneficiaries who have included DNI in gross income based on the original computation of DNI before the NOL carryback may be entitled to a refund since the amount included in their gross income is limited to the estate's or trust's DNI *after* application of the NOL carryback. The income beneficiaries must file their amended return within three years of the due date of the return (including extensions) of the taxable year of the NOL (i.e., the 2007 refund claim resulting from the 2009 NOL carried back to 2007 must be filed by April 15, 2013—or later if the 2009 return was extended).

Example 4B-1 Benefit of NOL carryback to income beneficiaries.

In 2007, its first year of existence, the Adie Johnson Trust has DNI of $50,000, which it distributed to Ethel, its sole beneficiary. In 2009, the trust sustains a $40,000 NOL, which is carried back to 2007. The carryback results in the DNI being reduced to $10,000. Ethel may file an amended return (Form 1040X) to claim a refund based on the difference between the tax on her originally reported taxable income, which included the $50,000 of DNI from the trust, and the tax on her revised taxable income, which includes only $10,000 of DNI.

Carryforward Period

Any remaining loss at the end of the carryback period is carried forward. The carryforward period extends up to 20 years (15 years for NOLs from pre-1998 tax years). Any NOL that is carried forward is included with other deductions not subject to the 2% AGI floor on future years' tax returns.

Any portion of the NOL not used by the end of the 20-year carryforward period expires. Any unused NOLs pass through to the beneficiaries upon termination of the estate or trust.

Recomputations of NOL

There are two instances when a fiduciary's prior year AGI-based income and deductions are recomputed when dealing with NOL carrybacks, as follows:

1. *Recomputing Tax for the Carryback Year.* When the NOL is deducted in the carryback year, tax for that year is refigured by claiming the NOL as a deduction in arriving at AGI. AGI-based items of income and deduction, as well as credits, are then recomputed based on this lower amount of AGI and tax.
2. *Determining the Amount of NOL Remaining after Carryback.* After the NOL is deducted in a carryback year, the amount remaining for use in other tax years is determined by computing modified taxable income for the carryback year (also called the intervening year). Modified taxable income for the intervening year is essentially the taxable income as reported for that year before the current NOL carryback, but increased by adding back certain items.

Thus, the adjustments to AGI-based items differ primarily because in the first instance, the NOL carryback deduction reduces AGI, while in the second instance, the NOL carryback deduction is not considered (although there are other adjustments made to AGI).

Recomputing Tax in the Carryback Year

When recomputing the tax liability for the tax year to which the NOL is carried back (i.e., the carryback year), tax items subject to percent-of-AGI or taxable income limitations are recomputed based on AGI (or taxable income) after the NOL deduction. Consequently, items that are deductible only to the extent that they exceed a certain percentage of AGI (e.g., miscellaneous itemized deductions) are increased for the recomputed items. However, this increase in deductions is beneficial only to the extent that the carryback year's taxable income is not reduced below zero. If the taxable income for the carryback year is reduced below zero, the benefit of these increased deductions is lost in the calculation of the NOL remaining to be carried forward, which is based on AGI (or taxable income) without the NOL deduction.

Determining NOL Remaining after Carryback

When an NOL carryback exceeds the taxable income of the year to which it is carried (i.e., carryback year), taxable income for that year must be modified to determine the NOL used in the carryback year and remaining for carryback to the next preceding and all subsequent years. At this point, the carryback year is often referred to as an "intervening year" since it is now a tax year that has absorbed part of the NOL carryback. These modifications do not affect the taxable income or tax liability of the intervening year. They are made solely to determine the amount of the NOL carryback absorbed in that year.

The following adjustments must be made to determine the modified taxable income of the intervening year:

1. The NOL for the loss year or any tax year thereafter is not considered.

2. Capital losses cannot exceed capital gains (i.e., no net capital loss deduction is allowed).
3. Taxable income is computed without the charitable contribution deduction.
4. Taxable income is computed without the allowable income distribution deduction.
5. No deduction is allowed for a personal exemption.

In addition, AGI must be recomputed after adjustments 1, 2, 3, and 4 are made in order to redetermine any deduction subject to a percentage limitation. Items that may need to be recomputed include—

1. miscellaneous itemized deductions,
2. casualty losses, and
3. percentage depletion.

Example 4C-1 Computing modified taxable income for an intervening year.

The Estate of Barbara Brooke sustained a $50,000 NOL for 2009. The estate had taxable income in the previous two years and does not elect to forgo the carryback period. The estate's Form 1041 for 2007 reflects the following items of income and expense:

Business income	$ 25,000
Interest income	5,000
Capital loss	(1,000)
Executor fees	(2,000)
Adjusted gross income	27,000
Miscellaneous itemized deductions, net of 2% AGI floor	(460)[a]
Personal exemption	(600)
Taxable income	$ 25,940

Note:

[a] Deductible miscellaneous itemized deductions are computed as follows: $1,000 – (.02 × $27,000).

Since the estate's NOL carryback to 2007 exceeds the taxable income for that year, the 2007 taxable income must be modified to determine the amount of the NOL remaining for carryback to 2008. The amount deemed used is the amount of "modified taxable income."

Business income	$ 25,000
Interest income	5,000
Capital loss (none allowed)	—
Executor fees	(2,000)
Modified adjusted gross income	28,000
Miscellaneous itemized deductions, net of 2% AGI floor	(440)[a]
Personal exemption (none allowed)	—
Modified taxable income	$ 27,560

Note:

[a] Deductible miscellaneous itemized deductions are recomputed as follows: $1,000 – (.02 × $28,000).

The amount of NOL remaining to offset taxable income in 2008 is determined as follows:

NOL for 2009	$ 50,000
Amount absorbed in carryback to 2007	(27,560)
Amount available for carryback to 2008	$ 22,440

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following is true about the relationship of net operating losses (NOLs) to estates and trusts?

    a. It is very common for an estate or trust to have NOLs.

    b. Estate or trust NOLs arise from at-risk and passive activities.

    c. An estate or trust with a NOL for regular tax purposes could have one under AMT.

    d. NOLs are generally carried back 20 years and carried forward two years.

36. Compute an estate's current year's NOL based on the following information.

Taxable interest income:	$	6,000
Business income:		40,000
Business expenses (including administration expenses allocable to business income:		(50,000)
Administration expenses and commissions not allocable to business income:		(8,000)
Personal exemption:		(600)

    a. $5,000.

    b. $10,000.

    c. $10,600.

    d. $12,600.

37. The Kale Trust incurs a NOL in 2009 and carries it back the standard two years. At the end of the carryback period, a portion of the NOL remains unallocated. Is there any way the trust can use the remainder of the NOL?

    a. Any NOL remaining after the carryback period expires.

    b. The trust can carry the NOL forward a maximum of 20 years.

    c. Unused NOL can only be passed through to trust beneficiaries.

    d. Unused NOL is only carried forward if no other deductions exist.

38. A portion of which type of NOL is eligible for three-year carryback?

    a. Shipwreck losses.

    b. Farming losses.

    c. Real estate investment trust (REIT) losses.

39. In 2007, the Anthony Trust distributes $75,000 of distributable net income (DNI) to Carla, the sole beneficiary. In 2009, the trust incurs a $50,000 NOL and uses the standard two-year carryback. What is the effect of the carryback?

a. The trust can apply for a tax refund and distribute the refund to Carla.

b. Carla can apply for a refund of $50,000.

c. Carla can apply for a refund based on the reduced amount of her 2006 taxable income.

d. Neither Carla nor the estate is eligible for a refund under these circumstances.

40. A NOL is carried back to 2008 and taxable income for 2008 is exceeded. When calculating the modified taxable income for 2007, which of the following adjustments must be made?

a. The net capital loss deduction must be factored into taxable income.

b. The personal exemption amount must be deducted from taxable income.

c. Miscellaneous itemized deductions may need to be recomputed.

d. The NOL for 2009 must be considered in the calculation.

41. The Silvertree Estate sustains a $85,000 NOL in 2009, and decides to carry the NOL back the allowable two years because it had taxable income in both 2007 and 2008. The estate's Form 1041 for 2007 reflects the following:

Business income:	$	60,000
Interest income:		18,000
Capital loss:		7,000
Executor fees:		4,000
Miscellaneous itemized deductions subject to the 2% AGI floor:		3,500
Personal exemption:		600

Based on these amounts, calculate the amount of the NOL remaining in 2008.

a. $13,020.

b. $21,460.

c. $64,240.

d. $71,980.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following is true about the relationship of net operating losses (NOLs) to estates and trusts? **(Page 91)**

    a. It is very common for an estate or trust to have NOLs. [This answer is incorrect. NOLs are fairly uncommon for trusts and estates, because NOLs are the result of activities that are less likely to occur for estates and trusts.]

    b. Estate or trust NOLs arise from at-risk and passive activities. [This answer is incorrect. For estates and trusts, NOLs arise from business activities that are (1) conducted through the activities of flow-through entities (e.g., LLCs) or within the fiduciary entity and/or (2) casualty and theft losses incurred by the estate or trust. Losses could be affected by at-risk limitations and passive activity rules before they become eligible for NOL treatment.]

    c. An estate or trust with a NOL for regular tax purposes could have one under AMT. [This answer is correct. The NOL under AMT might also not be the same as the NOL under the regular tax system.]

    d. NOLs are generally carried back 20 years and carried forward two years. [This answer is incorrect. The opposite is, in fact, true—NOLs generally are carried back two years and forward 20 years, unless created in a taxable year prior to August 6, 1997.]

36. Compute an estate's current year's NOL based on the following information. **(Page 91)**

Taxable interest income:	$	6,000
Business income:		40,000
Business expenses (including administration expenses allocable to business income:		(50,000)
Administration expenses and commissions not allocable to business income:		(8,000)
Personal exemption:		(600)

    a. $5,000. [This answer is incorrect. In this NOL calculation, the nonbusiness deductions were not subtracted from the total of the nonbusiness income and the nonbusiness capital gains.]

    b. $10,000. [This answer is correct. To calculate the NOL, the personal exemption and the positive difference between nonbusiness deductions and nonbusiness gain (both capital gain and income) were added back into the taxable income (or the taxable loss, in this scenario). The resulting calculation was (12,600) + 600 + 2,000 = (10,000), so the NOL is $10,000.]

    c. $10,600. [This answer is incorrect. In this NOL calculation, the personal exemption was not added back to the estate's negative taxable income.]

    d. $12,600. [This answer is incorrect. Based on the above information, the estate's taxable income for the current year is a negative $12,600 (i.e., the estate had a taxable loss in the current year). Further computations are needed to determine the estate's NOL.]

37. The Kale Trust incurs a NOL in 2009 and carries it back the standard two years. At the end of the carryback period, a portion of the NOL remains unallocated. Is there any way the trust can use the remainder of the NOL? **(Page 91)**

   a. Any NOL remaining after the carryback period expires. [This answer is incorrect. Remaining NOL that has not been used can be carried forward.]

   b. The trust can carry the NOL forward a maximum of 20 years. [This answer is correct. The NOL carryforward period extends for 20 years, except for NOLs from pre-1998 returns which can only be carried forward a maximum of 15 years.]

   c. Unused NOL can only be passed through to trust beneficiaries. [This answer is incorrect. When the trust terminates, any unused NOL is passed through to the beneficiaries, but when the trust is still operating, the NOLs will not be passed through.]

   d. Unused NOL is only carried forward if no other deductions exist. [This answer is incorrect. Existing deductions do not eliminate the ability to carry unused NOL forward. If NOL is carried forward, it is included on future tax returns with other deductions that are not subject to the 2% AGI floor.]

38. A portion of which type of NOL is eligible for three-year carryback? **(Page 93)**

   a. Shipwreck losses. [This answer is correct. Losses that arise from shipwreck, storm, fire, other casualties, or theft, as well as losses incurred in presidentially declared disaster areas under certain circumstances, are eligible for three-year carryback.]

   b. Farming losses. [This answer is incorrect. A NOL or a portion of a NOL related to farming loss can by carried back five years, not three.]

   c. Real estate investment trust (REIT) losses. [This answer is incorrect. REIT NOLs may not be carried back to any year in which a trust is qualified as a REIT.]

39. In 2007, the Anthony Trust distributes $75,000 of distributable net income (DNI) to Carla, the sole beneficiary. In 2009, the trust incurs a $50,000 NOL and uses the standard two-year carryback. What is the effect of the carryback? **(Page 93)**

   a. The trust can apply for a tax refund and distribute the refund to Carla. [This answer is incorrect. Under these circumstances, the trust would not be eligible to apply for any refund.]

   b. Carla can apply for a refund of $50,000. [This answer is incorrect. Any allowable refund in this situation would not be the whole NOL amount.]

   c. Carla can apply for a refund based on the reduced amount of her 2007 taxable income. [This answer is correct. Carla would apply for the refund as the DNI was distributed to her from the trust in 2006. The amount of the refund Carla could receive is the difference between the tax she paid on her original amount of 2007 taxable income and the revised taxable income once the NOL is taken into account.]

   d. Neither Carla nor the estate is eligible for a refund under these circumstances. [This answer is incorrect. Due to the carryback, a tax refund is a possibility. In addition, Carla is within the three-year time limit for filing an amended return to claim a refund.]

40. A NOL is carried back to 2008 and taxable income for 2008 is exceeded. When calculating the modified taxable income for 2007, which of the following adjustments must be made? **(Page 95)**

   a. The net capital loss deduction must be factored into taxable income. [This answer is incorrect. When calculating the NOL carryback, capital losses are not allowed to exceed capital gains.]

b. The personal exemption amount must be deducted from taxable income. [This answer is incorrect. The personal exemption deduction is not allowed in this calculation. Deductions for charitable contributions or allowable income distributions are also not allowed.]

c. Miscellaneous itemized deductions may need to be recomputed. [This answer is correct. AGI is recomputed after all necessary adjustments are made to the modified taxable income. Items that may need to be recomputed include casualty losses, percentage depletion, and miscellaneous itemized deductions.]

d. The NOL for 2009 must be considered in the calculation. [This answer is incorrect. NOL for the loss year, as well as the NOL for any tax year thereafter, will not be considered in this calculation.]

41. The Silvertree Estate sustains a $85,000 NOL in 2009, and decides to carry the NOL back the allowable two years because it had taxable income in both 2007 and 2008. The estate's Form 1041 for 2007 reflects the following:

Business income:	$	60,000
Interest income:		18,000
Capital loss:		7,000
Executor fees:		4,000
Miscellaneous itemized deductions subject to the 2% AGI floor:		3,500
Personal exemption:		600

Based on these amounts, calculate the amount of the NOL remaining in 2008. **(Page 95)**

a. $13,020. [This answer is correct. Based on the amounts above, the estate had $64,240 of taxable income in 2007. Since the NOL exceeds that amount, the estate's modified taxable income (without capital loss or the personal exemption) must be calculated. The modified adjusted gross income is $71,980. To complete the NOL calculation, the 2007 modified taxable income is subtracted from the NOL amount of $85,000, which leaves $13,020 of the NOL available to offset taxable income in 2008.]

b. $20,760. [This answer is incorrect. In this calculation, the 2007 taxable income was subtracted from the NOL amount. However, the taxable income must be adjusted before it is subtracted from the NOL.]

c. $64,240. [This answer is incorrect. This is the 2007 taxable income amount based on the amounts above, not the 2008 NOL amount.]

d. $71,980. [This answer is incorrect. This is the 2007 modified adjusted gross income, not the 2008 NOL amount.]

NOL Carryback Refund Claims

Administrative Consequences of Filing Form 1045

The estate or trust may file a claim for refund arising from the carryback of an NOL by using either Form 1045 (Application for Tentative Refund) or an amended Form 1041. The main advantage in using Form 1045 instead of an amended 1041 for the carryback is that the IRS must act on a Form 1045 within 90 days from the later of (1) the date it is filed or (2) the last day of the month in which the due date falls (including any extensions) for filing the return for the year in which the NOL was generated. For practical purposes, another advantage of using Form 1045 is the use of the schedule on the form that facilitates the NOL calculation.

In the 90-day period, the IRS may only check the computations and look for omissions; it cannot look for new issues to raise with the taxpayer when reviewing a Form 1045. Later, however, the IRS can audit the return (i.e., Form 1041) for the year of the loss. If it determines that the quick refund it previously allowed was unwarranted or excessive, it has several options. It can treat the excess refund as a mathematical error and immediately assess and collect the applicable tax under the authority of IRC Sec. 6213(b)(3), it can issue a Notice of Deficiency under IRC Sec. 6501(h), or it can file suit against the taxpayer to collect the erroneous refund under IRC Sec. 7405(b).

A disadvantage in using Form 1045 is that, unlike an amended Form 1041, it must be filed within one year after the end of the year in which the NOL arose. For example, if the NOL was generated in 2008 by a calendar-year fiduciary, Form 1045 must be filed by December 31, 2009. If Form 1045 is filed after that date, it will be returned by the IRS. In that instance, the practitioner should file an amended Form 1041 to carry back the NOL.

Under a special rule, the statute of limitations for filing a refund claim for an NOL carryback is three years from the date prescribed for filing the return (including extensions) for the tax year the NOL is generated. This rule is in place of the general statute of limitations for filing refund claims. If no return was filed, the claim for refund must be filed within two years from the time the tax was paid.

Example 4D-1 Computing refund for NOL carryback.

Assume the same facts as in Example 4C-1. Furthermore, in 2008 the Estate of Barbara Brooke's AGI was \$32,500 before deducting miscellaneous deductions of \$1,400. The AGI reported on page 1 of the estate's 2008 Form 1041 was \$31,750 after the miscellaneous deductions were reduced by \$650 (\$32,500 × 2%). A capital loss of \$2,500 was included in the estate's 2008 AGI. By carrying the 2009 NOL back to 2007 and 2008, the estate may claim a refund of \$8,123 for 2007 and \$7,962 for 2008. After the carryback, the 2009 NOL is fully absorbed, as reflected on Schedule B of Form 1045.

The quick refund procedure results in a "tentative refund" because Form 1045 is not considered a claim for credit or refund. This means the taxpayer cannot file a suit in court if the IRS disallows the quick refund request. Instead, the taxpayer must file a "regular" claim for refund using an amended Form 1041. If the IRS then fails to act on the claim for refund within six months or disallows it, the taxpayer can file suit for refund.

General Filing Requirements

Form 1045 or an amended Form 1041 is filed with the IRS Service Center where the trust or estate's income tax return for the year of the loss was filed. The form should be filed after the tax return is filed (and thus is filed separately from the return). The IRS must process the Form 1041generating the NOL before processing the claim for refund. The following items should be attached:

1. Page 1 of Form 1041 and Schedule D (1041) (if applicable) for the year of loss;
2. Schedules K-1 received from any partnership, S corporation, another estate or trust that contributed to the loss carryback;
3. A copy of any application(s) for extension to file the income tax return for the loss year; and

4. Any form or schedule showing losses that resulted in or contributed to the carryback (e.g., Schedules C, E, and F).

5. Copies of forms or schedules for items recomputed in the carryback years.

An Election to Forgo NOL Carryback

General Rules of the Election

For NOLs arising in 2009, the general carryback period is two years, although carryback periods of three and five years apply to losses attributable to certain eligible losses and farm losses. Depending on the causes of the NOL, it is possible that more than one carryback period applies. The fiduciary of an estate or trust can elect to forgo the NOL carryback period or periods if more than one apply.

An estate or trust entitled to either the two-year (regular NOLs) or three-year (NOLs attributable to eligible losses) carryback period can elect under IRC Sec. 172(b)(3) to waive the carryback period and only carry the loss forward. The five-year carryback period for NOLs attributable to farming losses can be waived as well. However, waiving the five-year carryback period for farming losses results in the two-year or three-year carryback periods applying. Thus, a taxpayer wanting to only carry a farm loss NOL forward must also elect to waive both the five-year and applicable two-year or three-year NOL periods. Because qualified disaster losses are not eligible for the three-year NOL carryback period, waiving the five-year carryback period will not result in a three-year carryback.

To make a valid election, the fiduciary must attach a separate election statement to the return for the year of the NOL. The election must be made by the due date (including extensions) for filing the return for the loss year. It may be made on an amended return filed by this deadline.

Once the election is made, it is generally irrevocable. However, the permanent regulations relating to this election (which have not yet been issued) will provide for revocation with the Commissioner's consent. No applications for consent to revoke will be accepted until the permanent regulations are issued.

When Should the Election Be Made?

The election should be considered if:

1. Carryback of the NOL will offset all of the income in the year to which it is carried and free up tax credits that may be lost in part if carried forward.

2. The tax rates are expected to be higher in the carryover years than in the carryback years.

3. Carryback of the NOL will cause loss of tax benefits such as personal exemptions and miscellaneous itemized deductions.

4. Intervening years' adjustments, such as loss of the charitable contributions deduction, reduce benefits of the NOL carryback.

5. Carryback of the NOL reduces income previously reported to a beneficiary who has deductions and losses from other sources to offset the reported income (e.g., distributed passive income is offset by passive losses of the beneficiary).

6. Carryback of the NOL generates alternative minimum tax (AMT) in the year(s) to which it is carried. However, a portion of the AMT paid may generate a minimum tax credit that may be used to offset regular tax in subsequent years.

7. The NOL is small, and it is not practical or cost-effective to carry it back.

Dealing With Unused NOLs When an Estate or Trust Is Terminated

Any unused NOL carryovers existing upon termination of an estate or trust are passed through to the beneficiaries succeeding to the property of the trust or estate. The beneficiaries may then carry forward, but not back, the pass-through NOL from the estate or trust.

Beneficiaries succeeding to the property of an intestate estate (one without a will) are the heirs and next of kin to whom the estate is distributed. For a testate estate (one with a will), they are normally the residuary beneficiaries (including a residuary trust). Beneficiaries succeeding to the property of a trust include any remainder beneficiaries who receive all or a fractional share of the property of the trust.

Any item of income or deduction used in determining the NOL of the estate or trust for its termination year cannot also be taken into account in determining the excess deductions on termination of the trust or estate (which also pass through in the final year).

When determining the number of years to which an NOL may be carried forward by a beneficiary, the last tax year of the estate or trust (whether or not a short tax year) and the first tax year of the beneficiary to which the NOL is carried over each is considered a separate tax year. If the final tax year of the estate or trust is the last tax year to which an NOL can be carried over, the NOL is an excess deduction on termination.

Example 4F-1 Pass-through of NOL in year of termination.

The Estate of Henry Mathews terminates at the end of 2009. John Mathews is the sole beneficiary of the estate. The estate has the following taxable income for 2009:

Dividend income	$ 3,500
Business income	4,000
Business expenses (including administration expenses allocable to business income)	(6,000)
Administration expenses not allocable to business income	(10,800)
Personal exemption	(600)
Taxable income	$ (9,900)

The amount of the estate's NOL for year of termination is computed as follows:

Taxable income		$ (9,900)
Personal exemption		600
Nonbusiness deductions	10,800	
Nonbusiness income	(3,500)	
Excess of nonbusiness deductions over nonbusiness income		7,300
NOL for 2009		$ (2,000)

If the estate elects to forgo the NOL carryback, the $2,000 NOL is available to John to use on his personal income tax return for 2009. Any excess NOL may be carried forward by John for up to 19 additional years in accordance with IRC Sec. 172. John may not carry the NOL back to any tax year.

The $7,300 excess of nonbusiness deductions over nonbusiness income will pass through to John as excess deductions in the year of termination, since that amount was not taken into account in determining the NOL of the estate.

Any unused NOL, as recomputed for alternative minimum tax purposes (AMT NOL), will also pass through to beneficiaries succeeding to the property of the trust or estate. This amount is reported to the beneficiary as a separate item on Schedule K-1.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

42. The Haven Trust sustains an NOL and carries it back. The trust submits its claim for refund by filing an amended Form 1041. What is an advantage of filing an amended Form 1041 instead of using the Form 1045?

    a. The taxpayer has more time to submit the amended Form 1041.

    b. A schedule is available to facilitate calculation of the NOL.

    c. An amended Form 1041 allows the IRS to cut down processing time.

    d. The IRS must act on the Form 1041 in a 90-day period.

43. For a NOL that arises in 2009, what happens if a trust elects to forgo carryback and carries the NOL forward instead?

    a. The election can be revoked with the Commissioner's consent.

    b. The election can be made by the return due date in the carryforward year.

    c. The trust must be terminated and the NOL passed to the beneficiaries.

    d. The trust must attach a separate election statement to the tax return.

44. The Ginger Family Trust has a NOL that is eligible for carryback to the previous year. However, if the estate carries the NOL back, income previously reported to Joe, a beneficiary, will be reduced. Joe had deductions and losses from other sources that offset the reported income from the trust. Should the election to forgo NOL carryback be considered in this scenario?

    a. Yes, the election should be considered in this scenario.

    b. No, the election is not allowed in this situation.

    c. Only if AMT would be generated.

    d. Only if Joe has a large personal exemption.

45. The Estate of Landon Willis terminates at the end of 2009, and its sole beneficiary is Landon's daughter, Alma. The estate's 2009 taxable income is as follows:

Dividend income:	$	6,000
Business income:		7,000
Business expenses (including administration expenses that are allocable to business income):		8,000
Administration expenses that are not allocable to business income:		9,000
Personal exemption:		600

The estate elects to forgo NOL carryback in 2008, so how much NOL will be carried forward to Alma for use on her personal income tax return in 2009?

a. $1,000.

b. $1,600.

c. $3,000.

d. $4,600.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

42. The Haven Trust sustains an NOL and carries it back. The trust submits its claim for refund by filing an amended Form 1041. What is an advantage of filing an amended Form 1041 instead of using the Form 1045? **(Page 102**)

    a. The taxpayer has more time to submit the amended Form 1041. [This answer is correct. A disadvantage of using the Form 1045 is the timing of the filing. Form 1045 must be filed one year after the end of the year in which the NOL was sustained. Taxpayers who file an amended Form 1041 have more time to file.]

    b. A schedule is available to facilitate calculation of the NOL. [This answer is incorrect. This is a practical advantage of filing the Form 1045. The lack of availability of a schedule could be a disadvantage of filing an amended Form 1041 instead.]

    c. An amended Form 1041 allows the IRS to cut down processing time. [This answer is incorrect. No matter how the taxpayer files for an NOL carryback refund, the IRS must process the tax return (original Form 1041) first; therefore, for processing time, it does not matter if the taxpayer files a Form 1045 or an amended Form 1041.]

    d. The IRS must act on the Form 1041 in a 90-day period. [This answer is incorrect. The limited amount of time the IRS has to act is the main advantage to filing a Form 1045 instead of an amended Form 1041. When a Form 1045 is filed, the IRS must act within 90 days of the later of (1) the last day of the month of the due date for filing the return in the year the NOL was generated or (2) the date the Form 1045 is filed.]

43. For a NOL that arises in 2009, what happens if a trust elects to forgo carryback and carries the NOL forward instead? **(Page 103)**

    a. The election can be revoked with the Commissioner's consent. [This answer is incorrect. Generally, this election will be irrevocable. However, future regulations are expected that will allow the election to be revoked under these circumstances. No applications for consent to revoke will be accepted until such permanent regulations are issued.]

    b. The election can be made by the return due date in the carryforward year. [This answer is incorrect. The election must be made by the tax return due date, including extensions, during the year that the NOL is incurred.]

    c. The trust must be terminated and the NOL passed to the beneficiaries. [This answer is incorrect. Forgoing carryback is an allowable election and, as such, would not cause a trust to terminate. However, if a trust does terminate, the NOL carryovers will pass through to the beneficiaries. Once that pass through has taken place, the beneficiaries can carry the NOLs forward, but not backwards.]

    d. The trust must attach a separate election statement to the tax return. [This answer is correct. The election statement must be attached to the return filed in the year of the NOL per IRS regulations.]

44. The Ginger Family Trust has a NOL that is eligible for carryback to the previous year. However, if the estate carries the NOL back, income previously reported to Joe, a beneficiary, will be reduced. Joe had deductions and losses from other sources that offset the reported income from the trust. Should the election to forgo NOL carryback be considered in this scenario? **(Page 103)**

    a. Yes, the election should be considered in this scenario. [This answer is correct. This scenario is one of the seven instances that the election to forgo NOL carryback should be considered. Because Joe's passive income was offset by passive losses, it might not be the best choice for the estate to carry the NOL back.]

b. No, the election is not allowed in this situation. [This answer is incorrect. The election to forgo NOL carryback would be allowed in this scenario.]

c. Only if AMT would be generated. [This answer is incorrect. AMT does not affect the scenario described above. However, if carrying an NOL back would generate AMT in the carryback year, it might be wise to consider electing to forgo NOL carryback.]

d. Only if Joe has a large personal exemption. [This answer is incorrect. Joe's personal exemption would not affect this particular scenario. However, if carrying back an NOL would cause loss of tax benefits (e.g., miscellaneous itemized deductions or personal exemptions), it might be wise to consider the election to forgo carryback.]

45. The Estate of Landon Willis terminates at the end of 2009, and its sole beneficiary is Landon's daughter, Alma. The estate's 2009 taxable income is as follows:

Dividend income:	$	6,000
Business income:		7,000
Business expenses (including administration expenses that are allocable to business income):		8,000
Administration expenses that are not allocable to business income:		9,000
Personal exemption:		600

The estate elects to forgo NOL carryback in 2008, so how much NOL will be carried forward to Alma for use on her personal income tax return in 2009? **(Page 103)**

a. $1,000. [This answer is correct. Based on the amounts above, the estate had of a taxable loss of $4,600 in 2009. When the $600 personal exemption and the $3,000 difference between nonbusiness deductions and nonbusiness income were added back to the total, the NOL amount is $1,000.]

b. $1,600. [This answer is incorrect. To arrive at this total, the personal exemption was not added back to the taxable loss.]

c. $3,000. [This answer is incorrect. This is the amount of nonbusiness deductions ($9,000) minus the nonbusiness income ($6,000).]

d. $4,600. [This answer is incorrect. This is the amount of total taxable loss the estate had in 2009.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (T41TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

35. The Bordeaux Estate includes a net operating loss (NOL) that was created on July 7, 1997. How many years can this NOL be carried forward.

    a. 2.

    b. 3.

    c. 15.

    d. 20.

36. List all of the following taxable income deductions that must be added back to the estate during the NOL computation.

i. Personal exemption	v. NOL carryover from another year
ii. Section 1202 exclusion	vi. Excess of nonbusiness capital losses over nonbusiness capital gains
iii. All nonbusiness deductions	vii. Section 642(c) charitable contribution deductions
iv. Section 199 domestic production activities deduction	viii. All business capital gains

    a. i., ii., v., and vi.

    b. iii., iv., v., vi., and viii.

    c. i., ii., iv., v., vi., and vii.

    d. i., ii., iii., iv., v., vi., vii., and viii.

37. The following amounts represent the taxable income for the Estate of Fredrick Meyers in 2009:

Taxable interest income:	$ 5,000
Business income:	75,000
Business expenses (including administration expenses allocable to business income:	(100,000)
Administration expenses and commissions not allocable to business income:	(9,000)
Personal exemption:	(600)

Compute the estate's 2009 NOL.

a. $25,000.

b. $25,600.

c. $29,600.

d. $70,400.

38. Jason owned and operated a farm before his death. The estate continues to operate the farm. During 2009, the estate has a farming NOL of $8,000. If the estate uses the maximum amount of carryback, how far back can the NOL be carried?

a. 2007.

b. 2006.

c. 2004.

d. No carryback is available in this situation.

39. The Murdock Estate is eligible for three-year carryback on a NOL. It would be more beneficial to the estate to carry an NOL forward than to carry it back. Is this possible, and, if so, what is the next step?

a. The estate must take all eligible carryback before the NOL can be carried forward.

b. The estate may carry a portion of the NOL back and carry the remainder of the NOL forward.

c. The estate can elect to forgo the five- and three-/two-year carryback and carry the NOL forward instead.

d. The estate can elect to forgo five-year carryback, but two-year carryback must be used before a NOL is carried forward.

40. Under what circumstances would a fiduciary's AGI-based income from a prior year be recomputed when dealing with NOL?

a. When determining tax in an NOL carryforward year.

b. When a NOL expires before use in an intervening year.

c. When NOL is passed through to the fiduciary's beneficiaries.

d. When determining the amount of NOL after carryback.

41. The Harmon Estate sustains a $47,000 NOL in 2009, and carries the NOL back two years, as allowed. The estate had taxable income in both 2007 and 2008. The estate's Form 1041 for 2007 reflects the following:

Business income:	$	32,000
Interest income:		7,000
Capital loss:		5,000
Executor fees:		2,500
Miscellaneous itemized deductions subject to the 2% AGI floor:		1,500
Personal exemption:		600

Based on these amounts, calculate the amount of the NOL remaining in 2008.

a. $2,100.

b. $11,270.

c. $16,970.

d. $35,730.

42. The Brecken-Smythe Estate has an NOL carryback and files for a refund using the Form 1045. What is an advantage of using Form 1045 instead of claiming the refund with an amended Form 1041?

    a. The taxpayer can file suit in court if the IRS disallows the refund.

    b. The taxpayer has more time to file the Form 1045 than it does the Form 1041.

    c. The IRS must act on the Form 1045 more quickly than on the amended Form 1041.

    d. The IRS is not allowed to audit refund claims on a Form 1045.

43. In which scenario should the taxpayer elect to forgo NOL carryback in favor of carrying the NOL forward to a future tax year?

    a. NOL carryback will cause the loss of the taxpayer's personal exemption.

    b. It is expected that tax rates will be higher in the carryback years.

    c. The NOL is less than the taxypayer's income in the carryback year.

    d. The NOL is large and carrying it back is not cost-effective.

44. The Estate of Edward St. John terminates in 2009 with the following taxable income for its final year:

Dividend income:	$	2,000
Business income:		5,000
Business expenses (including administration expenses that are allocable to business income):		6,000
Administration expenses that are not allocable to business income:		4,000
Personal exemption:		600

The estate forgoes NOL carryback, and the NOL passes through to the sole beneficiary, Mitchell. In addition, the estate passes excess deductions to Mitchell that were not used in calculating the NOL. What is the total dollar amount of the NOL and the excess deductions flow through to Mitchell in 2009?

a. $1,000.

b. $2,000.

c. $3,000.

d. $3,600.

45. Assume the same details as in the question above. How can Mitchell use the NOL that is passed to him by the St. John Estate?

    a. He can carry the NOL back only.

    b. He can carry the NOL forward only.

    c. He can carry the NOL either forward or back.

    d. He can only use the NOL in the last tax year of the estate.

GLOSSARY

Adjusted gross income (AGI): Gross income minus allowed business deductions and other deductions allowed as adjustments to income "above the line," such as business expenses, capital loss deduction, and one-half of self-employment tax. AGI is used as a standard for limiting the amount recognized for certain itemized deductions, such as medical expenses, casualty losses, and charitable contributions, and for the child and dependent care credit, and the phaseout of other tax benefits, such as the child tax credit and personal exemptions.

Administration expenses: Executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, investment advisor fees, and other administration expenses reasonably and necessarily incurred for the collection, management, and preservation of the estate.

Beneficiary: The party for whose benefit a will, trust, insurance policy, or contract is created. The beneficiary may be an individual or an organization (e.g., charity, school, club, or business). The party may receive title to property by will or by equitable interest in a trust.

Capital gain/loss: Capital gain or loss is derived from the sale or exchange of capital assets. The transaction may result in short-term or long-term gain or loss. Short-term gain or loss results when an asset is held for one year or less. Long-term gain or loss results when an asset is held for more than one year.

Casualty loss: The damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event. Losses caused by fires, storms, and floods are deductible casualty losses.

Decedent: The deceased individual whose estate is being administered.

Deduction: An amount that may be subtracted to arrive at taxable income.

Deductions in respect of a decedent (DRD): Certain expenses for which the decedent was liable at the date of death. Only certain specified items can be DRD:

1. Business expenses.
2. Interest expense.
3. Taxes.
4. Investment expenses.
5. Depletion.

Estate: A taxable entity that comes into being upon the death of a taxpayer. It consists of all the decedent's property and personal effects. The estate exists until the final distribution of its assets to the heirs and other beneficiaries. During the period of administration, the executor must usually file a return.

Executor: A person named in the will and empowered by the court to administer the decedent's estate, to act for the estate, and to carry out the terms of the will. An executor is empowered to marshal the assets and pay the debts of the estate and distribute the remaining assets as specified in the will. An executor is empowered to sell assets to pay debts. It is a fiduciary relationship. An executor has certain powers, duties, and liabilities, which are identical to those of administrators.

Fiduciary: One who holds a position of trust with respect to another party or its property. It is the fiduciary's duty to act selflessly for the benefit of another, with undivided loyalty, obedience, and diligence—with due care and in good faith. This is the primary duty of an agent to the principal, of a trustee to the trust, and of an executor to the estate.

Gross income method: One of two method trusts and estates use to allocate direct and indirect expenses to tax-exempt income. Under the gross income method, indirect expenses are allocated before reducing gross income by direct expenses.

Income in respect of a decedent (IRD): Gross income a decedent was entitled to receive at the time of death but was not included in his final Form 1040 (or any prior return) under his regular method of accounting. IRD represents income that would have been taxable to the decedent if he or she had lived and received the income personally. Thus, IRD includes the following:

1. All accrued income of a cash-basis taxpayer at the time of death.
2. Income accrued solely by reason of the decedent's death by an accrual-basis taxpayer.
3. Income to which the decedent had a contingent claim at the time of his death.

Indirect expenses: Deductions not directly attributable to a specific class of income, such as trustee fees. They may be allocated to any item of income included in DNI, as long as a "reasonable portion" is allocated to nontaxable income.

Miscellaneous itemized deduction: A Schedule A expense that is more general in nature than deductible expenses from other Schedule A categories. Deductibility is limited in most cases. There are two types of miscellaneous itemized deductions:

1. Those that can be deducted without applying the 2% limitation test, including federal estate taxes paid on IRD.
2. Those limited to the amount greater than 2% of AGI, including tax preparation fees and trust management fees.

Net income method: One of two method trusts and estates use to allocate direct and indirect expenses to tax-exempt income. Under the net income method, fiduciary accounting gross income is first reduced by direct expenses before allocation of indirect expenses.

Net operating loss (NOL): The NOL deduction is available to estates and trusts much like it is to individuals when deductible business expenses and losses exceed gross income from that business plus taxable income earned from all other sources. They tend to be fairly uncommon for estates and trusts since they result only when (1) business activities are conducted within the fiduciary entity or through activities of flow-through entities and/or (2) the estate or trust incurred casualty or theft losses.

NOL carrybacks and carryforwards: Prior to the Taxpayer Relief Act of 1997, the NOL carryback was three years and the carryforward was 15 years. Effective for NOLs arising in tax years beginning after August 5, 1997, the carryback period became two years and the carryforward period was changed to 20 years. Certain losses qualify for a three-year or five-year carryback.

Tax-exempt income: This includes tax-exempt interest, compensation for illness or injury, debt forgiveness income (Chapter 11 bankruptcy), and death benefits.

Theft loss: A deductible theft loss is the result of illegal activity with criminal intent.

Trust: A tax entity created by a trust agreement. This entity distributes all or part of its income to beneficiaries as instructed by the trust agreement. This entity is required to pay taxes on undistributed income.

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 2

DISTRIBUTIONS (T41TG092)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses different types of distributions available to estates and trusts. Lesson one covers the basics of making distributions to beneficiaries, including income distribution deductions, distributable net income, and other issues. Lesson two discusses property distributions, including specific bequests, pecuniary requests, and more.

PUBLICATION/REVISION DATE: December 2009

RECOMMENDED FOR: Users of *PPC's 1041 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of income taxes

CPE CREDIT: 9 QAS Hours, 9 Registry Hours

9 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

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FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2010**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Distributions to Beneficiaries

Completion of this lesson will enable you to:
- Summarize the important elements of deducting distributions of taxable income.
- Define distributable net income (DNI), compute DNI, and determine when taxable gains are included.
- Compute the distribution deduction for simple trusts and complex trusts and estates, as well as determine distributions of amounts other than current income.
- Assess issues related to the separate share rule, treating distributions as made in the prior year, distributions of tax-exempt income, and generation-skipping transfer tax reporting.

Lesson 2—Property Distributions

Completion of this lesson will enable you to:
- Summarize the tax effects of property distributions and determine when distributions of specific property are considered specific bequests and, thus, are not eligible for the distribution deduction.
- Develop a strategy for dealing with distributions of property that are not specific bequests.
- Assess and compute gain or loss recognition related to distributions in lieu of specific property or dollar amounts, distributions of property in lieu of income, and distributions of depreciated property.

- Determine the tax implications of distributions of installment obligations, partnership interests, and S corporation stock.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Lesson 1: Distributions to Beneficiaries

Introduction

Although estates and trusts are subject to income tax as separate taxable entities, they also serve as conduits when they distribute income to beneficiaries. Distributable net income (DNI) is a tax concept originating conceptually in the Internal Revenue Code. The primary purpose of DNI is to allocate the trust's or estate's taxable (and tax-exempt) income between the fiduciary and its beneficiaries, ensuring income is only taxed once, either to the fiduciary or the beneficiaries. Estates or trusts making, or required to make, distributions are allowed an income tax deduction, referred to as the distribution deduction, which ensures that the estate or trust is not taxed on those amounts. An estate or trust can generally deduct amounts distributed, or required to be distributed, to the extent of the taxable portion of DNI. Any taxable income accumulated or remaining after the distribution deduction and exemption amount is taxed to the estate or trust.

To the extent a trust or estate is required or permitted by its governing instrument to make distributions that qualify for a distribution deduction, the beneficiaries must include a corresponding amount in their own gross income. The tax attributes of distributions to estate or trust beneficiaries are reported to the IRS and the beneficiaries via Schedule K-1 (Form 1041).

Distributions of property are governed by different rules than distributions of cash.

Distributions made in error are not taxed to a beneficiary if they are returned to the trust.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the important elements of deducting distributions of taxable income.
- Define distributable net income (DNI), compute DNI, and determine when taxable gains are included.
- Compute the distribution deduction for simple trusts and complex trusts and estates, as well as determine distributions of amounts other than current income.
- Assess issues related to the separate share rule, treating distributions as made in the prior year, distributions of tax-exempt income, and generation-skipping transfer tax reporting.

Taxable Income and the Deduction for Distributions

Overview of Distribution Deduction and DNI Rules

For tax purposes, a distribution of cash or other property (whether from income or principal), from an estate or trust to a beneficiary is generally treated as a distribution of current taxable income to the extent of distributable net income (DNI). The fiduciary deducts the taxable income so distributed and a corresponding amount is included in the gross income of the beneficiary. However, distributions made in error are not taxed to the beneficiary if they are returned to the trustee. Widow's or family allowances are subject to the normal distribution rules when paid to estate beneficiaries if such allowances are at the discretion of the executor or probate court.

The word "income," in Subchapter J (except in Subpart E, dealing with grantor trusts) when not prefaced with modifiers such as "gross," "taxable," or "distributable net," means fiduciary accounting income. When the governing instrument requires the fiduciary to distribute all or a portion of the income currently, the reference is to fiduciary accounting income. The fiduciary determines fiduciary accounting income by referring to the governing instrument, which is based on the intent of the creator. If the instrument is silent, the fiduciary must turn to local (i.e., state) law for guidance. Most states have adopted a version of the original (1931) or Revised (1962 or 1997) Uniform Principal and Income Act, which, in absence of direction in the governing instrument, provides guidance as to whether certain receipts and disbursements should be classified as income or principal (corpus) transactions.

The Internal Revenue Code creates a parallel concept referred to as distributable net income (DNI), which serves as the maximum amount of taxable income for which the fiduciary can claim as an income distribution deduction and the maximum amount required to be included in gross income of the beneficiaries. DNI is a modified form of fiduciary taxable income before the distribution deduction, which may or may not equal fiduciary accounting income.

Example 1A-1 Relationship between the distribution deduction and DNI.

The terms of the William Wonka Family Trust require the trust to pay all college expenses of Billy Wonka. College expenses are not a parental support obligation under local law. In 2009, the trustee paid $15,000 for Billy's tuition, books, room, and board, and made no other distributions. DNI for the year was $12,000 and there was no tax-exempt trust income.

The trust's distribution deduction is limited to the $12,000 of DNI. Billy will receive a Schedule K-1 from the trust reflecting $12,000 of taxable income, even though he received $15,000. The $12,000 is included in Billy's gross income for 2009 and taxed to him individually. The $3,000 distribution in excess of DNI is either a distribution of undistributed net income accumulated in prior years or a distribution of principal. If the trust had distributed $10,000 instead of $15,000, the distribution deduction and income inclusion amounts each would have been $10,000.

Example 1A-2 Distribution from principal rather than income.

In 2009, the DNI and fiduciary accounting income of the Mae Daye Testamentary Trust were both $30,000. The trust instrument provides that the trustee may distribute or accumulate income. The trustee also has the discretion to invade trust principal for the benefit of the sole beneficiary, Dee Daye.

According to the accounting records, on November 2, 2009, the trustee distributed $50,000 to Dee from the proceeds from a bond that matured November 1. The bond proceeds were allocated to principal. The trustee made no other distributions during the year and did not have a regular practice of distributing capital gains.

For fiduciary accounting purposes, the trustee made a distribution of $50,000 of principal. However, for federal income tax purposes, the first $30,000 of the distribution is deemed to have been made from DNI, which will be deductible by the trust and included as income on Dee's Schedule K-1 from the trust.

Exception for Specific Bequests

The general rule discussed previously treats a distribution of cash or other property (whether from income or principal) as coming from current income to the extent of DNI. However, any amount that, under the terms of the governing instrument, is (1) payable either as a gift or bequest of a specific sum of money or of specific property, (2) that is paid or credited all at once or in not more than three installments, and (3) is not payable out of income generally does not carry out DNI to the beneficiaries. Therefore, no DNI is allocated to such specific gifts or bequests. The fiduciary cannot claim a deduction for the distributions, nor will the specific gifts or bequests be taxable to the beneficiaries. DNI is only carried out if the bequest is entitled to income or to share in appreciation/depreciation of the assets. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI.

To qualify as a gift or bequest of a specific sum of money or of specific property, the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of death or under the terms of an *inter vivos* trust instrument as of the date of the inception of the trust. An amount that can be paid only from income cannot be treated as a specific bequest.

Example 1A-3 Specific cash bequest does not carry out DNI.

According to the provisions in the decedent's will, a specific sum of $25,000 is to be distributed to the decedent's niece within two years of death (2009). The estate has taxable DNI in 2009 of $100,000. The executor makes the $25,000 distribution to the niece in 2009, and there were no other distributions that year.

Even though the estate had taxable undistributed income for 2008, there is no distribution deduction for the $25,000 distributed to the niece since the amount qualifies as a distribution of a specific bequest.

Computing the Distribution Deduction on Form 1041

Schedule B on page 2 of Form 1041 provides the format for calculating distributable net income (DNI) and the income distribution deduction. In addition, fiduciary accounting income must be disclosed by complex trusts on Schedule B.

Once DNI has been determined, it is compared to the amount of total distributions for the tax year (excluding specific bequests), and the lesser amount is generally the distribution deduction. However, no distribution deduction is allowed for amounts not included in the gross income of the estate or trust. Therefore, tax-exempt income, net of allocable expenses, is not included in DNI or in total distributions when computing the income distribution deduction.

The amount of total distributions on Schedule B is the sum of two amounts: (1) income required to be distributed currently, and (2) other amounts paid, credited, or required to be distributed.

"Income required to be distributed currently" refers to fiduciary accounting income, whether or not actually distributed. Thus, the estate or trust is entitled to a distribution deduction if the income is *payable* to the beneficiary each year regardless of whether income is actually distributed. If the fiduciary can make a required distribution from income or principal, the amount to enter on Schedule B as income required to be distributed currently is the portion of the distribution paid from current income.

"Other amounts paid, credited, or required to be distributed" include all other distributions, whether from income or principal.

Example 1A-4 Distribution deduction for income required to be distributed.

In 2009, the taxable DNI and fiduciary accounting income of the Allen Pate Testamentary Trust were both $50,000. The trust instrument provides that the trustee must distribute $15,000 from income, $20,000 from principal (not a specific bequest), and $10,000 from either income or principal. The fiduciary makes the $10,000 distribution from income.

The "income required to be distributed currently" is $25,000 and the "other amounts paid, credited, or required to be distributed" is $20,000. If the fiduciary had made the $10,000 distribution from principal, the "income required to be distributed" would have been $15,000, and the "other amounts paid, credited, or required to be distributed" would have been $30,000. Either way, the total distribution deduction is $45,000.

Without a special election under IRC Sec. 643(e)(3), the amount to report on Schedule B for noncash distributions is the lesser of the adjusted basis of the property to the beneficiary or the property's fair market value on the date of distribution. If the Section 643(e)(3) election is made, the amount of the distribution is the fair market value of the property distributed. This rule does not pertain to specific bequests, which are not reported as distributions on Schedule B.

Tier System Determines Who Bears the Tax Burden

Simple Trusts. Simple trusts have the following characteristics:

1. they are required to distribute all income currently,

2. they make no distributions of principal in a given year, and

3. they cannot claim a charitable contribution deduction under IRC Sec. 642(c) for the year.

A simple trust is allowed to deduct the amount of income required to be distributed currently, up to the amount of taxable DNI (IRC Sec. 651).

The character of a trust from "simple" to "complex" can change from year to year. An otherwise simple trust will be classified as a complex trust for any year that principal is distributed. Trusts are characterized as complex trusts in the year of termination since principal distributions are required.

The character of a trust from "simple" to "complex" can change from year to year. An otherwise simple trust will be classified as a complex trust for any year that principal is distributed. Trusts are characterized as complex trusts in the year of termination since principal distributions are required.

Complex Trusts and Estates. All other trusts, referred to as "complex trusts," and estates compute their distribution deduction under a tier system whereby all amounts distributed to beneficiaries are classified as Tier 1 or Tier 2 distributions. Income required to be distributed currently is considered a Tier 1 distribution, and the beneficiaries are referred to as Tier 1 beneficiaries. Note that distributions of principal can be made as a Tier 1 distribution, but only to the extent of current income. Other distributions (whether from income or principal) are Tier 2 distributions, and the beneficiaries are referred to as Tier 2 beneficiaries. Tier 2 distributions include discretionary distributions of income and all distributions of principal that are in excess of required income, whether required or discretionary (excluding specific bequests).

DNI, computed without any deduction for charitable contributions, is first allocated to Tier 1 distributions. To the extent there is DNI remaining after Tier 1 distributions and any charitable contributions deduction, it is allocated to Tier 2 distributions. A single beneficiary can be both a Tier 1 and a Tier 2 beneficiary if he or she receives both mandatory and discretionary distributions of income in a single tax year.

Distribution Deduction Triggers AMT Reporting Requirements

Every estate or trust claiming an income distribution deduction must complete Schedule I, Form 1041, to compute:

1. the fiduciary's alternative minimum taxable income,

2. the income distribution deduction on a minimum tax basis, and

3. the fiduciary's alternative minimum tax (AMT).

Timing of Beneficiary Income Inclusion

Nongrantor trusts, other than those exempt from tax and certain wholly charitable trusts, are required to use a calendar year for tax reporting purposes. However, the executor or administrator of a decedent's estate can choose any tax year permitted under the general rules for selecting allowable year ends.

When the fiduciary and beneficiary share a common tax year, the beneficiary must report the income from the estate or trust in the same year the fiduciary claims the distribution deduction. When the fiduciary and beneficiary have different tax years (i.e., an estate), the beneficiary generally must report the income in his or her year during which the fiduciary's tax year ended. This rule applies to short tax years as well as full years. However, in the year of an individual beneficiary's death, the final Form 1040 includes only the income to which the beneficiary is entitled that is actually distributed to the beneficiary before his or her death. Income required to be distributed, but distributed to the decedent's estate is included in the gross income of the estate as income in respect of a decedent (IRD).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. In 2009, the Nelson Trust distributes $15,000 to each of the trust's two beneficiaries. The cash used for the distributions came from trust income. How will the distributions be handled for tax purposes?

   a. As distributions of current taxable income to the extent of distributable net income (DNI).

   b. As widow's or family allowances excluded from the DNI rules.

   c. The entire distribution amount is included in the trust's gross income.

   d. The distributions will not be included in DNI or carried out to either of the beneficiaries.

2. Marilyn is the sole beneficiary of the Bleaker Testamentary Trust. According to the trust instrument, the trustee may distribute or accumulate income, and the trustee is granted the discretion to invade trust principal for Marilyn's benefit. In 2009, the trust had DNI and fiduciary accounting income of $50,000. On October 7, 2009, the trustee distributed $75,000 to Marilyn. These funds were the proceeds from a bond that matured on October 6. The bond proceeds were allocated to principal. This was the only distribution made by the trustee in 2009, and the trustee did not have a regular practice of distributing capital gains. Which of the following statements best describes the consequences of this transaction for fiduciary accounting purposes?

   a. The $75,000 was a distribution of principal.

   b. The first $50,000 is deemed to be DNI.

   c. $50,000 is deductible by the trust.

   d. $50,000 is deductible by Marilyn.

3. The Gregor Trust has both DNI and fiduciary accounting income of $30,000 in 2009. Under the trust instrument, the trustee must distribute $5,000 from income, $7,000 from principal, and $12,000 from either income or principal. None of these distributions are specific bequests. Of the total $24,000 distributed by the trustee in 2009, $12,000 is from income. What is the trust's total distribution deduction?

   a. $7,000.

   b. $12,000.

   c. $24,000.

   d. $30,000.

4. What is reported on Schedule B of Form 1041?

   a. The fiduciary's alternative minimum taxable income and alternative minimum tax.

   b. The fiduciary's income distribution deduction on a minimum tax basis.

   c. The fiduciary's DNI calculation and income distribution deduction.

   d. The fiduciary's charitable contribution deduction.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. In 2009, the Nelson Trust distributes $15,000 to each of the trust's two beneficiaries. The cash used for the distributions came from trust income. How will the distributions be handled for tax purposes? **(Page 121)**

   a. As distributions of current taxable income to the extent of distributable net income (DNI). [This answer is correct. The fiduciary deducts the taxable income distributed by claiming an income distribution deduction up to DNI. That amount is included in the beneficiaries' gross income.]

   b. As widow's or family allowances excluded from the DNI rules. [This answer is incorrect. Widow's or family allowances are subject to normal DNI rules when paid to beneficiaries at the discretion of probate court or the trustee.]

   c. The entire distribution amount is included in the trust's gross income. [This answer is incorrect. In this scenario, the amount that corresponds to the amount that the trustee deducted in taxable income would be included in the beneficiaries' gross income. It would not be included in the trust's gross income.]

   d. The distributions will not be included in DNI or carried out to either of the beneficiaries. [This answer is incorrect. This would be true if the distribution, under the terms of the governing instrument, is a gift or bequest of a specific property or sum of money. Such a gift must be paid all at once or in not more than three installments.]

2. Marilyn is the sole beneficiary of the Bleaker Testamentary Trust. According to the trust instrument, the trustee may distribute or accumulate income, and the trustee is granted the discretion to invade trust principal for Marilyn's benefit. In 2009, the trust had DNI and fiduciary accounting income of $50,000. On October 7, 2009, the trustee distributed $75,000 to Marilyn. These funds were the proceeds from a bond that matured on October 6. The bond proceeds were allocated to principal. This was the only distribution made by the trustee in 2009, and the trustee did not have a regular practice of distributing capital gains. Which of the following statements best describes the consequences of this transaction for fiduciary accounting purposes? **(Page 121)**

   a. The $75,000 was a distribution of principal. [This answer is correct. The treatment used for fiduciary accounting purposes should reflect the way amounts of cash actually moved. In this scenario, the trustee accumulated all of the year's income and made a $75,000 distribution from principal.]

   b. The first $50,000 is deemed to be DNI. [This answer is incorrect. This would be correct for federal income tax purposes, not fiduciary accounting purposes.]

   c. $50,000 is deductible by the trust. [This answer is incorrect. Though the trust can make this deduction, it is for federal income tax purposes, not fiduciary accounting purposes.]

   d. $50,000 is deductible by Marilyn. [This answer is incorrect. For federal income tax purposes, Marilyn would count all $75,000 of the distribution as income, and it would be reported on her Schedule K–1 from the trust.]

3. The Gregor Trust has both DNI and fiduciary accounting income of $30,000 in 2009. Under the trust instrument, the trustee must distribute $5,000 from income, $7,000 from principal, and $12,000 from either income or principal. None of these distributions are specific bequests. Of the total $24,000 distributed by the trustee in 2009, $12,000 is from income. What is the trust's total distribution deduction? **(Page 121)**

   a. $7,000. [This answer is incorrect. The amount paid from principal would be included in the trust's 2009 distribution deduction, but other amounts are included in the calculation.]

   b. $12,000. [This answer is incorrect. The amount that the trustee paid to the beneficiary is included in the trust's distribution deduction for 2009; however, other amounts factor in to the calculation of the total deduction.]

c. $24,000. [This answer is correct. The "other amounts paid, credited, or required to be distributed" is 7,000, and the "income required to be distributed currently" is $17,000. The total distribution deduction is $24,000. The trust is entitled to a distribution deduction for all of the income that is payable to beneficiaries during the year (but not more than DNI), rather than what is actually paid.]

d. $30,000. [This answer is incorrect. Neither the total amount of DNI nor the total amount of fiduciary accounting income would be the trust's 2009 distribution deduction because the actual distributions must be taken into account.]

4. What is reported on Schedule B of Form 1041? **(Page 121)**

a. The fiduciary's alternative minimum taxable income and alternative minimum tax. [This answer is incorrect. An estate or trust would compute these two items on Schedule I of Form 1041.]

b. The fiduciary's income distribution deduction on a minimum tax basis. [This answer is incorrect. A fiduciary's income distribution deduction on a minimum tax basis is reported on Schedule I of Form 1041.]

c. The fiduciary's DNI calculation and income distribution deduction. [This answer is correct. Schedule B on page 2 of Form 1041 provides the format for calculating distributable net income (DNI) and the income distribution deduction. Additionally, if the fiduciary is a complex trust, it must also disclose its fiduciary accounting income on the Schedule B.]

d. The fiduciary's charitable contribution deduction. [This answer is incorrect. This would be reported on Schedule A of Form 1041, not Schedule B.]

The Important Elements of Distributable Net Income (DNI)

Maximum Distribution Deduction to Fiduciary and Income Inclusion to Beneficiary

Distributable net income (DNI) serves as an upper limitation on the amount of the distribution deduction that can be claimed by simple trusts, complex trusts, and estates in computing the taxable income of the fiduciary entity. DNI is also the maximum amount the beneficiaries will have to include in their gross income.

Example 1B-1 DNI provides upper limit for distribution deduction.

The Robert Johnson Testamentary Trust requires all income to be distributed currently. In 2009, the trust has $3,000 of dividend income, $8,000 of taxable interest income, and the trustee's fee is $1,000. DNI in this example is simply the sum of the dividend and interest income less the trustee's fee, or $10,000. Fiduciary accounting income is also $10,000, assuming the entire trustee's fee is allocated to income. Therefore, the trustee is required to distribute $10,000. The maximum distribution deduction that can be claimed by the trust is also $10,000.

If the trustee's fees of $1,000 were allocated to principal, DNI would remain at $10,000 while the fiduciary accounting income would be $11,000. The distribution deduction would be limited to $10,000, because DNI is the upper limit for the distribution deduction.

If the trust had an additional $5,000 of tax-exempt interest income, DNI (and fiduciary accounting income) would include the tax-exempt income, but the distribution deduction would not; the deduction is limited to the taxable portion of DNI by IRC Sec. 651(b) (simple trusts) and IRC Sec 661(c) (complex trusts and estates).

The limitation on the distribution deduction applies even if a trust or estate distributes an amount greater than DNI to beneficiaries. A simple trust could distribute an amount greater than DNI in a given year if fiduciary accounting income is greater than DNI (e.g., if tax-deductible trustee fees are allocated to principal under the terms of the trust agreement for fiduciary accounting purposes). An estate or complex trust could make distributions in excess of DNI since those entities are defined, among other criteria, as fiduciaries that make distributions of principal. However, the maximum distribution deduction is limited to DNI.

The amount included in the gross income of the beneficiaries may be less, but never more than DNI, even when all income is required to be distributed. For example, a simple trust whose DNI is greater than fiduciary accounting income is required to distribute only the amount of fiduciary accounting income. The amount taxable to the beneficiary cannot exceed the amount of DNI distributed.

Example 1B-2 Taxable distribution to beneficiary is limited to DNI.

The preparer of a 2009 Form 1041 for a complex trust determines from the information provided by the trustee that the trust received dividend income of $5,000 and taxable interest income of $15,000. The trust paid a fiduciary fee of $2,000. The trustee made a $20,000 discretionary distribution to the beneficiary as permitted by the trust instrument.

DNI equals $18,000 (dividends plus taxable interest less trustee fee). Even though $20,000 was distributed, the beneficiary will include only $18,000 in his gross income, an amount equal to DNI.

Determining Character of Distributions to Beneficiaries

DNI is also important in determining the character of amounts distributed to beneficiaries. The gross income distributed by an estate or trust to its beneficiaries generally retains the same character in the hands of the beneficiary as it had to the estate or trust. Therefore, DNI must be broken down by class of income, net of expenses, before the income can be allocated to the beneficiaries.

Income is reportable to beneficiaries if it is included in DNI and distributions are made, regardless of whether it is included in fiduciary accounting income. The fact that a distribution is classified as principal for fiduciary accounting purposes does not determine its tax treatment for inclusion in DNI. However, distributions of cash or property that are considered specific bequest do not carry out DNI to beneficiaries.

The governing instrument or state law can require a special allocation of income among beneficiaries, although this is quite uncommon. To be effective, the allocation must have "economic effect."

Deductions directly attributable to one class of income are allocated to that income. If the direct expenses exceed the related income, they can be allocated to other classes of income. Indirect expenses may be allocated to any item of income included in DNI, as long as a "reasonable portion" is allocated to nontaxable income.

Computing DNI

Defining DNI for Domestic Estates and Trusts

For domestic estates and trusts, DNI is defined as the taxable income of the estate or trust computed with the following modifications:

1. No deduction is allowed for distributions made to the beneficiaries.
2. No deduction is permitted for the personal exemption.
3. Capital gains are generally *excluded* from DNI. However, capital gains are *included* in DNI if the gains are:
    a. Allocated to income under the terms of the governing instrument and local law by the fiduciary on its books or by notice to the beneficiary.
    b. Allocated to principal, but actually distributed to the beneficiaries during the tax year (e.g., a distribution required by the terms of the governing instrument upon the occurrence of a specified event). This includes capital gains realized by a trust or estate in its final year or in years in which a partial termination occurs, such as a distribution made to a beneficiary who attains a specified age.
    c. Used in determining the amount distributed or required to be distributed by the fiduciary, under the terms of the governing instrument or in accordance with the consistent practice of the fiduciary.
    d. Contributed to charity (producing a charitable deduction) under IRC Sec. 642(c).
4. Short-term capital gain dividends from a regulated investment company (mutual fund) are generally included in DNI.
5. Capital losses are excluded except to the extent they are taken into account in determining the amount of gain from the sale or exchange of capital assets paid, credited, or required to be distributed to any beneficiary during the tax year.
6. The income tax deduction for estate taxes paid on income in respect of a decedent (IRD) is not allowed.
7. Gains on the disposition of qualified small business stock may be excluded from taxable income under IRC Sec. 1202 but must be included in DNI.
8. For simple trusts, extraordinary dividends or taxable stock dividends are excluded from DNI if the fiduciary, in good faith, does not pay or credit them to any beneficiary by reason of his determination that such dividends are allocable to principal under the terms of the governing instrument and applicable local law. However, such dividends are included in the distributable net income of complex trusts and estates.
9. Net tax-exempt interest is included in DNI. Net tax-exempt interest is gross tax-exempt interest, reduced by the tax-exempt interest paid or set aside for charity and by otherwise deductible expenses (e.g., trustee fees) allocated to the tax-exempt interest.

DNI Mechanism Ensures No Deductions Are Lost

When calculating DNI, there is no adjustment for expenses charged to principal (such as state income taxes on capital gains taxed to the trust or fiduciary fees allocated to principal). Since the starting point for the DNI calculation is the taxable income of the entity before any distribution deduction and without any adjustment for items charged to principal, the income beneficiary receives the full tax benefit (i.e., deduction) of principal expenses when fiduciary accounting income is greater than or equal to DNI. If the entity is an estate or complex trust making no distributions to beneficiaries, the entity itself will receive the tax benefit of deductions allocated to principal.

Example 1C-1 Income beneficiary receives tax benefit from fees charged to principal.

The Ann Smith Testamentary Trust was created to benefit Ann's surviving spouse, Tom, and her daughter, Elizabeth. Tom is to receive income for his life, and Elizabeth will receive the remainder interest after Tom's death. For the current year, assume the trust has interest income of $10,000; dividend income of $20,000; long-term capital gains of $40,000; and trustee fees amounting to $30,000. The trust document requires that all trustee fees are charged to principal. This treatment results in an advantage for the income beneficiary as follows:

	DNI	Allocated to Income	Allocated to Principal
Interest income	$ 10,000	$ 10,000	
Qualified dividends	20,000	20,000	
Long-term capital gains			$ 40,000
Trustee fees	(30,000)		(30,000)
	$ -0-	$ 30,000	$ 10,000

Tom, as income beneficiary, receives a distribution of $30,000, but reports no taxable income because he has received the tax benefit of the deductible trustee fees, even though the fees were charged to principal. When Elizabeth, the remainder beneficiary, ultimately receives the trust assets, those assets will have been reduced by the fees charged to principal in prior years; however, she will not receive any tax benefit from those fees. She will only receive tax benefit from any fees applicable to the DNI calculation in the year of final distribution.

Similarly, DNI is not adjusted for income items allocated to principal. This could mean that DNI exceeds fiduciary accounting income due to capital transactions or other gross receipts allocated to principal (e.g., receipts of income in respect of a decedent) rather than income. When this occurs, even a simple trust could bear the tax burden (and receive the tax benefits of expenses charged to principal), as demonstrated in Example 1C-2.

Example 1C-2 DNI may exceed fiduciary accounting income.

During the tax year, the preparer of a 2009 Form 1041 for a simple trust reviews the following receipts and other transactions shown on the trust records provided by the trustee bank:

Description of Receipt or Disbursement	Amount of Transaction	
1. 1000 shares XYZ common stock (gift—basis $1,000)	$ 200,000	(FMV)
2. Decedent's pension (under will—lump sum)	350,000	
3. Cash, ABC stock sale (prior-year gift—basis $1,000)	75,000	(FMV)
4. DEF stock receipt (IRC Sec. 355 spin-off—basis $3,000)	55,000	(FMV)
5. GHI stock (50% stock dividend—basis $200)	10,000	
6. Cash (extraordinary dividend on JKL stock)	13,000	
7. Gross oil royalties (qualifies for percentage depletion)	8,000	
Production tax paid on oil royalty income	(500)	
Property tax paid on producing oil property	(600)	
8. Imputed income on zero-interest term loan received from the decedent's estate	40,000	
9. Cash, sale of business equipment (fully depreciated)	17,000	
10. Fines paid (allocable to income & not reimbursed)	(1,000)	
11. Trustee fee paid (allocable to income)	(3,200)	
12. Trustee fee paid (allocable to principal)	(3,200)	
13. Interest expense paid to IRS for underpayment of income taxes	(1,500)	
14. Legal fee paid to defend trust's title to real property	(3,000)	

The trust document requires a depreciation reserve and requires a depletion reserve equal to the depletion deductible for federal income tax purposes. The trust records indicate the depletion expense for the year taken by the trustee and the accumulated depreciation and depletion reserve amounts at year-end. There is no depreciation expense for 2009 since the depreciable assets were fully depreciated in prior years. The trust instrument allocates capital gain to trust principal, and the trustee, in good faith, allocated the extraordinary dividend to principal.

The preparer first calculates the trust's taxable income (as if there were no distribution deduction) and then determines the modifications necessary to reach the DNI for 2009:

Description of Receipt or Disbursement	**Taxable Amount**
2. Lump-sum pension distribution is fully taxable (employer contributions)	$ 350,000
3. Stock sale produced capital gain	74,000
6. Extraordinary cash dividend is taxable	13,000
7. Oil royalties are taxable	8,000
Production tax paid is deductible	(500)
Property tax paid is deductible	(600)
Percentage depletion allowed (15%) is deductible	(1,200)
8. Imputed OID income on zero-interest loan is taxable	40,000
9. Section 1245 recapture amount is taxable	17,000
11. Trustee fees allocable to income are deductible (not subject to 2% limit)	(3,200)
12. Trustee fees allocable to principal are deductible (not subject to 2% limit)	(3,200)
Exemption allowed for a trust required to currently distribute all its income	(300)
Taxable income of simple trust (before distribution deduction)	493,000
Adjustments to taxable income required to reach DNI:	
Add back personal exemption	300
Eliminate capital gain	(74,000)
Eliminate extraordinary dividend (principal) paid to simple trust	(13,000)
Distributable net income (DNI)	$ 406,300
(Items 1, 4, 5, 10, 13, and 14 have no income tax effect.)	

Although DNI is $406,300, fiduciary accounting income is zero. When computing fiduciary accounting income, all receipts other than the royalties are allocated to principal, and the royalty income ($8,000) is offset by the production ($500) and property ($600) taxes, depletion ($1,200), fines ($1,000), trustees fee charged against income ($3,200), and interest expense ($1,500). A simple trust is required to distribute all of its fiduciary accounting income but no other amounts of any kind. Since fiduciary accounting income was zero, this simple trust will not be required to make any distributions to the beneficiaries and will pay tax at the trust level on the $493,000 of taxable income.

The income beneficiaries of a trust similar to Example 1C-2 will appreciate an advance warning that they are entitled to no distributions, particularly if they have some knowledge of the trust's assets and cash flow and know the trust document requires "all income" to be distributed to them currently. Improper distributions of "income" can create ill will among all parties and may trigger lawsuits.

Computing DNI for Simple Trusts

Distributions of income required to be distributed (or payable) each year are referred to as Tier 1 distributions, as discussed previously. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, before any deduction for charitable contributions.

Example 1C-3 DNI is modified taxable income.

In 2009, its first tax year, the Harold Hollis Family Trust had the following receipts and other transactions:

	Effect on Fiduciary Accounting Income	
Description of Receipt or Disbursement	**Income**	**Principal**
1. Cash from grantor—funding of the trust		$ 250,000
2. ABC Mutual Fund—ordinary cash dividends	$ 4,800	
3. Certificates of deposit—interest received	6,560	
4. DEF Corporate Bond Fund—income received	4,000	
5. Trustee fee paid	(1,360)	

The trust instrument states that "All current income is to be distributed monthly to the income beneficiary, Bill Hollis, while he is alive." Upon Bill's death, the entire principal is to be distributed to Bill's daughter, Betty. The trust instrument does not permit the trustee to make charitable contributions of any kind and allocates capital gain to principal. State law requires a trustee's fee to be charged against trust income.

DNI are calculated as follows:

Description of Receipt or Disbursement	Taxable Amount
1. The gift to the trust is not taxable	$ —
2. Ordinary dividends are taxable	4,800
3. CD interest income is taxable	6,560
4. Corporate bond fund income is taxable	4,000
5. The trustee fee is deductible (not subject to 2% of AGI limit)	(1,360)
6. Personal exemption for a trust required to currently distribute its income	(300)
Taxable income of simple trust, before distributions	13,700
Modifications to taxable income required to reach DNI:	
Add back personal exemption	300
Distributable net income (DNI)	$ 14,000

Since fiduciary accounting income is also $14,000, this simple trust is required to distribute $14,000 to the income beneficiary. The trust will obtain a distribution deduction equal to the taxable portion of DNI (also $14,000 in this case since there was no tax-exempt income). Bill, the current income beneficiary, will report $14,000 of gross income on his Form 1040 for 2009.

Computing DNI for Complex Trusts and Estates

Distributions from complex trusts and estates are classified as either Tier 1 or Tier 2 distributions. Tier 1 distributions are made from income required to be distributed currently. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, computed without any deduction for charitable contributions. Tier 2 distributions consist of other amounts paid or credited or required to be distributed during the tax year (whether from income or principal). The deduction for Tier 2 distributions is limited to the amount of taxable DNI remaining after Tier 1 distributions and deductible charitable contributions.

Example 1C-4 DNI and application of the tier system.

The trust instrument of the Theodore Turner Testamentary Trust provides that $60,000 of its income must be distributed to beneficiary Ty (Tier 1). Any remaining income may either be distributed to beneficiary Ted (Tier 2), given to charity, or accumulated.

The trust has $80,000 of taxable interest income in 2009. There are no other income items and no trust expenses. The trustee distributed the required $60,000 to Ty and made a discretionary distribution of $20,000 to Ted and $100,000 to charity in 2009.

The maximum amount of Ty's (Tier 1) distribution deduction is $80,000, which is the modified taxable DNI (computed without the charitable contribution deduction). Tier 1 distributions receive no benefit of the charitable contribution deduction against DNI. Thus, the deduction for the distribution to Ty is $60,000, the income required to be distributed currently.

When determining the amount of distribution deduction at the trust level and the corresponding income inclusion amount to Ted for the $20,000 distribution, the full charitable contribution is deducted in computing DNI, because the distribution to Ted is discretionary (i.e., a Tier 2 distribution). Ted's distribution is entirely tax-free because there is no remaining DNI to be allocated to Tier 2 beneficiaries after the Tier 1 distribution and charitable deduction are taken into account (i.e., deducted).

Depreciation and Depletion and DNI

According to IRC Sec. 642(e), depreciation and depletion are deductible by an estate or trust only to the extent not allocable to the income beneficiaries. For trusts, unless the controlling instrument or state law requires or permits a reserve to be maintained at the entity level and the trustee actually does so, this type of deduction is apportioned between the trust and the income beneficiaries on the basis of the fiduciary accounting income allocated to each.

When depreciation and depletion deductions are allocated to the income beneficiaries, they are allocated directly and do not flow through to page 1 of Form 1041. Thus, for a trust required to distribute all income currently that does not require or permit a reserve for depreciation or depletion to be maintained, DNI is not reduced by the amount of the depreciation or depletion deductions; rather, the income beneficiaries receive the depreciation and depletion deductions directly via Schedule K-1.

For trusts, if the controlling instrument or local law requires or permits a reserve to be maintained and the trustee does so, the current income beneficiaries may bear the burden of the reserve in the form of reduced distributions since fiduciary accounting income is decreased by the reserve. This will occur in the case of a simple trust, and in the case of a complex trust that makes a distribution based on fiduciary accounting income.

Simultaneous Equations May Be Required

As with individuals, certain deductions by estates and trusts must be reduced by a percentage of adjusted gross income (AGI). A fiduciary's AGI, as defined in IRC Sec. 67(e), is computed net of the income distribution deduction. However, the distribution deduction may be contingent on DNI, and DNI is computed after application of the 2% of AGI floor for miscellaneous itemized deductions, which in turn can only be determined if the distribution deduction is known.

To properly compute both DNI and the deductible portion of miscellaneous itemized deductions, simultaneous equations for the two unknown values are required.

Once DNI is calculated, the various components of income (e.g., ordinary, capital gains, and tax-exempt) must be determined. The character of each item of income will be the same to the beneficiaries as reportable by the estate or trust.

DNI and Capital Gains

Capital Gains Generally Excluded from DNI

Capital gains are not generally included in DNI and "are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." (Thus, any capital gains are taxed to the fiduciary rather than being included in DNI and "carried out" to the beneficiaries.) Under this general rule, gains from the sale or exchange of capital assets are *excluded* from DNI to the extent such gains are:

1. allocated to principal under the terms of the governing instrument or local law by the fiduciary on its books, or by notice to the beneficiary, and

2. not paid, credited, or required to be distributed to any beneficiary during the tax year, or

3. not paid, permanently set aside, or used for charitable purposes.

However, there are certain exceptions of when capital gains are included in DNI.

Example 1D-1 Distributed capital gains are generally not included in DNI.

Under the will of the late John Hill, assets worth $400,000 were transferred into trust for the benefit of Joan Hill. The instrument required that $20,000 be distributed to Joan each year during her lifetime, with any excess of current income accumulated and distributed to Joan's younger brother, Bill, when he reaches age 25. Neither the trust instrument nor state law allocates capital gains to income or gives the trustee the discretionary power to treat distributions that are in excess of ordinary income as being made from capital gains.

In the current year, the trust earned $17,000 in interest and dividends. To satisfy the required $20,000 payment to Joan, the trustee sold some of the trust's stock for a capital gain of $3,000. In satisfaction of its obligation, the trust distributed $20,000 to Joan.

Although the $3,000 capital gain is included in the taxable income of the trust, it is excluded from DNI (i.e., not allocated to Joan) because the gain was (a) allocated to principal, rather than income, for fiduciary accounting purposes, (b) not paid or required to be paid to Joan (although income is required to be distributed, there is no such requirement for capital gains), and (c) not allocated to charity.

On Schedule D, the gain is allocated to the trust (rather than to Joan) in Part III. The gain will flow from Schedule D to page 1 of Form 1041; it will not be reflected on Schedule K-1. On Schedule B, the capital gain is excluded (backed out) from "adjusted total income" (which is taxable income before the distribution deduction, personal exemption, and estate tax deduction) to arrive at DNI. Joan is treated as having received taxable DNI of $17,000 and principal of $3,000.

Capital losses are netted against capital gains at the fiduciary level, except for capital gains used in determining the amount distributed, or required to be distributed, to a particular beneficiary. Thus, if a fiduciary determines that current year capital gains are included in computing the income distributions, such gains will not be available to offset a capital loss carryover.

Specific Bequests. If the fiduciary is required to distribute a specific bequest, any capital gain included in the distribution to satisfy the bequest is not included in DNI, even if made in partial termination of the beneficiary's interest.

Example 1D-2 Capital gains are excluded from DNI if distributed as specific bequest, including a specific dollar amount each year.

Assume the same facts as in Example 1D-1, except the trust instrument requires the trustee to distribute $20,000 a year for 10 years (note that this requirement is for a specific sum of money, rather than an amount of trust accounting income), before distributing the remainder of the trust assets to Bill. The results are the same as in Example 1D-1, i.e., the capital gain would not be included in DNI.

When Capital Gains Are Included in DNI

There are a number of exceptions to the general rule of excluding capital gains from DNI. Capital gains are *included* in DNI if they are:

1. Specifically allocated to income according to the governing instrument and local law.

2. Exercised according to the fiduciary's reasonable and impartial discretionary power and

   a. allowed by the governing instrument and local law or

   b. made according to the fiduciary's reasonable and impartial discretion as one of the following items, which is authorized in the governing instrument and not prohibited by local law:

      (1) *Fiduciary Accounting Income*. However, if the amount of income is determined by a unitrust amount (e.g., a fixed rate of 4%), the discretionary power must be exercised consistently because

a fixed amount of income is determined by the unitrust amount. This exercise of discretionary power has no effect on the amount of the distribution, but on who will be taxed on the capital gains (the beneficiary or fiduciary).

(2) *Principal but Treated Consistently by the Fiduciary on the Trust's Books, Records, and Tax Returns as Part of a Distribution to a Beneficiary.*

(3) *Principal but Actually Distributed to the Beneficiary.* Note, however, that the IRS has ruled that there must be a connection specified in the trust instrument between the distribution and a particular event (e.g., termination of the trust, marriage of the beneficiary, or the beneficiary reaching a certain age) for DNI to include capital gains allocated to principal but actually distributed.

(4) *Principal but Utilized by the Fiduciary in Determining the Amount that Is Distributed or Required to be Distributed to a Beneficiary.*

3. Paid, permanently set aside, or used for charitable purposes [thus producing a charitable deduction under IRC Sec. 642(c)] [Reg. 1.643(a)-3(c)].

If capital gains are included in DNI, but only a portion are distributed to the beneficiaries in the current year, an allocation must be made to determine the amount reportable to the beneficiaries versus the amount taxable to the fiduciary.

<u>If Directed by Governing Instrument and Local Law.</u> Capital gains can be included in DNI if directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in fiduciary income, as defined in IRC Sec. 643(b), is included in DNI.

Example 1D-3 Capital gains properly allocated to income are included in DNI.

Assume the same facts as in Example 1D-1, except that the trust instrument allocates capital gains to income, which is consistent with local law. In this case, the $3,000 capital gain is taxed to Joan. The gain is included on Line 3 of Schedule B and allocated to the beneficiary in Part III of Schedule D.

When fiduciary income is based on a unitrust amount, e.g., a fixed rate of 4%, capital gains are included in DNI according to the governing instrument or local law, which should refer to the sources of income from which the unitrust amount is deemed to be paid. (For example, the provisions may read: "The trustee shall determine the unitrust distribution in accordance with the following ordering rules.") The capital gain allocated to DNI is the extent to which the unitrust amount exceeds DNI, determined without regard to the capital gains.

Example 1D-4 Capital gains are included in DNI when state law defines fiduciary income as a unitrust amount, and the capital gain is a component of the unitrust amount.

Assume the same facts as in Example 1D-1, except that the governing instrument is silent as to how fiduciary income is defined. According to local law, however, the trustee is to pay Joan (the income beneficiary) a unitrust amount of 4% of the annual fair market value of the trust assets. Local law also provides an ordering rule for characterizing the unitrust amount so that it is first considered paid from ordinary income, then from net short-term capital gain (if any), then from net long-term capital gain (if any) and finally from a return of principal. The trustee elects to use the unitrust amount to determine what to pay Joan.

At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, the Trust receives $5,000 of dividend income and realizes $80,000 of net long-term capital gain from the sale of ABC stock. The trustee distributes $20,000 to Joan (4% of $500,000) in satisfaction of her right to income. Of the $20,000 unitrust distribution, $5,000 is allocated to ordinary income and $15,000 is allocated to net long-term capital gain according to the state law's ordering rules. Thus, the $15,000 capital gain is included in the Trust's DNI for the year, which is then "carried out" to Joan. The remaining $65,000 capital gain ($80,000 − $15,000) is excluded from DNI and is taxed entirely to the Trust.

<u>If Allowed by Discretionary Power.</u> Capital gains can also be allocated to DNI if a fiduciary, according to a discretionary power granted by local law or the governing instrument (if not inconsistent with local law), reasonably and impartially treats the capital gains as income. For example, if a fiduciary exercises a discretionary power to consistently treat any distribution in excess of ordinary income as being made from realized capital gains, such distributions of capital gains are included in DNI.

According to Reg. 1.643(a)-3, a "consistent practice" is determined by how the capital gains are classified in the first year the estate or trust reports them. However, Rev. Rul. 68-392 takes the position that distributions of capital gains cannot be included in DNI in the first year the estate or trust reports capital gains because first-year distributions are not part of a "regular practice" of distributing capital gains (i.e., only capital gain distributions in later years could qualify). In the opinion of this course, the revenue ruling extends beyond the scope of the Code and existing regulations.

Example 1D-5 Capital gains are included in DNI if trustee exercises power to treat discretionary distributions of principal as being paid from income.

According to the terms of the Keller Trust's governing instrument, all income is to be paid to Sam for the trust term, with the remainder payable to Matt. The trust instrument gives the trustee (Sam's aunt, Dottie) discretionary powers (in a provision not prohibited by law) to invade principal as needed for Sam's benefit and to treat such distributions as being made from capital gains realized during the year.

During its first taxable year, the Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of ABC stock. According to the terms of the trust instrument and applicable local law, Dottie allocates the $10,000 capital gain to income. During the year, she distributes $17,000 to Sam, consisting of the trust income ($5,000) and a discretionary distribution of principal ($12,000). However, Dottie decides to treat the discretionary distributions of principal as being paid from income during the year. Therefore, the realized capital gains are included in DNI and are taxed entirely to Sam.

Note that Dottie must be consistent from year to year in her choice to exercise (or to not exercise) her power to treat discretionary distributions as being made from realized capital gains. Dottie's choice to exercise her power in the Trust's first year apparently establishes a precedent for the same treatment in successive years. However, she should be able to file amended fiduciary income tax returns if, in future years, she believes she made the wrong choice.

If the fiduciary income is based on a unitrust amount, e.g., a fixed rate of 4%, and the governing instrument or local law includes discretionary language for ordering ("the trustee may determine . . . ."), the fiduciary may decide whether to include capital gains in DNI, but the fiduciary's exercise of discretion must be used consistently from year to year. The amount allocated may not be greater than the excess of the unitrust amount over the DNI determined without the capital gain.

Example 1D-6 Capital gains are included in DNI when state law defines fiduciary income as a unitrust amount, and the trustee exercises discretionary power to treat the capital gain component of the unitrust amount as income.

Assume the same facts as in Example 1D-5, except that there is no ordering rule in the trust instrument or state law, but leaves that to the trustee's discretion. The trustee intends to consistently treat the excess of the 4% unitrust amount over ordinary income as income.

Thus, the entire $10,000 of net long-term capital gain will be included in DNI, so that it is taxed entirely to Sam, rather than by the trust. Sam is taxed only on $5,000 ordinary income. In future years, the trustee must follow this same treatment on all realized capital gains.

<u>If Used To Determine Amount of Distribution.</u> If the capital gain is allocated to principal but actually distributed to the beneficiary or used to determine the amount distributed or required to be distributed, according to the terms of the governing instrument or the customary practice of the fiduciary, the gain is included in DNI.

Example 1D-7 Capital gains are included in DNI when allocated to principal but used to determine the amount that is to be distributed to the beneficiary.

Assume the same facts as in Example 1D-5, except that Dottie decides that discretionary distributions of principal will be made only if the Trust has realized capital gains during the year and capital gains are allocated to principal under the trust instrument. The discretionary distribution to Sam is $10,000, rather than $12,000. Because Dottie will consistently use the amount of any realized capital gain to determine the amount of the discretionary distribution to Sam, the $10,000 capital gain is included in the Trust's DNI for the taxable year. Thus, Sam, rather than the trust, will be taxed on the capital gain.

Example 1D-8 Capital gains are included in DNI if sale proceeds determine the amount of the required distribution to the beneficiary.

The Kramer Trust is required by the trust instrument to hold closely held stock for 12 years, then sell it and distribute all net proceeds to Ryan Kramer. Since the trustee must use the sales proceeds, which include realized capital gains, to determine the amount of the distributions to Ryan, the capital gains are included in DNI and are taxed to Ryan.

If Distributed as Partial or Complete Termination. Capital gains are included in DNI if they are allocated to principal but distributed to the beneficiaries in partial or complete liquidation of the beneficiary's interest.

Example 1D-9 Capital gains are included in DNI if made in partial or complete termination of beneficiary's interest in the trust.

Assume the same facts as in Example 1D-8, except that all income is to be paid to Ryan during the trust's term. Upon attaining age 35, Ryan is to receive one-half of the trust assets, with the balance to be distributed when he reaches age 45. If the trustee sells half of the stock and distributes the net sale proceeds to Ryan, all the capital gain on that sale is included in DNI and taxed to Ryan.

If the trustee sells all of the stock and distributes the required one-half of the sales proceeds to Ryan when he reaches age 35, the trustee may, if authorized by the governing instrument and state law, determine how much of the capital gain is distributed to Ryan, up to a maximum of the total capital gain amount. If not authorized by the governing instrument and state law, only one-half of the capital gain on the sale can be included in DNI, since that is the amount actually distributed to Ryan.

Variation: If the trust had required that all of the trust assets were to be distributed to Ryan upon his attaining age 35, all capital gains realized in the trust's final year are included in DNI and taxed to Ryan.

Short-term Capital Gains and DNI

Although IRC Sec. 643(a)(3) does not distinguish between the treatment of short-term and long-term capital gain, the IRS has held that ordinary dividends from a regulated investment company are included in DNI even if they consist of short-term capital gain not includible in DNI under the provisions of IRC Sec. 643(a)(3).

Example 1D-10 Short-term capital gain distributions and DNI.

A newly-created testamentary trust requires that the trust's "net income" be paid annually to the income beneficiary for life. The trust instrument contains no provision regarding capital gain. The trustee has invested the principal in equity funds and income funds that qualify as regulated investment companies ("mutual funds").

The trust's total cash dividend payments from the regulated investment companies during the year totaled $15,000, consisting of "capital gain dividends" of $5,000 and "ordinary dividends" of $10,000. Based upon the supplemental information provided by the investment companies, the trustee determines that $6,000 of the $10,000 "ordinary dividend" amount is short-term capital gain income. The trust has no expenses. Fiduciary accounting income is determined to be $4,000 under the general rule that fiduciary accounting income does not include capital gain (regardless of the holding period of the asset).

IRC Sec. 643(a)(3) establishes a uniform standard on whether or not capital gain recognized by the trust is included in DNI and requires the capital gain income of this trust to be excluded from DNI. However, a regulated investment company's ordinary dividend distribution, including any portion derived from short-term capital gain realized, is considered a dividend from a corporation that is ordinary income in its entirety and is thus includible in DNI.

DNI of the trust is therefore $10,000, the entire amount of the ordinary income distribution, even though $6,000 of the $10,000 is short-term capital gain. Because the trustee is required to distribute the trust "net income" (i.e., the annual net fiduciary accounting income) to the income beneficiary, $4,000 is distributed to that person. This results in a distribution deduction of the same amount, leaving both the $5,000 of "capital gain dividends" to be treated by the trust as long-term capital gain under the provisions of IRC Sec. 1222(11) and the $6,000 of short-term capital gain income to be taxed at the trust level.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. In 2009, the Justin Mills Trust has $5,000 of dividend income, $7,000 of taxable interest income, $3,000 of tax-exempt interest income, and $500 of trustee's fees. The trustee's fees are allocated to income, and all income is required to be distributed currently. Calculate the trust's DNI.

   a. $11,500.

   b. $12,000.

   c. $14,500.

   d. $15,000.

6. Assume the same details as in the question above. What is the trust's distribution deduction?

   a. $11,500.

   b. $12,000.

   c. $14,500.

   d. $15,000.

7. Which of the following is a modification made to taxable income when computing a domestic estate or trust's DNI?

   a. All capital gains and losses must be excluded from DNI.

   b. Distributions made to beneficiaries are deducted from DNI.

   c. The personal exemption amount is deducted from DNI.

   d. Net tax-exempt interest is included in DNI.

8. A trust receives the following in 2009:

Interest income:	$ 30,000
Qualified dividends:	50,000
Long-term capital gains:	110,000
Trustee's fees:	80,000

   Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal.

   a. DNI: $80,000; Income: $30,000; Principal: $50,000.

   b. DNI: $30,000; Income: $0; Principal: $80,000.

   c. DNI: $0; Income: $80,000; Principal: $30,000.

   d. DNI: $0; Income: $110,000; Principal: $80,000.

9. Due to a series of capital transactions, a simple trust's DNI exceeds its fiduciary accounting income. For the tax year, the trust's DNI is $47,000, but its fiduciary income is zero. What are the consequences of these results?

   a. The trust is required to distribute the $47,000 to the beneficiaries.

   b. The trust will pay tax at the trust level on the $47,000.

   c. The lack of fiduciary accounting income changes the trust to a complex trust.

   d. The trust is forced to use a depreciation reserve.

10. When dealing with a complex trust, which of the following would be considered a Tier 2 distribution?

    a. An income distribution to a beneficiary required by the trust document.

    b. A distribution limited to the taxable portion of DNI.

    c. A distribution made to a beneficiary at the trustee's discretion.

    d. A distribution made from income required to be distributed currently.

11. Which of the following statements about the relationship of depreciation and depletion to DNI is true?

    a. Estates or trusts only deduct depreciation and depletion to the extent it is not allocable to beneficiaries.

    b. Neither trusts nor estates can maintain a reserve to address the depreciation and depletion deduction.

    c. Depreciation and depletion deductions flow to income beneficiaries by the beneficiary's receipt of Form 1041.

    d. DNI is always reduced by the amount of the depreciation or depletion deduction.

12. When Casey dies, his will instructs assets to be placed in a trust for his daughter, Deana, and requires $10,000 to be distributed to her every year during her lifetime with any excess income distributed to charity. In 2009, the trust only earns $9,000 in interest and dividends, so the trustee sells trust stock for a capital gain of $1,000 to complete the annual distribution to Deana. What are the consequences of this action?

    a. Deana will report $10,000 of DNI for 2009.

    b. The capital gain is included in the trust's taxable income.

    c. The capital gain is allocated to income.

13. Assume the same details as the question above; however, the governing instrument is silent about how to define fiduciary income. Under local law, the trustee must pay Deana a unitrust amount that equals 4% of the annual fair market value (FMV) of the trust's assets. Under the law, the unitrust amount is first considered paid from ordinary income, then from long-term capital gain, and then from a return of principal. The trustee uses the unitrust amount to determine what to pay Deana. In 2009, the trust's assets are valued at $250,000. During the year, the trust receives $3,000 of dividend income and $15,000 of net long-term capital gain from the sale of stock. What will happen after the trust distributes the annual $10,000 distribution to Deana?

    a. All $10,000 will be allocated to the net long-term capital gain.

    b. The trust must distribute all $15,000 of the capital gain to Deana.

    c. All $15,000 of the capital gain is taxed entirely to the trust.

    d. $7,000 of the capital gain is included in DNI and carried out to Deana.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. In 2009, the Justin Mills Trust has $5,000 of dividend income, $7,000 of taxable interest income, $3,000 of tax-exempt interest income, and $500 of trustee's fees. The trustee's fees are allocated to income, and all income is required to be distributed currently. Calculate the trust's DNI. **(Page 128)**

   a. $11,500. [This answer is incorrect. If the trust had no tax-exempt interest in 2009, this would be the correct amount of DNI.]

   b. $12,000. [This answer is incorrect. Neither the trustee's fees nor the tax-exempt interest were addressed correctly in this calculation.]

   c. $14,500. [This answer is correct. DNI is calculated as the dividend income ($5,000), plus the taxable interest income ($7,000), plus the tax-exempt interest income ($3,000), minus the trustee's fees.]

   d. $15,000. [This answer is incorrect. If the trustee's fees had been allocated to principal instead of income, this would be the correct DNI amount.]

6. Assume the same details as in the question above. What is the trust's distribution deduction? **(Page 128)**

   a. $11,500. [This answer is correct. Though DNI includes the tax-exempt income, the distribution deduction is limited to the taxable portion of DNI; therefore, the calculation would be $5,000 + $7,000 − $500 = $11,500.]

   b. $12,000. [This answer is incorrect. If the trustee's fees had been allocated to principal instead of to income, this would be the correct distribution deduction.]

   c. $14,500. [This answer is incorrect. If all of the interest income in the scenario were taxable, the DNI and the distribution deduction would be the same; however, that is not the case in this scenario.]

   d. $15,000. [This answer is incorrect. Neither the tax-exempt interest income nor the trustee's fees were correctly dealt with in this calculation.]

7. Which of the following is a modification made to taxable income when computing a domestic estate or trust's DNI? **(Page 129)**

   a. All capital gains and losses must be excluded from DNI. [This answer is incorrect. Generally, capital gains are excluded from DNI, but there are some exceptions. Capital losses are excluded except to the extent that they must be taken into account to determine the amount of gain from the sale or exchange of capital assets credited, paid, or required to be distributed during the tax year to the beneficiary.]

   b. Distributions made to beneficiaries are deducted from DNI. [This answer is incorrect. When calculating DNI, no deduction is allowed for distributions to beneficiaries.]

   c. The personal exemption amount is deducted from DNI. [This answer is incorrect. In the DNI calculation, no deduction is allowed for the personal exemption. That amount must be added back to the taxable income.]

   d. Net tax-exempt interest is included in DNI. [This answer is correct. To calculate net tax-exempt interest, the gross tax-exempt interest income is reduced by any tax-exempt interest paid or set aside for charity and also by other deductible expenses allocated to the tax-exempt interest (such as trustee fees).]

8. A trust receives the following in 2009:

Interest income:	$ 30,000
Qualified dividends:	50,000
Long-term capital gains:	110,000
Trustee's fees:	80,000

Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal. **(Page 129)**

a. DNI: $80,000; Income: $30,000; Principal: $50,000. [This answer is incorrect. Though the interest income figures into the calculation of the allocated income, there is more than must be considered. Similarly, though the trustee fees are considered in the DNI calculation, other amounts must be taken into account. The qualified dividend amount is not part of the calculation of allocated principal.]

b. DNI: $30,000; Income: $0; Principal: $80,000. [This answer is incorrect. Though the interest income would be considered in the DNI calculation, other amounts would figure into the calculation, as well. The trustee fees would not be considered allocated principal, and based on the amounts in this scenario, there would be allocated income.]

c. DNI: $0; Income: $80,000; Principal: $30,000. [This answer is correct. Because the interest income and the qualified dividends are equal to the trustee fees, there is no DNI. Allocated income is determined by adding the interest income and the qualified dividends. Allocated principal is the long-term capital gains minus the trustee fees.]

d. DNI: $0; Income: $110,000; Principal: $80,000. [This answer is incorrect. All of the long-term capital gains would not be allocated income, and neither the trustee fees nor the total of the interest income and the qualified dividends would be considered allocated principal.]

9. Due to a series of capital transactions, a simple trust's DNI exceeds its fiduciary accounting income. For the tax year, the trust's DNI is $47,000, but its fiduciary income is zero. What are the consequences of these results? **(Page 129)**

a. The trust is required to distribute the $47,000 to the beneficiaries. [This answer is incorrect. A simple trust is only required to distribute its fiduciary income, and that amount was zero in this scenario; therefore, the trust is not required to make a distribution to its beneficiaries during this tax year.]

b. The trust will pay tax at the trust level on the $47,000. [This answer is correct. When DNI exceeds fiduciary accounting income, the trust bears the tax burden, as well as receives the tax benefits of expenses charged to principal.]

c. The lack of fiduciary accounting income changes the trust to a complex trust. [This answer is incorrect. DNI exceeding fiduciary accounting income will not cause the trust to convert from a simple trust to a complex trust.]

d. The trust is forced to use a depreciation reserve. [This answer is incorrect. A depreciation reserve must be required by the trust document—it is not an automatic requirement when DNI exceeds fiduciary accounting income.]

10. When dealing with a complex trust, which of the following would be considered a Tier 2 distribution? **(Page 129)**

a. An income distribution to a beneficiary required by the trust document. [This answer is incorrect. This distribution is required to be distributed currently and it comes from income; therefore, it is a Tier 1 distribution.]

b. A distribution limited to the taxable portion of DNI. [This answer is incorrect. The distribution deduction for a Tier 1 distribution is limited to the taxable portion of DNI.]

c. A distribution made to a beneficiary at the trustee's discretion. [This answer is correct. Another example of a Tier 2 distribution would be a distribution to charity made at the trustee's discretion.

Tier 2 distributions are other amounts paid, credited, or required to be distributed during the year either from income or principal.]

d. A distribution made from income required to be distributed currently. [This answer is incorrect. A Tier 1 distribution is made from income required to be distributed currently.]

11. Which of the following statements about the relationship of depreciation and depletion to DNI is true? **(Page 133)**

a. Estates or trusts only deduct depreciation and depletion to the extent it is not allocable to beneficiaries. [This answer is correct. Under IRC Sec. 642(e), this is the correct way for estates and trusts to deal with any depreciation or depletion deduction.]

b. Neither trusts nor estates can maintain a reserve to address the depreciation and depletion deduction. [This answer is incorrect. Trusts are allowed to maintain such a reserve if either state law or the controlling instrument requires or permits such a reserve. If the trustee actually maintains such a reserve, the depreciation and depletion deduction will then be apportioned between the trust and the income beneficiaries on a fiduciary accounting income basis.]

c. Depreciation and depletion deductions flow to income beneficiaries by the beneficiary's receipt of Form 1041. [This answer is incorrect. Such deductions are allocated directly to income beneficiaries, so they receive the deductions directly on the Schedule K-1.]

d. DNI is always reduced by the amount of the depreciation or depletion deduction. [This answer is incorrect. If a trust is required to distribute all of its income currently and does not have a reserve for depreciation or depletion, the DNI will not be reduced by the amount of any depreciation or depletion deductions.]

12. When Casey dies, his will instructs assets to be placed in a trust for his daughter, Deana, and requires $10,000 to be distributed to her every year during her lifetime with any excess income distributed to charity. In 2009, the trust only earns $9,000 in interest and dividends, so the trustee sells trust stock for a capital gain of $1,000 to complete the annual distribution to Deana. What are the consequences of this action? **(Page 133)**

a. Deana will report $10,000 of DNI for 2009. [This answer is incorrect. The $1,000 of capital gain would be excluded from DNI; therefore, it will not be reflected on Deana's Schedule K-1. Deana will only report DNI of $9,000.]

b. The capital gain is included in the trust's taxable income. [This answer is correct. The $1,000 of capital gain is included in the trust's taxable income; however, it will be excluded from DNI.]

c. The capital gain is allocated to income. [This answer is incorrect. Because stock had to be sold to earn the $1,000, the capital gain is allocated to principal, not income.]

13. Assume the same details as the question above; however, the governing instrument is silent about how to define fiduciary income. Under local law, the trustee must pay Deana a unitrust amount that equals 4% of the annual fair market value (FMV) of the trust's assets. Under the law, the unitrust amount is first considered paid from ordinary income, then from long-term capital gain, and then from a return of principal. The trustee uses the unitrust amount to determine what to pay Deana. In 2009, the trust's assets are valued at $250,000. During the year, the trust receives $3,000 of dividend income and $15,000 of net long-term capital gain from the sale of stock. What will happen after the trust distributes the annual $10,000 distribution to Deana? **(Page 133)**

a. All $10,000 will be allocated to the net long-term capital gain. [This answer is incorrect. Under local law, the first $3,000 of the annual distribution is allocated to the dividend income received by the trust in 2009.]

b. The trust must distribute all $15,000 of the capital gain to Deana. [This answer is incorrect. Only 4% of the FMV of the trust's assets is a required payment to Deana as the unitrust amount. The rest of the capital gain is not a required distribution.]

c. All $15,000 of the capital gain is taxed entirely to the trust. [This answer is incorrect. Only $8,000 of the capital gain is taxed entirely to the trust due to the requirements of local law for the unitrust amount.]

d. $7,000 of the capital gain is included in DNI and carried out to Deana. [This answer is correct. The $7,000 of capital gain that is allocable to Deana's annual distribution (after the $3,000 of dividend income is accounted for) will be included in the trust's DNI (and, thus, carried out to Deana).]

Distribution Deduction for Simple Trusts

Overview of Allowable Distribution Deduction Rules

If the terms of a trust governing a particular tax year (1) require all "income" to be distributed to the beneficiaries currently, and (2) do not provide for any amounts to be paid, permanently set aside, or used for charitable purposes, and if the trust makes no distributions other than of current income during the year, the trust is classified as a "simple" trust for that tax year. Income, for this purpose, is fiduciary accounting income.

For simple trusts, an income distribution deduction is allowed, generally in the amount of the taxable portion of income required to be distributed for that year. However, the deduction is limited to the taxable portion of the trust's DNI.

Income does not actually have to be distributed to beneficiaries in order for a simple trust to claim the income distribution deduction. The important consideration is whether the fiduciary is under a duty to distribute the income currently, even if, as a practical matter, the income is not distributed until after the close of the trust's taxable year.

Example 1E-1 Income distribution requirement, rather than actual payment, is determining factor for a simple trust.

Jed Stewart is the beneficiary of a trust created by his deceased father. The trust agreement requires all income to be distributed currently to Jed during his lifetime. In 2009, the trustee notified Jed that the current income was available to him. However, the income was never actually distributed by the trustee, and Jed never disclaimed, renounced, or made any other effective assignment of his rights under the trust.

Even though the trust's income for 2009 was never distributed, the trust is entitled to an income distribution deduction on its 2009 Form 1041. In addition, Jed is required to report the income deemed distributed from the trust on his 2009 Form 1040. Under an identical fact pattern, the Tax Court ruled that an individual taxpayer who was a beneficiary of a simple trust was in constructive receipt of the trust's income and was liable for additional tax and penalties for negligent or intentional disregard of the rules and regulations.

If all income is required to be distributed currently, a trust otherwise qualifying as a simple trust will not lose that status merely because the trustee has the discretion to distribute (i.e., sprinkle) the income among a class of beneficiaries or among named beneficiaries as he or she sees fit.

Example 1E-2 Sprinkling power of trustee does not affect simple trust status.

The Fox Children's Trust requires the trustee to distribute all income among the three Fox children each year as he, in his sole discretion, sees fit.

Even though the amount distributable to a particular beneficiary is unknown until the trustee exercises his discretion, the trust is still a simple trust. It is irrelevant that the amount of income allocated to a particular beneficiary is not specified in the instrument, as long as all income is required to be distributed currently.

A trust's classification as a simple trust does not change if the trust instrument also grants the fiduciary the discretion to invade trust principal for the benefit of a beneficiary, provided that if a distribution of trust principal is made for the year in question, it does not exceed current income. However, if the trust instrument grants the power to accumulate income, the trust is not a simple trust for that year even though all income is distributed. In other words, the power to distribute amounts in excess of the required income is fatal to simple trust status only if exercised, but the power to accumulate income causes a trust to be complex even if that power is not exercised.

Example 1E-3 Trust classification may change from complex to simple.

Brenda Lane established a trust for her son, Ted. The trust document specifies that the fiduciary may accumulate income until Ted reaches the age of 40. Thereafter, income must be distributed currently. The trust is a complex trust until Ted reaches the age of 40, and it is a simple trust for subsequent taxable years, unless amounts other than income are distributed.

If a trust instrument requires that a reserve for depreciation be maintained, the charge to fiduciary accounting income for that purpose will not disqualify the trust from being a simple trust.

A trust entitled to a charitable contribution deduction in a given year is not a simple trust for that year. However, a trust with a remainder to a charitable organization generally is not disqualified as a simple trust for any year in which it does not claim a charitable deduction.

An otherwise "simple" trust becomes a complex trust in the year of termination, since it is distributing principal.

Meaning of the Unmodified Word "Income" in a Trust/Estate Context

The word *income* when used in the Internal Revenue Code in conjunction with the income taxation of estates and trusts, if not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means fiduciary accounting income. Fiduciary accounting income (also called "trust accounting income") is the income of the estate or trust determined according to the terms of the governing instrument and local (usually state) law.

Meaning of the Term *Fiduciary Accounting Income*

Generally, fiduciary accounting income may be thought of as the "fruit" (income) that grows from one or more "trees" (assets) after the settlor or grantor (donor) transfers them to the trust. Expenditures closely associated with producing income are charged against the particular type of income. Expenditures closely associated with the assets in the body (or principal) of the trust, are generally charged to the particular asset (principal) and not against income.

Although fiduciary accounting income is more of a common law than an income tax concept, it is important in determining which entity bears the income tax liability associated with the fiduciary's income. If there is any doubt when determining fiduciary accounting income as to whether a particular receipt is income or principal (or whether a given expenditure is chargeable to income or principal), the controlling instrument and the particular state's Principal and Income Act should be consulted.

The creator of a trust may specify the fiduciary accounting rules applying to the trust. However, if the provisions depart fundamentally from local law in the determination of what is income, they will be ignored for tax purposes. A decedent may do the same for an estate by means of language in the will.

Income Distributions in the Form of Property

A simple trust may distribute property in satisfaction of the income beneficiary's right to receive all income currently and still retain classification as a simple trust if no amount in excess of fiduciary accounting income is distributed during the year. The trust claims an income distribution deduction for the income required to be distributed, limited to DNI. However, because the trust is treated as having sold the property for its fair market value on the date of distribution, the trust must recognize gain on the distribution. No loss would be allowed because of the related party rules under IRC Sec. 267(b). The beneficiary of the simple trust takes the property with a basis equal to fair market value. The results would be the same for property distributed in satisfaction of income required to be distributed (i.e., Tier 1) from a complex trust.

Example 1E-4 Property distributions by simple trusts.

Hillary Hartman is the current income beneficiary of the Harvey Hartman Testamentary Trust. The trust instrument requires all income to be distributed to Hillary each year, and makes no allowance for charitable contributions. In 2009, the trust had $40,000 of gross income. In lieu of cash, the trustee distributed stock worth $40,000 (with a basis to the trust of $25,000) to Hillary.

The distribution of the stock is treated as if the trustee had distributed $40,000 cash to Hillary, who in turn purchased the stock from the trustee with the cash at fair market value. The trust is allowed an income distribution deduction of $40,000, and Hillary will include $40,000 in gross income on her personal return. In addition, the transfer of the stock in satisfaction of the beneficiary's right to receive all current income results in a $15,000 capital gain to the trust ($40,000 − $25,000). The basis of the stock to Hillary is the price she is deemed to have paid for it ($40,000).

Different rules apply for property distributions from complex trusts and estates.

Effect of Depreciation Reserve

If the trust instrument requires or permits the trustee to retain a reasonable reserve for depreciation, retention of current income for that purpose will not prevent the trust from being a simple trust. Funding an annual reserve decreases the amount of cash flow to the income beneficiaries of a simple trust, since depreciation expense reduces trust accounting income when reserves are funded.

Four Steps to Compute Distribution Deduction for a Simple Trust

Once a trust has been classified as a simple trust, the tax return preparer will need to determine the amount of the income distribution deduction. This determination can be broken down into four distinct steps:

1. Determine fiduciary accounting income, the amount required to be distributed currently.

2. Calculate distributable net income (DNI), which is the upper limit on the amount of the distribution deduction.

3. Compute the actual distribution deduction, in light of steps 1 and 2 above, after adjusting for nontaxable income and related expenses.

4. Determine the character of the income distributed to the beneficiaries (e.g., interest, dividends, etc.).

Example 1E-5 Simple trust's distribution deduction: Step 1—trust accounting income.

The Jack Jones Testamentary Trust is required to distribute currently all its income to Janice Jones. Capital gains are allocated to principal by the trust instrument. The trust instrument and state law neither require nor permit a depreciation reserve.

During 2009, the trust had the following income and expenses:

Business income	$ 25,000
Qualified dividends	50,000
Tax-exempt interest income	25,000
Long-term capital gain	15,000
Tax depreciation expense	(5,000)
Other business expenses	(5,000)
Trustee fee allocated to income	(2,600)
Trustee fee allocated to principal	(1,300)
Subtotal	101,100
Adjustments to calculate fiduciary accounting income:	
Eliminate capital gains allocable to principal	(15,000)
Add back depreciation expense	5,000
Add back trustee fee allocated to principal	1,300
Fiduciary accounting income	$ 92,400

Capital gains are not part of fiduciary accounting income because the trust instrument specifies that capital gains are allocable to principal. Similarly, the trustee fee allocated to principal is not deducted in reaching fiduciary accounting income. Depreciation expense is not allowed as a deduction in reaching fiduciary accounting income since the trust document neither requires nor permits a reserve for depreciation. The tax depreciation will be allocated to the beneficiary (because all income is required to be distributed) directly on Schedule K-1, bypassing Form 1041 entirely. The preparer confirms from the records that $92,400 was distributed to Janice Jones.

Fiduciary accounting income must be calculated to determine a simple trust's distribution deduction, since fiduciary accounting income, not DNI, is the amount required to be distributed. If fiduciary accounting income is less than DNI, not all DNI would be distributed, limiting the distribution deduction and causing the simple trust to be subject to tax. Such excess DNI is sometimes referred to as "phantom income."

Once fiduciary accounting income has been determined, the second step is to compute DNI, the maximum amount that can be deducted.

Example 1E-6 Simple trust's distribution deduction: Step 2—DNI.

Assuming the same facts as in Example 1E-5, the preparer calculates the trust's DNI as:

Business income		$ 25,000
Qualified dividends		50,000
Tax-exempt interest income	$ 25,000	
Less: expenses allocated to tax-exempt income ($25,000 ÷ $100,000) × $3,900	(975)	24,025
Other business expenses		(5,000)
Deductible trustee fees ($3,900 − $975)		(2,925)
Distributable net income		$ 91,100

Capital gains are excluded from DNI. The $3,900 amount is the total trustee fees from Example 1E-5 since both components of the fee are deductible for tax purposes (to the extent not allocated to tax-exempt income). Since capital gains are excluded from DNI, they are also excluded from the denominator of the fraction used to allocate a portion of the trustee fee to tax-exempt income ($100,000 is the total of all income items included in DNI).

Since all of the income of the trust is required to be distributed currently, the tax depreciation expense is directly allocated to the beneficiary, and no depreciation deduction is allowable in calculating DNI (in the absence of provisions in the governing instrument requiring depreciation reserves to be maintained).

After fiduciary accounting income and distributable net income have been computed, the third step is to determine the deduction for distribution of current income. Schedule B (Form 1041) is again used for reporting purposes.

Example 1E-7 Simple trust's distribution deduction: Step 3—"taxable" DNI.

Using the facts in Examples 1E-5 and 1E-6, the simple trust will receive a deduction for the taxable portion of DNI, that is, DNI less tax-exempt income, net of the expenses allocated to it:

DNI (determined in Example 1E-6)		$ 91,100
Less:		
Tax-exempt interest income (TEI)	$ 25,000	
Expenses allocated to TEI (Example 1E-6)	(975)	(24,025)
Taxable DNI		$ 67,075

Since fiduciary accounting income, less net tax-exempt income ($92,400 − $24,025 = $68,375), exceeds taxable DNI ($67,075), the distribution deduction is limited to the taxable portion of DNI (although $92,400, the fiduciary accounting income, will actually be distributed to the beneficiary).

Finally, the fourth step is to determine how distributions are characterized to beneficiaries.

Amounts Taxable to Beneficiaries of Simple Trusts

The beneficiary of a simple trust must include in gross income the amount of fiduciary accounting income required to be distributed to the extent of the taxable portion of DNI, i.e., the lesser of fiduciary accounting income required to be distributed or taxable DNI. This is true whether or not it is actually distributed. A beneficiary of a simple trust is never taxed on more than the fiduciary accounting income required to be distributed, but could be taxed on less if DNI is less.

Distribution Deduction for Estates and Complex Trusts

Overview of Allowable Distribution Deduction Rules

Estates and complex trusts are allowed to deduct distributions to beneficiaries. All trusts that are not simple trusts are classified as complex trusts. Thus, if a trust is allowed to accumulate income, claims a charitable contribution deduction, or makes a distribution of principal in excess of required income, it is a complex trust.

A trust instrument may authorize distribution of principal under certain circumstances or at the trustee's discretion (perhaps limited by specific standards). In those years the trust distributes principal in excess of required income, it is a complex trust, even if it is a simple trust in other years.

Schedule B, the income distribution deduction schedule on page 2 of Form 1041, in keeping with the statutory scheme of IRC Sec. 661, specifies that income required to be distributed currently is stated separately from any other amounts paid, credited, or required to be distributed. The sum of these two components is the total distribution, which is deductible up to the amount of taxable distributable net income (DNI).

> **Example 1F-1 Complex trusts and estates may accumulate income.**
>
> The preparer of a Form 1041 for 2009 determines that the DNI and fiduciary accounting income both equal $35,000 and consist of $15,000 in dividends, $25,000 of taxable interest income, and $5,000 of trustee fees chargeable to trust income. The trust records do not reflect any distributions.
>
> The trust instrument states that distributions of income are subject to the trustee's discretion. The trust is a complex trust, since all income is not required to be distributed currently. Thus, it was entirely permissible for the trustee to accumulate the entire $35,000 in 2009, distributing nothing to the income beneficiary. Alternatively, the trust could have distributed the entire $35,000 or some lesser amount.

The trust instrument of a complex trust can require any amount to be distributed to the beneficiary each year, even if that amount exceeded the trust's income. The trust instrument can also give the trustee discretion to distribute or accumulate any fiduciary accounting income in excess of the stated amount. The distribution powers that can legally be granted a trustee are very flexible. Note, however, that different powers have different income or transfer tax consequences associated with them.

The distribution deduction on Schedule B should not include amounts paid to a charitable organization. This is because amounts distributed to a charity from income or principal are deducted on Schedule A of Form 1041, to the extent they are included in DNI. If the amounts paid to charity are not included in DNI, neither a charitable contribution nor distribution deduction is available. Thus, an estate or trust should not issue a Schedule K-1 to a charitable organization to report a distribution of income or principal.

Two Tiers of Distributions Exist for Complex Trusts and Estates

Estates and complex trusts are allowed a deduction in computing taxable income equal to the sum of two components after adjusting for tax-exempt income and related expenses:

1. the amount of income required to be distributed currently under the terms of the governing instrument or local law (whether distributed or not), plus

2. any other amounts properly paid or credited to, or required to be distributed to, the beneficiaries for the tax year, to the extent the total deduction does not exceed the taxable portion of distributable net income (DNI).

<u>Tier 1 Distributions.</u> Distributions of the first component are called *Tier 1* distributions and include any amount required to be distributed that may be paid out of income or principal (such as an annuity), to the extent it is actually

paid out of income for the tax year. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, computed without any deduction for charitable contributions.

Tier 2 Distributions. Distributions of the second component are called *Tier 2* distributions and generally include "proper" payments of income not required to be distributed currently and distributions of principal, whether required or discretionary. Distributions from estates are nearly always Tier 2 distributions, since the executor has discretion in distributing income and principal, paying debts and claims, and marshaling estate assets. Tier 2 distributions are referred to on Schedule B of Form 1041 as "other amounts paid, credited, or required to be distributed" (OAPC). Determining whether an amount was "properly" paid or credited is made according to local law.

Impact of Tier 1 vs. Tier 2 Distributions. The distinction between Tier 1 and Tier 2 distributions governs the taxability of distributions to the two corresponding classes of beneficiaries. DNI is first carried out (via the distribution deduction) by Tier 1 distributions and, to the extent there is DNI remaining, it is carried out by Tier 2 distributions. Therefore, the deduction for Tier 2 distributions is limited to the amount of taxable DNI remaining after Tier 1 distributions. If more than one beneficiary receives Tier 2 distributions of the remaining DNI, it is allocated among the Tier 2 beneficiaries on the basis of the relative amount of Tier 2 distributions made to each.

A Tier 1 beneficiary (entitled to a mandatory distribution of income) will be both a Tier 1 and Tier 2 beneficiary if Tier 2 amounts are also distributed to him or her.

Charitable Contributions. Charitable deductions are often referred to as "Tier 1½ distributions" because they are not deducted from the amount distributed to Tier 1 beneficiaries, but will take precedence over Tier 2 distributions, if any exist.

When a distribution made to a charitable organization qualifies for the charitable deduction under IRC Sec. 642(c), the distribution is ignored when computing the Tier 1 and Tier 2 distributions to that charity, and DNI is not allocated to the charitable beneficiary. The deduction for amounts of income paid or permanently set aside for charitable purposes is deducted as a charitable contribution on Schedule A of Form 1041, rather than a distribution deduction on Schedule B of Form 1041.

Five Steps to Compute Distribution Deduction for a Complex Trust or Estate

Once a trust has been classified as a complex trust, the return preparer must determine the income distribution deduction. This determination, also applicable for estates, can be broken down into five distinct steps:

1. Determine fiduciary accounting income, upon which Tier 1 distributions (income required to be distributed currently, if any) are based.

2. Determine the amount of other amounts paid, credited, or required to be distributed (the Tier 2 distributions).

3. Calculate distributable net income (DNI), which is the upper limit on the amount of the distribution deduction.

4. Compute the actual distribution deduction, which is the sum of amounts determined in Steps 1 and 2 above, limited to the amount determined in Step 3, after adjusting for tax-exempt income and related expenses.

5. Determine the character of the income distributed to the beneficiaries (e.g., interest, dividends, etc.).

Example 1F-2 Complex trust's distribution deduction: Step 1—fiduciary accounting income and Step 2—other amounts paid or credited.

In 2009, the Bill Baker Testamentary Trust had tax-exempt income, made a mandatory distribution to charity and a discretionary distribution to an individual beneficiary. Thus, the trust is a complex trust.

The trust instrument requires the trust to pay $10,000 out of its income to a specific charity each year. The remaining income may, at the trustee's discretion, be accumulated or distributed to Allen Baker. Therefore, Allen is a Tier 2 beneficiary since there are no mandatory distributions of income to him.

According to the trust instrument, all expenses are allocable against income, and a reserve for depreciation is required (and is actually maintained). Tax and book depreciation expense are equal. During 2009, the trustee makes the $10,000 distribution to the charity and a discretionary distribution of $15,000 to Allen.

The trust has the following items of income and (expense) for 2009, which the preparer uses to calculate fiduciary accounting income, as shown:

Qualified dividends	$ 10,000
Taxable interest	10,000
Tax-exempt interest	10,000
Business income	20,000
Business depreciation expense	(3,000)
Other business expenses	(2,000)
Trustee fee (allocated to income)	(5,000)
Fiduciary accounting income	$ 40,000

There are no required distributions to individual beneficiaries. Therefore, the $15,000 distributed to Allen is a Tier 2 distribution (i.e., other amounts paid or credited).

The third step in computing the distribution deduction for estates and complex trusts is to calculate distributable net income (DNI).

Example 1F-3 Complex trust's distribution deduction: Step 3—DNI.

The preparer of the 2009 Form 1041 for the trust in Example 1F-2 calculates the trust's DNI in the following manner:

Qualified dividends		$ 10,000
Taxable interest		10,000
Tax-exempt interest	$ 10,000	
Less allocable expenses ($10,000 ÷ $50,000[a]) × $5,000	(1,000)	
Less allocable charitable deduction ($10,000 ÷ $50,000[a]) × $10,000	(2,000)	7,000
Business income		20,000
Total income		47,000
Other business expenses		(2,000)
Business depreciation expense		(3,000)
Trustee fee (net) ($40,000 ÷ $50,000[a]) × $5,000		(4,000)
Charitable contribution (net) ($40,000 ÷ $50,000[a]) × $10,000		(8,000)
Distributable net income (DNI)		$ 30,000

Note:

[a] This amount consists of the total income of the trust (dividends, taxable interest, tax-exempt interest, and business income) before expenses.

The next step is to determine the portion of DNI allowed as an income distribution deduction.

Example 1F-4 Complex trust's distribution deduction: Step 4—apportion taxable DNI between fiduciary and beneficiaries.

DNI is $30,000 as calculated in Example 1F-3. The taxable portion of DNI is $23,000, which is the $30,000 DNI reduced by the $7,000 adjusted tax-exempt interest income. However, the trust's allowable distribution deduction is not equal to the entire taxable portion of DNI because the total of the Tier 1 and Tier 2 distributions ($15,000) is less than total DNI ($30,000); in other words, not all of the DNI was distributed. Thus, the distribution will carry out only a portion of DNI to the beneficiaries.

The $15,000 distribution to beneficiary Allen (from Example 1F-2) is half of the $30,000 DNI. Therefore, the distribution deduction equals $11,500, $15,000 distribution reduced by half the amount of the tax-exempt component of DNI ($7,000 × $^1/_2$ = $3,500).

The fifth and final step is to determine the character of amounts distributed to beneficiaries.

Amounts Taxable to Beneficiaries of Complex Trusts and Estates

The beneficiary of a complex trust or estate must include distributed amounts in gross income. Up to a maximum amount equal to the trust's taxable DNI, the beneficiary must include—

1. The amount of fiduciary accounting income required to be distributed currently, whether or not it is actually distributed, and

2. All other amounts paid, credited, or required to be distributed to such beneficiary, except for amounts not deductible by the fiduciary, such as a specific bequest.

Amounts Distributed to Satisfy "Support" Obligation

If trust income is used, or required to be used to discharge a grantor's legal obligation to provide support or maintenance of a beneficiary, the grantor will be taxed on the current income of the trust used (or required to be used) to provide the support (as defined under local law) under the grantor trust rules. However, to the extent principal or accumulated income is used to discharge a grantor's support obligation, the support payments are treated as "other amounts paid or credited," deductible by the trust and taxable to the grantor as Tier 2 distributions. Parallel rules apply to a trustee of a trust (i.e., a person other than the grantor) who makes distributions in satisfaction of his own support obligations.

To the extent an amount, pursuant to a trust instrument, is used to discharge a support obligation of a person who is neither a grantor nor a trustee (e.g., a beneficiary), the amount so used is treated as a distribution from a complex trust directly to that person.

Payments made by an estate to provide support for the decedent's widow or dependents for a limited time during the administration of the estate are considered Tier 1 or Tier 2 distributions, as appropriate, if paid or required to be paid during the tax year pursuant to a court order or local law.

Example 1F-5 Payments used to discharge grantor's support obligation.

George Jones established the Jones Children's Trust to accumulate funds for the college education of his children. The agreement also permits the trustee to pay the children's medical expenses to the extent not covered by insurance. In George's state of residence, the provision of medical care for one's minor children is a parent or guardian's legal obligation of support, but paying for a college education is not. In 2009, one of George's children was hospitalized and incurred $5,000 of expenses not covered by insurance. The expenses were paid by the trust. Fiduciary accounting income and DNI were each $3,000 for the year.

The trust is not a grantor trust simply because of a provision that trust assets could potentially be used to pay the children's medical bills. However, the actual payment of the medical bills by the trust in 2009 is support, and therefore, the trust is considered a grantor trust for 2009 to the extent of current trust income ($3,000) used to provide the support. The income is reported directly by George on his Form 1040. The additional $2,000 in excess of current income paid in discharge of George's support obligation is an "other amount paid or credited," or a Tier 2 distribution under IRC Sec. 661. However, since there is no DNI remaining to be carried out, the trust receives no distribution deduction for (and George is not taxed on) the additional $2,000.

Amounts Distributed to Fund a Charitable Remainder Trust

Normally, an income distribution made directly to a charitable organization, pursuant to the terms of the governing instrument, is deductible under IRC Sec. 642(c) and does not qualify as a distribution deduction under IRC

Sec. 661. Thus, amounts paid to a charity are not reported on Schedule K (Form 1041) if the distribution qualifies for the charitable income tax deduction under IRC Sec. 642(c). However, the tax treatment for distributions to charitable remainder trusts (CRTs), when they are residual beneficiaries of estates and trusts, is not clear since the distributions are made to split-interest trusts, with a required annual payment payable to noncharitable beneficiaries and the remainder to qualified charities.

To be deductible as a charitable income tax deduction under IRC Sec. 642(c), the possibility of amounts being insufficient to distribute to the charity must, under the terms of the governing instrument and circumstances of a particular situation, be so remote as to be negligible. If there is a possibility that principal will be needed to make the required CRT annuity or unitrust amount, no charitable income tax deduction is allowed under IRC Sec. 642(c). In that case, a Section 661 distribution deduction should be available for the amount of income used to fund a CRT. When a charitable remainder annuity trust (CRAT) was a beneficiary of the residuary estate, the IRS has ruled that the estate could not claim a charitable deduction under IRC Sec. 642(c) for amounts used to fund the CRT, but a Section 661 distribution deduction was allowed.

If the amounts distributed to the CRT are paid from the estate or testamentary trust's gross income, DNI is allocated to the CRT as if the CRT were a regular noncharitable beneficiary. In other words, Schedule K-1 should be issued to the CRT upon funding, to the extent of the CRT's share of DNI. The character of DNI allocated to the CRT will be accounted for under the CRT's four-tier system and available for future allocation to the CRT's noncharitable beneficiary.

Amounts Other Than Current Income

Determining Other Amounts Paid, Credited, or Required to Be Distributed

When an estate or complex trust distributes amounts, including property, in excess of "income required to be distributed currently" to beneficiaries, the return preparer must determine if the distribution is included in "other amounts properly paid or credited or required to be distributed" (OAPC) under IRC Sec. 661(a)(2). If the distributions are OAPC, they are Tier 2 distributions and carry out DNI to beneficiaries to the extent of taxable DNI remaining after Tier 1 distributions.

As a practical matter, actual payments or credits to beneficiaries are "proper" unless they are not in accordance with the terms of the governing instrument as interpreted by state law.

The word "credited" is intended to encompass the concept of constructive receipt by the beneficiaries. That is, if the fiduciary "credits" an amount via a bookkeeping entry to the beneficiary's account and there is actual or implied notice to the beneficiary that the fiduciary is legally bound to pay the beneficiary on demand, then there is constructive receipt of the amount by the beneficiary. "Credited" would also include funds over which the beneficiary had control, whether or not the beneficiary opted to collect the funds from the entity. Effectively, "credited" prevents the beneficiary from avoiding an income allocation by merely refusing to accept a distribution from the fiduciary or choosing to accept the distribution at another time. The trust or estate may therefore claim the appropriate distribution deduction. A mere entry on the fiduciary's books is likely insufficient unless it places the amount legally beyond the reach of the fiduciary.

All distributions are considered OAPC unless they are—

1. income required to be distributed currently, or
2. specific gifts and bequests under IRC Sec. 663(a).

Example 1G-1 Other amounts properly paid, credited, or required to be distributed.

The Mae Daye Trust does not require all income to be distributed currently. However, the trust instrument permits the trustee to distribute principal. The return preparer calculates the DNI and fiduciary accounting income both to be $100,000 for 2009. The trustee distributed $250,000 to the beneficiary during the year.

The preparer determines the entire $250,000 is an "other" amount paid, credited, or required to be distributed and consists of $100,000 of income (a Tier 2 income distribution since all income is not required to be distributed) and a $150,000 distribution of accumulated income from a prior year or of principal. The return preparer reports the $250,000 on Schedule B (Form 1041), line 10.

An estate's distribution of real estate is not considered OAPC if title to the real estate vests in the distributee immediately upon the death of the decedent.

Exception for Specific Gifts and Bequests

A gift or bequest of a specific sum of money or of specific property that is properly paid or credited to a beneficiary under the terms of the governing instrument is not deductible by the fiduciary or taxable to the beneficiary, unless the gift or bequest is payable in more than three installments or is paid from income. Such specific gifts and bequests have no income tax consequences.

The amount of money or the identity of the specific property must be ascertainable under the testator's will at the date of death, or under the terms of an *inter vivos* trust instrument at the date of the trust's inception. For example, a decedent's bequest to his or her surviving spouse of money or property, to be selected by the executor, and expressed as a fraction of the "adjusted gross estate" is not a specific bequest (and is therefore an OAPC that carries out DNI). Similarly, a distribution of the residuary estate or principal of a trust is not a specific gift or bequest and thus, carries out DNI.

Determining Amount of Property Distribution

When OAPC takes the form of property other than cash, the amount taken into account in computing the fiduciary's distribution deduction and the amount taxable to the beneficiary is generally the lesser of:

1. the basis of the property to the beneficiary, which is a carryover basis from the fiduciary, adjusted for any gain or loss recognized by the fiduciary on the distribution; or

2. the fair market value of the property.

However, the fiduciary can elect to recognize gain on the distribution under IRC Sec. 643(e)(3), in which case the distribution deduction/income inclusion amount is the property's fair market value. However, because of the related party rules, an estate or trust is not allowed to deduct a loss except for pecuniary bequests made by an estate.

Payments to Third Parties for Beneficiary's Personal Expenses

Sometimes it is more efficient for the fiduciary to make a payment on a beneficiary's behalf than to make a distribution to the beneficiary and then have the beneficiary make the payment. Often, a trust is used to manage property for a beneficiary who is incapable of managing the property personally. Therefore, the trust will pay the beneficiary's personal expenses directly rather than make a distribution to the beneficiary. If the payment is for the beneficiary's personal benefit, the payment is classified as an OAPC.

Example 1G-2 Trust's payment of personal expenses considered other amounts properly paid, credited, or required to be distributed.

A testamentary trust was established for the decedent's incapacitated daughter, Jana. The trustee had total discretion as to whether any distributions could be made. Due to Jana's poor health, the trustee paid all of her personal expenses, such as food, medical bills, and clothing. During the current year, the trustee made payments on Jana's behalf totaling $35,000. The entire $35,000 is classified as a Tier 2 distribution, and DNI is allocated to Jana for the lesser of DNI or $35,000.

If the trust is required to make income distributions (Tier 1), the payment of personal expenses would be treated as part of the required income distribution. However, when payments for personal expenses are made that discharge a grantor's support obligation, the grantor will be subject to taxation.

When an estate or trust maintains a personal residence for the beneficiary, the fiduciary's payment of the residence expenses are subject to a different set of rules. Since the residence is an asset of the estate or trust and the expenses are necessary to maintain the property, such payments are not allocated as income to the beneficiary, even if the beneficiary received some benefit from the expenditures. However, except for interest and taxes, the expenses are not deductible by the fiduciary since the residence is not an income-producing asset. Any residential expenses are nondeductible expenses of the fiduciary, and thus, the estate or trust must pay income taxes on the taxable income used to pay the residential expenses.

In *Du Pont*, a trust was required to maintain the property as the surviving spouse's personal residence. Although the spouse's health caused her to remain in the residence, the expenses were not attributable to her since she could have moved. Regardless of whether the spouse lived in the house, the trust was required to maintain the property, and thus, the residence expense payments were made to maintain the trust's assets rather than for the spouse's benefit. The Tax Court held that the payments could not be allocated to the spouse via the income distribution deduction of IRC Sec. 661. Although a deduction is allowed for "the management, conservation, and maintenance of property held for the production of income," the administrative expenses must be directly connected or proximately related to the management, conservation, or maintenance of the property. Because a residence is not an income-producing asset, any expenses other than interest or taxes is nondeductible by the trust.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. In which scenario below would a simple trust become a complex trust?

    a. The Wright Family Trust distributes property to Julia, satisfying her right to receive all current income.

    b. The trust instrument of the Lane Children's Trust grants the fiduciary the power to accumulate income.

    c. The Zucker Trust has a remainder due to charity, but in 2009 it does not claim a charitable deduction.

    d. The Hill Trust retains current income for its depreciation reserve, as permitted by the trust instrument.

15. The Michael Halford Testamentary Trust is a simple trust with the following income and expenses in 2009:

Business income:	$	75,000
Qualified dividends:		100,000
Tax-exempt interest income:		25,000
Long-term capital gain (allocated to principal):		30,000
Tax depreciation expense:		7,000
Other business expenses:		4,000
Trustee fee allocated to income:		1,500
Trustee fee allocated to principal:		500

    Compute the trust's fiduciary accounting income.

    a. $194,500.

    b. $217,000.

    c. $224,500.

    d. $243,000.

16. Assume the same details as in the question above, and compute the trust's available distribution deduction.

    a. $24,750.

    b. $169,250.

    c. $194,000.

    d. $199,750.

17. Which of the following statements best describes the two tiers of distributions allowed for complex trusts and estates?

    a. Income required to be distributed currently is a Tier 2 distribution.

b. Annuities and discretionary distributions of principal are both Tier 1 distributions.

c. DNI is first carried out to Tier 1 distributions; any remaining is carried out to Tier 2 distributions.

d. Charitable contribution deductions are called Tier 3 distributions.

18. The Larson Testamentary Trust is a complex trust. The trust instrument requires an annual $20,000 income distribution to a specific charity, and allows any remaining income to be distributed to Janine at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2009, the trustee distributes $20,000 to the charity and $30,000 to Janine. The trust also has the following items of income and expense:

Qualified dividends:	$	20,000
Taxable interest:		20,000
Tax-exempt interest:		20,000
Business income:		40,000
Business depreciation expense:		6,000
Other business expenses:		4,000
Trustee fee (allocated to income):		10,000

Calculate the trust's DNI for 2009.

a. $14,000.

b. $60,000.

c. $80,000.

d. $94,000.

19. The Kinch Children's Trust was established by David Kinch to accumulate funds for Arthur and Joshua's college education. The trust agreement also permits the trustee to pay their medical expenses to the extent that they are not covered by insurance. In David's state of residence, paying for college education is not a legal obligation of support, but paying for one's minor children's medical care is. In 2009, Joshua was hospitalized, and $7,000 of expenses not covered by insurance were incurred. These expenses were paid by the trust. Fiduciary accounting income and DNI were both $4,000 for the year. Which of the following will occur in this scenario?

a. The trust will always be considered a grantor trust.

b. The $4,000 of income will be reported by the trust on Form 1041.

c. David must pay taxes on the entire $7,000 as a support obligation.

d. $3,000 is considered an "other amount paid or credited" to David.

20. Which of the following statements accurately describes estates and trusts?

a. Estates and trusts are not allowed to make payments to third parties on behalf of beneficiaries. They can only distribute funds to the beneficiaries themselves.

b. If an estate or trust maintains a personal residence for a beneficiary and pays expenses related to the residence, the payments are considered income to the beneficiary.

c. A payment made by an estate or trust for the beneficiary's benefit is considered "other amounts properly paid or credited or required to be distributed" (OAPC).

d. Payments of personal expenses on the behalf of a beneficiary made by a trust will always be considered a Tier 1 income distribution.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. In which scenario below would a simple trust become a complex trust? **(Page 144)**

    a. The Wright Family Trust distributes property to Julia, satisfying her right to receive all current income. [This answer is incorrect. As long as it does not distribute an amount that exceeds the year's fiduciary accounting income, the trust may distribute property in this instance and still retain its simple trust status.]

    b. The trust instrument of the Lane Children's Trust grants the fiduciary the power to accumulate income. [This answer is correct. Even if not exercised, this power will make the Lane Children's Trust a complex trust. However, if the trust merely had the power to distribute amounts in excess of required income, it would only become a complex trust if that power was utilized in the current year.]

    c. The Zucker Trust has a remainder due to charity, but in 2009 it does not claim a charitable deduction. [This answer is incorrect. A trust that is entitled to a charitable deduction in the current year is, for that year, not classified as a simple trust. However, as long as the charitable deduction is not claimed, it generally will not be disqualified from its simple trust status.]

    d. The Hill Trust retains current income for its depreciation reserve, as permitted by the trust instrument. [This answer is incorrect. Funding a depreciation reserve reduces the amount of cash flow to a simple trust's beneficiaries, but if the trust instrument requires or permits the reserve, retaining current income for that purpose will not cause the trust to lose its simple trust status.]

15. The Michael Halford Testamentary Trust is a simple trust with the following income and expenses in 2009:

Business income:	$ 75,000
Qualified dividends:	100,000
Tax-exempt interest income:	25,000
Long-term capital gain (allocated to principal):	30,000
Tax depreciation expense:	7,000
Other business expenses:	4,000
Trustee fee allocated to income:	1,500
Trustee fee allocated to principal:	500

    Compute the trust's fiduciary accounting income. **(Page 144)**

    a. $194,500. [This answer is correct. To calculate fiduciary accounting income, take $217,000 (the subtotal of all the trust's income minus all the trust's expenses), subtract $30,000 (the capital gains, which are allocable to principal), and add $7,000 (add back the depreciation expense) and $500 (add back trustee fees allocated to principal).]

    b. $217,000. [This answer is incorrect. This is the subtotal of the trust's income and expenses ($230,000 in income minus $13,000 of expenses). Further adjustments are needed to arrive at the trust's fiduciary accounting income.]

    c. $224,500. [This answer is incorrect. To arrive at this total, the capital gain was not dealt with correctly. It must be subtracted from the subtotal before the fiduciary accounting income can be determined.]

    d. $243,000. [This answer is incorrect. This is the total of all the trust's expenses ($230,000) plus all the trust's expenses ($13,000). Ordinarily, the expenses must be subtracted from the income to begin the calculation.]

16. Assume the same details as in the question above, and compute the trust's available distribution deduction. **(Page 148)**

   a. $24,750. [This answer is incorrect. This is the tax-exempt interest income ($25,000) minus the expenses allocated to it ($250). This is a portion of the calculation, but further calculations are needed to arrive at the trust's taxable DNI.]

   b. $169,250. [This answer is correct. To calculate the trust's taxable DNI, first the DNI must be calculated ($194,000) and then the tax-exempt interest income minus any allocated expenses ($24,750) must be subtracted. Assuming the trust distributed this much or more to beneficiaries, it is entitled to a deduction of this amount.]

   c. $194,000. [This answer is incorrect. This is the trust's DNI ($75,000 + $100,000 + $24,750 − $4,000 − 1750), but one more calculation is necessary to determine the trust's taxable DNI.]

   d. $199,750. [This answer is incorrect. This is the business income ($75,000) plus the qualified dividends ($100,000) plus the tax-exempt interest income minus allocated expenses ($24,750). This is the first part of the calculation of DNI. Further calculations are needed to determine the DNI and then the taxable DNI.]

17. Which of the following statements best describes the two tiers of distributions allowed for complex trusts and estates? **(Page 148)**

   a. Income required to be distributed currently is a Tier 2 distribution. [This answer is incorrect. This type of distribution is defined as a Tier 1 distribution. The requirement can come from the trust or estate's governing document or local law.]

   b. Annuities and discretionary distributions of principal are both Tier 1 distributions. [This answer is incorrect. An annuity paid out of principal would be a Tier 1 distribution, but discretionary distributions of principal would be considered Tier 2 distributions.]

   c. DNI is first carried out to Tier 1 distributions; any remaining is carried out to Tier 2 distributions. [This answer is correct. The purpose of defining Tier 1 and Tier 2 distributions is to determine how the taxability of the distributions will be governed. The deduction for a Tier 2 distribution will always be limited to the amount of DNI left after the Tier 1 distributions are accounted for.]

   d. Charitable contribution deductions are called Tier 3 distributions. [This answer is incorrect. Such distributions can be called Tier 1½ distributions. Charitable distributions take precedence over Tier 2 distributions, but they are not deducted from the amount distributed to Tier 1 beneficiaries.]

18. The Larson Testamentary Trust is a complex trust. The trust instrument requires an annual $20,000 income distribution to a specific charity, and allows any remaining income to be distributed to Janine at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2009, the trustee distributes $20,000 to the charity and $30,000 to Janine. The trust also has the following items of income and expense:

Qualified dividends:	$	20,000
Taxable interest:		20,000
Tax-exempt interest:		20,000
Business income:		40,000
Business depreciation expense:		6,000
Other business expenses:		4,000
Trustee fee (allocated to income):		10,000

   Calculate the trust's DNI for 2009. **(Page 148)**

   a. $14,000. [This answer is incorrect. This is the trust's taxable interest after the allocable expenses ($2,000) and allocable charitable deduction ($4,000) are taken into account.]

   b. $60,000. [This answer is correct. The trust has a fiduciary accounting income of $80,000. Once the allocable expenses ($2,000) and the allocable charitable deduction ($4,000) have been subtracted

from the taxable interest (leaving $14,000), the other business expenses, business depreciation expenses, net trustee fee, and net charitable contribution must be subtracted to arrive at the DNI ($94,000 – $4,000 – $6,000 – $8,000 – $16,000 = $60,000).]

c. $80,000. [This answer is incorrect. This amount reflects the trust's fiduciary accounting income.]

d. $94,000. [This answer is incorrect. This is the trust's total income once the allocable expenses and allocable charitable deduction ($2,000 and $4,000, respectively) have been taken into account in regards to the taxable interest.]

19. The Kinch Children's Trust was established by David Kinch to accumulate funds for Arthur and Joshua's college education. The trust agreement also permits the trustee to pay their medical expenses to the extent that they are not covered by insurance. In David's state of residence, paying for college education is not a legal obligation of support, but paying for one's minor children's medical care is. In 2009, Joshua was hospitalized, and $7,000 of expenses not covered by insurance were incurred. These expenses were paid by the trust. Fiduciary accounting income and DNI were both $4,000 for the year. Which of the following will occur in this scenario? **(Page 148)**

a. The trust will always be considered a grantor trust. [This answer is incorrect. The trust will only be considered a grantor trust in 2009. The potential that trust assets could be used in a support obligation does not make the trust a grantor trust into perpetuity. It will only be a grantor trust when assets are actually used for support.]

b. The $4,000 of income will be reported by the trust on Form 1041. [This answer is incorrect. The income will be reported by David on his Form 1040 because it was used by the trust to provide support to his minor children.]

c. David must pay taxes on the entire $7,000 as a support obligation. [This answer is incorrect. David only has to pay taxes on the $4,000 of the medical expenses that are allocated to the current trust income.]

d. $3,000 is considered an "other amount paid or credited" to David. [This answer is correct. This is a Tier 2 distribution under the guidance found in IRC Sec. 661. Because there is no remaining DNI to carry out, the trust receives no distribution deduction for this $3,000, and David is not taxed on it.]

20. Which of the following statements accurately describes estates and trusts? **(Page 148)**

a. Estates and trusts are not allowed to make payments to third parties on behalf of beneficiaries. They can only distribute funds to the beneficiaries themselves. [This answer is incorrect. Sometimes it can be more efficient for an estate or trust to make a payment to a third party on behalf of a beneficiary instead of distributing the income to the beneficiary so he or she can make the payment. For example, often, trusts are used to manage property for beneficiaries that are not capable of personally managing the property.]

b. If an estate or trust maintains a personal residence for a beneficiary and pays expenses related to the residence, the payments are considered income to the beneficiary. [This answer is incorrect. The residence is actually an asset of the trust or estate and the expenses are necessary to maintain the property; therefore, even if the beneficiary received benefit from the property, the payments would not be allocated to him or her as income. Except for interest and taxes, though, the payments will not be deductible by the estate or trust, as the residence does not produce income.]

c. A payment made by an estate or trust for the beneficiary's benefit rather than a required income distribution is considered "other amounts properly paid or credited or required to be distributed" (OAPC). [This answer is correct. When the payment is for the personal benefit of said beneficiary, the payment will be considered OAPC. However, if the trust is required to make income distributions, the payment of personal expenses are treated as part of the required income distribution.]

d. Payments of personal expenses on the behalf of a beneficiary made by a trust will always be considered a Tier 1 income distribution. [This answer is incorrect. If the trust is required to make income distributions, any payments of personal expenses would be part of that Tier 1 distribution. However, payments made to discharge a grantor's obligation of support would be taxed to the grantor.]

The Separate Share Rule for Multiple Beneficiaries

If a single complex trust or an estate has two or more beneficiaries who have substantially separate and independent shares, their shares are treated as separate trusts or estates for the sole purpose of determining the amount of DNI allocable to each beneficiary. When separate shares exist (in either estates or trusts), DNI must be computed separately for each share. Thus, all income, deductions, gains or losses attributable to that share will not be allocated to any other share.

When Separate Shares Exist

Separate shares exist when the governing instrument of the trust of estate and applicable local law create separate economic interests in one beneficiary or class of beneficiaries in such a way that their economic interests neither affect nor are affected by the economic interests of another beneficiary or class of beneficiaries. The rule applies when distributions must be made to the beneficiaries as if each beneficiary had his or her own substantially separate and independent share of the trust or estate. The language of the instrument determines whether the separate share rule applies. A separate share generally exists only if it includes both principal and the income attributable to that principal, and it is independent from any other share. Thus, if the beneficiary is not entitled to income on the principal, separate share treatment will generally not apply.

Separate shares are often found in trusts, which typically provide shares for more than one beneficiary. However, separate shares are often found in estates as well, particularly where each beneficiary is to receive a fraction of the residuary estate. Additionally, a separate share may have more than one beneficiary, and one beneficiary may be a beneficiary of more than one separate share. Furthermore, it does not matter whether the principal or accumulated income of each share is distributed to the beneficiary of that share, to the beneficiary's heirs, or to any other beneficiaries designated to receive his or her share upon termination of the interest, or simply added to the shares of other estate or trust beneficiaries.

Example 1H-1 Separate shares exist for multiple beneficiaries with different amounts of distributable income and/or principal.

Martha creates a trust for the benefit of her two granddaughters, Kelly and Amy, providing that the trust income is to be divided into two equal shares, one for each granddaughter. Each beneficiary's share of the income is to be accumulated until she becomes age 21. Upon becoming age 21, the beneficiary is entitled to either receive her share of the income or have the income accumulated and later distributed to her at the trustee's discretion. The trustee also has discretion to invade principal for the benefit of either Kelly or Amy (or both) to the extent of her share of the trust assets. Upon attaining age 35, each beneficiary is entitled to receive her share of the trust assets. If either Kelly or Amy dies before attaining age 35, her interest is to be distributed to her heirs, or if none, to be allocated entirely to the other beneficiary.

The trust is subject to the separate share rules under IRC Sec. 663(c) since different amounts of income and/or principal are distributable to different beneficiaries, and a distribution to one beneficiary cannot affect the other beneficiary's proportionate share. Thus, the DNI must be calculated separately for Kelly and Amy's shares to determine the amount of the total distribution deduction (i.e., the total of the distributions made to each beneficiary, as limited by her separate share of DNI).

Separate share treatment will not apply if the executor or trustee has the discretionary power to distribute, apportion, or accumulate income or distribute principal among beneficiaries. Nor will the separate share treatment apply if a distribution to one beneficiary can affect the proportionate share of any income, accumulated income, or principal of another beneficiary's share, and no adjustment is required to compensate for such distributions.

Example 1H-2 Separate shares do not exist if income may be distributed to or accumulated for any beneficiary.

Assume the same facts as in Example 1H-1 , except that the trustee has the power to make discretionary distributions of income and principal for Kelly and/or Amy, and these distributions will reduce the proportionate share available to both Kelly and Amy.

The separate share rules do not apply since the trustee has the discretionary power to distribute or accumulate income or distribute principal to Kelly or Amy, and the distribution to one beneficiary will affect the proportionate share of any income, accumulated income, or principal of the other beneficiary's share.

For the separate share rule to apply, it is not required that each beneficiary's share be separately and independently maintained in the accounting records of the trust or estate. No physical segregation of assets is required. However, separate share treatment is mandatory, not elective, and will continue unless an event occurs that, under the terms of the trust instrument or will, causes different treatment to be required (e.g., a beneficiary reaching a certain age).

Purpose of the Separate Share Rule

Under the separate share rule, a beneficiary is taxed only on the amount of income that belongs and is distributed to that beneficiary's separate share, based upon the amount to which that separate share is entitled under the terms of the governing instrument or local law. Without this provision, a beneficiary could be taxed on all the DNI being distributed, which may represent income accumulated for future distribution to another beneficiary. The rule is mandatory where separate shares exist.

Example 1H-3 Consequences of distributions without the separate share rule.

Nancy and Bob are each entitled to receive 50% of an estate created before the separate share rules applied to estates. In the first taxable year, the estate had DNI of $60,000. The executor decided to make a distribution of $100,000 to Nancy on the last day of the taxable year, postponing distributions to Bob until some later time. Because the deduction for distributions is limited to DNI, the estate can only deduct $60,000. The estate income is carried out to Nancy to the extent of total DNI, so that she will include the full $60,000 in her income.

Estate income and principal will ultimately be distributed equally to Nancy and Bob, after taking into account the disproportionate distribution made to Nancy in the first year. However, Nancy will have paid tax on a portion of Bob's share of the estate's income, which Bob will receive tax-free in a later year.

Example 1H-4 Consequences of distributions with the separate share rule.

Assume the same facts as in Example 1H-3, except that the estate was created when the mandatory separate share rules applied to estates. Nancy and Bob have separate shares of DNI of $30,000 each ($60,000 combined DNI × 50%) for the first taxable year. Thus, the estate will only be entitled to a deduction of $30,000 for the distribution made to Nancy, and Nancy need only include $30,000 in her income for the distribution she received. However, tax will be generated at the estate level on the amount of Bob's share of DNI ($30,000) not distributed to him.

Because estate income and principal is to be distributed equally to Nancy and Bob, after taking into account Nancy's larger distribution in the first year, neither will be taxed on more than his or her share of DNI.

Allocating DNI of Separate Shares

The general rule of allocating DNI requires that DNI be allocated to the beneficiaries based on the amount of cash or other property distributions (whether from income or principal). Under the separate share rule, each share of DNI is determined as if it were a separate estate or trust. DNI is allocated to the various beneficiaries according to their respective shares of income, which is based upon their right to fiduciary accounting income according to local law or the governing instrument. To the extent that beneficiaries are entitled to fiduciary accounting income included in DNI, the DNI is to be allocated among them. Distributions in excess of a beneficiary's share of DNI are not deductible by the estate or trust or taxable to the beneficiary. DNI allocated to a beneficiary but not distributed to that beneficiary is taxable to the estate or trust, rather than to the beneficiary. Once the DNI is allocated to each share, the distribution deduction is computed per each share, based on the respective distributions and DNI per share. The deductions per share are then combined into a total distribution deduction for the estate or trust.

Example 1H-5 Application of the separate share rule.

According to the trust document of the Ben Wheeler Family Trust, a "separate share" trust was created and funded at the beginning of 2009 with two equal beneficiaries, Bob and Bill. Each share's income and principal may be distributed to the beneficiary of that share or it may be accumulated for his future benefit. The principal and accumulated income (if any) of each share is to be distributed to that share's beneficiary when the individual reaches age 35.

In 2009, the trust has $100,000 of DNI, requiring $50,000 to be allocated to each share. The trustee distributed $60,000 to Bob and nothing to Bill, charging $50,000 of the distribution to Bob's share of trust income and $10,000 to Bob's share of trust principal.

Since the separate share rule applies, the trust's distribution deduction is limited to $50,000 even though $60,000 was actually distributed in a year the taxable portion of DNI exceeded $60,000. The extra $10,000 is a nontaxable distribution of trust principal to Bob. The trust will owe tax on the undistributed $50,000 of DNI.

Variation: If the trust had not been a "separate share" trust, the entire $60,000 would have been gross income to Bob, and the trust would have had a $60,000 distribution deduction. The remaining $40,000 would have been taxed to the trust, accumulated for the benefit of Bob and Bill, and would not have been specifically earmarked for either beneficiary.

Example 1H-6: Reporting DNI allocable to each separate share.

Assume the same facts as in Example 1H-5 and the application of the separate share rule. A statement, such as the following, is attached to the trust's Form 1041:

Ben Wheeler Family Trust	91-1515155
Form 1041	2009
DNI Allocable to Separate Shares	
Robert Wheeler (534-90-1279)	$ 50,000
William Wheeler (527-39-6426)	0
Income distribution deduction (Sched. B, line 15)	$ 50,000

Separate Share Rule and Charities

Although a charity may have a separate economic interest in the assets of an estate or trust and, in that sense, be considered a *separate share*, the separate share rule of IRC Sec. 663(c) should not apply to charities. Since charities are not allocated DNI [i.e., amounts distributed to them are deductible as charitable contributions under IRC Sec. 642(c) rather than as income distribution deductions under IRC Sec. 661], the separate share rule should not apply to them.

The regulations explaining the separate share rule include one example with a charity as a beneficiary of income during the estate administration. The example illustrates that each noncharitable beneficiary has a separate share together with the charity, rather than the charity having its own separate share.

Disproportionate Distributions

Disproportionate distributions to the separate share beneficiaries can change the relative portions of the separate shares after the distributions are made. Thus, numerous distributions of principal, which are common to estates, may create an accounting nightmare, particularly if they are made throughout the year rather than at once, typically the year-end. In that case, it may be necessary to make interim allocations of DNI to properly adjust the values of the separate shares. However, the fiduciary must use a "reasonable and equitable method" in determining the value of each separate share and the allocation of taxable income to each share. This gives the fiduciary flexibility in applying the separate share rules. The most logical approach, however, would be to either make only proportionate distributions or none until distributions upon termination are made. In the case of a trust, separate trusts should be considered for each of the beneficiaries.

Example 1H-7 Disproportionate distribution may require interim allocation.

Kim died on January 1, 2009, with a gross estate of $2 million. Her will contains a fractional formula bequest bequeathing 60% of her residuary estate to her surviving spouse, Bryan, and 40% to a trust for their children. A calendar year was elected for the estate's taxable year. On August 1, 2009, the executor made a distribution of $400,000 to partially fund the children's trust, but made no payment to Bryan. The estate's DNI was $50,000 in 2009. If the distribution had occurred on December 31, 2009, it would seem most correct to allocate the DNI based upon the 60/40 ratio. However, an interim allocation seems more reasonable and equitable for a funding on August 1. The executor makes the allocation as follows:

	January 1		(after funding) August 1		Weighted Average Percentage
Bryan	$ 1,200,000	60 %	$ 1,200,000	75 %	66.29 %[a]
Children's Trust	800,000	40 %	400,000	25 %	33.71 %[b]
Total	$ 2,000,000	100 %	$ 1,600,000	100 %	
Allocation of DNI ($50,000) to the separate shares as follows:					
Bryan	$ 33,145[c]				
Children's Trust	16,855[d]				

Notes:

[a] $(212 \div 365 \times 60\%) + (153 \div 365 \times 75\%) = 66.29\%$

[b] $(212 \div 365 \times 40\%) + (153 \div 365 \times 25\%) = 33.71\%$

[c] Since no distributions were made to Bryan in 2009, no distribution deduction will be allowed for his share of DNI. Instead, the estate will be subject to income tax on the undistributed DNI ($33,145).

[d] $50,000 × 33.71%.

Special Rules for Separate Shares

The general rule of separate share treatment is that a separate share exists if the economic interest of the beneficiary or class of beneficiaries neither affects nor is affected by the economic interests accruing to another beneficiary or class of beneficiaries. For example, separate shares exist in the following situations: (1) income on bequeathed property if the recipient of the specific bequest is entitled to such income, (2) a surviving spouse's elective share that under local law is entitled to income and appreciation/depreciation, and (3) a qualified revocable trust. In addition to the general rule, the final regulations provide special rules for certain types of shares.

Specific Bequests. A bequest of a specific sum of money or specific property payable in three or fewer installments is not considered a specific share because such bequests do not carry out DNI. However, if the recipient of the specific bequest is entitled to the income on the property, the income on the bequeathed property is a separate share.

Residuary Estate Bequest. The residuary estate, or a portion of the residuary estate, is a separate share if the bequest is entitled to income and to share in appreciation/depreciation under the governing instrument or local law.

Pecuniary Formula Bequest. A pecuniary bequest that can be determined as of the decedent's death (e.g., specific property or sum of money) is considered a specific bequest and is thus excluded from separate share treatment except for any right to income from the bequest. In contrast, a pecuniary formula bequest that is not determinable based on facts known on the decedent's death and is entitled to income *and* to share in appreciation/depreciation under the governing instrument or local law is a separate share. Thus, the share is subject to DNI carryout, limited to the separate share of income.

Under a special rule, a pecuniary formula bequest that is not entitled to income *or* to share in appreciation/depreciation is also considered a separate share if the will or trust instrument does not provide that the bequest is to be paid or credited in more than three installments. However, even though the pecuniary formula bequest is considered a separate share according to this special rule, no DNI is allocated to the share for the funding of the bequest with principal. DNI is only carried out if the bequest is entitled to income or to share in appreciation/depreciation of the assets, and even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI.

The same result would occur if a pecuniary disclaimer (a disclaimer of a specific dollar amount) was made. While not a specific bequest, the disclaimed amount would be considered a separate share since it would not be entitled to any income or to share in any appreciation/depreciation. No DNI would be allocated to the disclaimed amount to the extent it is funded with principal.

If a pecuniary bequest is funded with appreciated assets under a true worth (date of distribution value) funding clause, all gain must be recognized by the estate, rather than being carried out to the beneficiaries.

Example 1H-8 Allocating DNI between a pecuniary bequest and the estate residue.

John Booth's will provides for a bypass trust to be funded with a pecuniary amount to fully use his applicable credit amount. The remainder of his estate is to fund a marital trust for his wife, Beth. The bypass trust is not entitled to income and does not share in any appreciation or depreciation in estate assets. During the year, the estate transfers $3.5 million to the bypass trust but does not make a distribution to the marital trust. Funding the bypass trust generates a $25,000 long-term capital gain. The estate's taxable income is $149,400 ($150,000 DNI − $600 personal exemption), which includes the $25,000 long-term capital gain recognized upon funding the pecuniary bequest.

The estate has two separate shares, one for the bypass share and another for the marital share. Since the bypass share does not share in income, the amount of the DNI allocated to the bypass share is zero. The estate is not entitled to any deduction for the $3.5 million distributed to the bypass share, since it is a pecuniary bequest. Although the estate has DNI of $150,000, nothing is allocated to the marital share, since it did not receive any distributions during the current year. The estate must pay taxes on the entire $149,400 of taxable income.

If the estate's taxable income had included pass-through income from an S corporation or partnership, the result would have been the same, since no income is allocated to the pecuniary bequest. However, the result would have been different if the separate shares of the pecuniary bequest had been funded with IRD (see Example 1H-10, below).

<u>Fractional Formula Bequest.</u> A fractional formula bequest that divides the residuary estate is subject to the separate share rules.

Example 1H-9 Allocating DNI based on a fractional formula.

Joan Curry's will divides her estate between a bypass trust and an outright gift to her husband based on a fractional formula. Under the fractional formula, Joan's husband's share is 60% of the estate, and the bypass trust is to receive 40% of the estate. During the current year, the estate distributed $5 million ($3 million to Joan's husband and $2 million to the bypass trust). DNI for the year was $100,000, comprised of $240,000 of taxable interest and $140,000 of deductions. Since the gift to Joan's husband and the bypass trust are separate shares, the estate must allocate $60,000 of the DNI ($100,000 × 60%) to Joan's husband and $40,000 of the DNI ($100,000 × 40%) to the bypass trust. Since distributions to each share exceed the DNI allocated to that share, the estate will have zero taxable income, and the spouse and bypass trust will have income of $60,000 and $40,000, respectively.

Allocating Non-cash Income among Separate Shares. The portion of gross income includible in DNI that is not attributable to cash received by the estate (e.g., original issue discount, a distributive share of partnership tax items and the pro rata share of an S corporation's tax items) is allocated among the separate shares according to the amount of accounting income that each share is entitled to receive from that source.

Allocating IRD among Separate Shares. Income in respect of a decedent is allocated among the separate shares that could potentially be funded with these amounts, regardless of whether a share is entitled to receive any income under the terms of the governing instrument or local law. The amount allocated to each share is based upon the relative value of each of the shares that could potentially be funded with such amounts.

Example 1H-10 Pecuniary formula bequest not required to, but could potentially, be funded with IRD.

Donald dies in 2009, survived by his wife, Rita, and their daughter, Mandie. Donald's will provides for a pecuniary formula bequest to be paid to a trust for Mandie's benefit in the largest amount that can pass free of federal estate taxes and a bequest of the residuary to Rita. The date of death value of the estate after payment of debts and expenses is $3.9 million. The estate was the designated beneficiary of Donald's IRA, and in 2009, the estate received a distribution of $500,000 from the IRA, which is included in the estate's gross income as IRD, under IRC Sec. 691(a). The entire $500,000 is allocated to principal according to local law.

The estate has two separate shares consisting of a pecuniary formula bequest to the bypass trust valued at $3.5 million and a residuary bequest to Rita, valued at $400,000. Both the separate share for Mandie's trust and the separate share for Rita may potentially be funded with the IRA proceeds. Thus, a portion of the $500,000 gross income must be allocated to each separate share. The amount allocated must be based upon the relative values of the two separate shares using a reasonable and equitable method. The executor allocates $448,718 to the trust for Mandie's benefit [$500,000 × ($3.5 million ÷ $3.9 million)] and $51,282 to Rita [$500,000 × ($400,000 ÷ $3.9 million)].

To the extent that DNI is allocated and distributions are made to the trust and/or Rita, the estate is entitled to a distribution deduction, and the distributee must include this amount in income for 2009.

Example 1H-11 Fractional share funding with requirement to be funded first with IRD.

Assume the same facts as in Example 1H-10, except that Donald's will bequeaths his entire residuary estate to his two nephews, Huey and Dewey. According to the will, the executor is to fund Huey's share first with the proceeds of Donald's IRA.

The estate has two separate shares, one for the benefit of Huey and one for Dewey's benefit. If any distributions are made to either Huey or Dewey during the taxable year, the entire $500,000 of IRD must be allocated to Huey's share when determining the DNI for each separate share.

To the extent that DNI is allocated and distributions are made to each share, the estate is entitled to a distribution deduction and the distributee must include this amount in income for 2009.

Application to Electing Revocable Trusts. A revocable trust electing under IRC Sec. 645 to be treated as part of the estate is always a separate share of the estate and may itself contain two or more separate shares. Therefore, if the estate or qualified revocable trust makes a distribution during the year, the DNI of the distributing share must be allocated separately to that share. Additionally, if the distributing estate or trust share has separate and independent shares, its DNI must be further allocated among such shares. According to the Preamble to the separate share regulations, a qualifying revocable trust is subject to the estate separate share rule even if the Section 645 election is not made.

A separate share making a distribution to another share must calculate its distribution deduction without reducing it by the amount of income excluded from gross income under IRC Sec. 661(c), e.g., net tax-exempt interest income. The share receiving the distribution must increase its gross income by the same amount when calculating DNI. The distribution will have the same character in the hands of the recipient share as in the hands of the distributing share.

Example 1H-12 Allocating DNI between the estate and an electing trust.

During his life, Sam Chambers created a revocable trust but failed to transfer all of his assets to the trust before his death. Sam had a pourover will requiring all of his probate estate to be transferred to his trust. The estate and trust elected to be a combined estate under IRC Sec. 645. During the year following Sam's death, the assets in his probate estate generated taxable interest income of $15,000, $10,000 of tax-exempt interest (TEI), and $5,000 of deductions. The estate distributed $20,000 to the trust, which had $25,000 of taxable interest income and $5,000 of deductions before receiving the distribution from the estate. The trust had one beneficiary, Nancy, who received $50,000 from the trust.

The estate's DNI for the year is $20,000 [$15,000 interest income − $3,000 deductions ($5,000 deductions reduced by the portion allocable to TEI) + $8,000 adjusted tax-exempt interest ($10,000 reduced by allocable deductions). The estate's income distribution deduction of $20,000 to the trust reduces its taxable income to zero.

After the estate's distribution, the trust has taxable interest income of $40,000 [the amount from the estate ($15,000) and trust ($25,000)], TEI of $10,000 (from the estate), and $10,000 of combined estate and trust expenses. The trust's taxable income before the distribution deduction and personal exemption is $32,000 [$40,000 taxable interest income − $8,000 ($10,000 deductions reduced by the portion allocable to tax-exempt interest income)]. The trust's DNI is $40,000 ($32,000 + $8,000 adjusted tax-exempt interest) and its distribution deduction is $32,000, which is reported on the Schedule K-1 for Nancy, in addition to the $8,000 of net tax-exempt interest.

Since the character of the estate distribution to the trust is determined at the estate level, the trust must allocate a portion of its expenses to tax-exempt income. This is consistent with the combined estate concept, in which adjusted total income is computed on an aggregate basis, but DNI is allocated between the shares. The combined estate will have gross income of $50,000 and tax-deductible expenses of $8,000. Expenses of $2,000 must be allocated to tax-exempt interest, using the gross income method to determine the allocation of expenses between taxable and tax-exempt income.

<u>Application to Spousal Elective Shares.</u> The separate share rule may apply to a spouse who exercises his/her elective share allowed by local law (because he or she is disinherited or dissatisfied with the will bequest or other inheritance). A spouse's elective share is a separate share of the estate for the sole purpose of determining the amount of DNI in applying IRC Secs. 661(a) and 662(a) if the surviving spouse's elective share is entitled, under local law, to income and appreciation/depreciation. Thus, the amount of DNI carried out to the surviving spouse will be limited to that share's income under state law. Further, under a special rule, a surviving spouse's elective share that is determined under local law as of the date of the decedent's death is also treated as a separate share, even though it is not entitled to income or any appreciation/depreciation. However, if the elective share is not entitled to income, distributions do not carry out DNI to the surviving spouse. Instead, the estate must bear any tax liability for the DNI not allocated and distributed to the other beneficiaries' shares.

An elective share entitled to interest only (rather than to income or appreciation/depreciation) is subject to the separate share rules. However, the elective share does not carry out DNI (because its share of DNI is zero) and the interest payment is considered nondeductible personal interest.

Electing to Treat Distributions Paid or Credited within the First 65 Days as Made in the Prior Year

General Rule

Any amount properly paid or credited to a beneficiary within the first 65 days following the close of the tax year of an estate or complex trust is considered paid or credited on the last day of the immediately prior tax year, if the fiduciary elects such treatment in accordance with the regulations. Any amount considered under IRC Sec. 663(b) as having been distributed in the immediately prior tax year shall be so treated for all purposes.

Although there can be little doubt as to whether an amount has been properly paid to a beneficiary within 65 days of the prior tax year-end, the regulations are unclear as to what it means to be "properly credited." The Tax Court held that a distribution was treated as "properly credited" even though the actual payment had not been made within the 65-day period. In that case, the executor had instructed the estate's accountants to credit the earnings to the beneficiaries, there was enough cash available to make the distribution, and the distribution was allowable under local law.

The Maximum Election Amount

The maximum amount covered by the election is limited to the greater of fiduciary accounting income or DNI for the immediately prior tax year, reduced by any amounts paid, credited, or required to be distributed in such tax year, other than any amounts considered paid or credited to the tax year preceding the tax year in question by reason of a prior Section 663(b) election.

Flexibility and Planning Opportunity

The fiduciary may designate some or all of the distributions made in the first 65 days of the tax year as covered by the election, limited to the greater of fiduciary accounting income or DNI of the immediately prior tax year, as discussed previously. Administratively, this provision allows a fiduciary to determine the income of the estate or complex trust for the year just ended, while there is still time to make distributions that can be treated as having been made at the end of that year. The election may also present an opportunity to minimize the combined income tax burden of the trust or estate and the beneficiaries.

Example 1I-1 The 65-day election.

On February 10, 2010, the preparer completes the 2009 Form 1041 for a calendar-year complex trust that had $100,000 of fiduciary accounting income and $95,000 of DNI. The workpapers indicate the trustee paid $50,000 to the beneficiary, Al, on January 31, 2009, and $60,000 on July 31, 2009. A copy of the prior year Form 1041 indicates a valid Section 663(b) election treating the $50,000 distribution as paid on December 31, 2008. A handwritten memo in the 2009 trust records indicates a distribution of $45,000 on January 31, 2010.

The maximum amount available for the Section 663(b) election on the 2009 Form 1041 is $40,000 ($100,000 fiduciary accounting income less the $60,000 distribution on July 31, 2009). The $50,000 distribution on January 31, 2009 does not reduce the maximum amount to which the 2009 election may apply because that amount was properly treated on the 2008 Form 1041 as distributed on December 31, 2008.

Since $5,000 in excess of the $40,000 maximum potential 2009 Section 663(b) election has already been distributed within the first 65 days of 2010, there is no reason to consider making another distribution before the end of the 65-day window. The question is how much, if any, of the $40,000 maximum should be designated as a Section 663(b) election for 2009. This decision may be made as late as the due date (including extensions) of the Form 1041 for 2009.

Distribution Deduction for Tax-exempt Income

Limiting the Distribution Deduction

The income distribution deduction for estates and trusts, and the amount of distributions taxable to beneficiaries, are limited to the amount of the fiduciary's distributable net income (DNI) for a particular year. For purposes of the distribution deduction, DNI is computed only with items of income and allocable deductions included in the entity's gross income for tax purposes.

Example 1J-1 Effect of tax-exempt DNI on distribution deduction.

The preparer of a Form 1041 for 2009 determines that DNI consists of $50,000 of taxable interest income and $30,000 of tax-exempt interest income. The individual trustee did not charge a fee and there are no other trust expenses. The trustee distributed $80,000 to the beneficiary in 2009.

The distribution deduction for 2009 is limited to $50,000, the taxable portion of DNI, even though $80,000 of trust income was distributed. Since the $30,000 of tax-exempt interest was not included in the fiduciary's taxable income, it is not included in distributable net income, for purposes of the limitation on the distribution deduction.

No Deduction for Expenses Directly Related to Tax-exempt Income

No deduction is allowed for expenses directly attributable to tax-exempt income. If a fiduciary has both taxable and tax-exempt income, and the only expenses relate directly to the taxable income, all the expenses are fully deductible. Conversely, if the only expenses relate directly to tax-exempt income, none of the expenses are deductible.

Mandatory Allocation of Indirect Expenses

When an expense is indirectly attributable to both taxable and tax-exempt income, the fiduciary must make an allocation of the expense to ensure an appropriate portion is not deducted. The allocation must be "reasonable" in light of all the facts and circumstances. The regulations often use a proration based upon total income, but this method of allocating indirect expenses to tax-exempt income is not required. When making the allocation of indirect expenses, no part of the deductions would be allocable to amounts not included in DNI (e.g., capital gains allocated to principal).

Example 1J-2 Allocating indirect expenses to tax-exempt income.

In 2009, the Ames Family Trust, a simple trust, had $25,000 of taxable interest income, $5,000 in fiduciary fees allocable to income for fiduciary accounting purposes, and no other income or expenses. Gross income is therefore $25,000. DNI and trust accounting income equal $20,000. The trust's distribution deduction also is $20,000, and the beneficiary must include $20,000 in taxable income.

If half the $5,000 of fiduciary fees had been allocable to principal under state law, fiduciary accounting income would increase to $22,500, the cash distribution would increase to $22,500, but DNI (and the distribution deduction) would remain $20,000, as would the amount included in the beneficiary's gross income.

In 2009, the Jones Family Trust is an identical trust, except that in this case the trust's $25,000 of interest income is composed of $15,000 of taxable interest income and $10,000 of tax-exempt interest income. A reasonable proration of the fiduciary fee must be made to tax-exempt income. An examination of the trust records reveals that none of the $5,000 fiduciary fees is directly related to either component of the interest income. Thus, the fees are entirely indirect expenses. The preparer determines that $2,000 ($10,000 ÷ $25,000 × $5,000) of the $5,000 fiduciary fees should be allocated to the tax-exempt interest income.

Taxable DNI for the Jones Family Trust equals $12,000 ($15,000 of taxable interest, less $3,000 of deductible trustee expenses). The tax-exempt component of DNI equals $8,000 ($10,000 of tax-exempt income less $2,000 of indirect expense allocable to tax-exempt income). Therefore, even though DNI and fiduciary accounting income both are $20,000, and the cash distributed to the beneficiary is $20,000, the distribution deduction and the amount the beneficiary includes in gross income is $12,000, the taxable portion of DNI ($8,000 of the distribution being tax exempt).

Charitable Contribution Deduction Reduced by Portion Deemed Paid from Tax-exempt Income

When a fiduciary makes a charitable contribution, the portion of the contribution deemed paid from tax-exempt income is not deductible. See the "Distribution Deduction for Estates and Complex Trusts" section of this lesson for an example and illustration of the reporting implications when the entity has tax-exempt income and a charitable contribution in the same year.

Interest Expense in Connection with Tax-exempt Income

A deduction for interest expense is disallowed for debt "incurred or continued to purchase or carry" municipal bonds or other investments for which the income is exempt from tax.

Example 1J-3 Interest expense allocable to tax-exempt interest income.

The preparer of a 2009 Form 1041 for a simple trust reviews the trust records provided by the fiduciary, a close friend of the grantor who does not take a trustee fee. The trust document reveals the settlor has granted the fiduciary unusually broad discretion to manage the trust's investments.

The preparer determines the trust received only two types of income in 2009: $70,000 in cash dividend on ABC growth stock and $30,000 in tax-exempt interest income from long-term municipal bonds. A call from the trustee to confirm the preparer had received the tax data also reveals the trustee's belief that the long-term municipal bond market rate will fall during 2009, producing a handsome capital gain for the trust when the bonds are sold (as the trustee projects) around the end of 2010.

The trust's only expense for 2009 was $28,000 in interest. The trustee was able to borrow the entire amount necessary to purchase the municipal bonds by pledging the bonds and the ABC stock as collateral for an interest-only, two-year loan with a balloon payment due in January 2011.

Since the proceeds from the loan can be traced directly to the funds used to purchase the bonds, and the bonds are the primary collateral for the loan, it is clear to the preparer that the entire interest expense of $28,000 was used to "purchase or carry" the bonds and is therefore not deductible as investment interest expense.

DNI and fiduciary accounting income both equal $72,000 ($100,000 − $28,000), and $72,000 was distributed to the income beneficiary. The beneficiary of this simple trust will include $70,000 in his or her gross income from the trust, classified as dividend income, in addition to $2,000 of tax-exempt interest income ($30,000 − $28,000). The trust will have no taxable income after the distribution deduction.

"Phantom" Taxable Income

Unless otherwise provided in Subchapter J of the Internal Revenue Code, estates and trusts compute taxable income in the same manner as individuals. However, Congress routinely fails to consider the effects of individual tax law revisions on the income taxation of fiduciaries, which can produce unpleasant surprises for clients.

When the creator of an estate or trust directs all income to be distributed currently to beneficiaries, "income" is fiduciary accounting income, which may be quite different from taxable income. To compute fiduciary accounting income, receipts and disbursements are classified as "income" or "principal" transactions in accordance with the wishes of the creator, as expressed in the governing instrument. Without explicit directions in the governing instrument, a Principal and Income Act or other legislation adopted by the state will govern the classification.

Deductions for Fiduciary Accounting Income May Differ for Taxable Income

Fiduciary accounting income may be reduced by certain expenses or losses charged against income for accounting purposes but not currently deductible (i.e., do not reduce DNI) for tax purposes. As a result, the amount of income required to be distributed currently and the income distribution deduction are reduced by these items, but taxable income is not reduced, causing the entity to incur tax even though the creator directed all income to be distributed currently. This effectively causes the remainder beneficiaries to bear the tax burden for the "phantom" income they never received. New York law allows trustees to make a discretionary adjustment, referred to as the "Holloway adjustment" that will reduce fiduciary accounting income and reimburse principal (on behalf of the remainder beneficiaries) for the income taxes paid. If the adjustment is required by state law when the governing instrument is silent, the trust's current fiduciary accounting income is reduced for the amount of the adjustment.

Some of the items that can reduce fiduciary accounting income but not DNI include the following:

1. Losses suspended at the fiduciary level under the passive activity loss rules, if such losses are charged against fiduciary accounting income under the terms of the governing instrument or applicable local law.

2. Expenses subject to the 2% of AGI floor at the fiduciary level.

3. Interest expense subject to the investment interest limitation at the fiduciary level.

4. Interest expense, such as that paid to the IRS on income tax deficiencies, that is nondeductible interest at the fiduciary level.

5. The addition to the accounting reserve for depletion under the original or revised Uniform Principal and Income Acts in excess of depletion allowed for tax purposes.

6. The addition to the accounting reserve for depreciation in excess of tax depreciation.

Example 1K-1 Rental loss creates phantom taxable income.

The trust agreement for the Merle Jones Family Trust requires a reserve for depreciation to be maintained. Additions to the reserve are to equal depreciation computed for tax purposes. All trust income is to be distributed currently. In 2009, the trust received $20,000 in taxable interest income and $6,000 of rental income. The trust incurred $5,000 of direct rental expenses, and the addition to the depreciation reserve was $4,000. Rental losses are charged against income under the terms of the trust agreement.

Fiduciary accounting income is computed as follows:

Interest income	$ 20,000
Rental income	6,000
Rental expenses	(5,000)
Addition to depreciation reserve	(4,000)
Trust accounting income	$ 17,000

Since all income is required to be distributed currently, the trustee distributed $17,000. However, the passive loss rules cause the net rental loss to be suspended at the trust level for tax purposes. DNI is therefore $20,000, since none of the $3,000 rental loss is currently deductible.

The distribution deduction for a simple trust is the amount of income required to be distributed currently, which is the $17,000 of fiduciary accounting income. The trust will be taxed on the remaining $3,000 of DNI (less the $300 personal exemption). This excess of DNI over accounting income is sometimes referred to as "phantom income."

Potentially Caused by Pass-through Income

A trust or estate that owns an interest in a partnership or S corporation (i.e., a pass-through entity) reports taxable income for the fiduciary's share of partnership or S corporation income reported on the pass-through entity's Schedule K-1. However, fiduciary accounting income is generally based upon distributions from the partnership or S corporation. Since the distributions from these entities usually do not equal the taxable income passed through to the owners, "phantom" income is created for the fiduciary if the taxable income reported on Schedule K-1 exceeds the actual distributions from the pass-through entity.

Reporting on the Generation-skipping Transfer Tax

Generation-skipping Transfers (GSTs)

The GST tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor and on transfers involving trusts having beneficiaries in more than one generation below that of the transferor. The GST tax applies to the following types of transfers: direct skips, taxable distributions, and taxable terminations. This lesson discusses taxable distributions from a trust.

The trustee of any trust that makes a taxable distribution, as defined in the next paragraph, is required to file Form 706-GS(D-1) to report the distribution to the distributee and the IRS. The distributee, who is liable for the tax, uses the information to compute the GST tax due on the distribution.

Taxable Distribution

A *taxable distribution* is any distribution of income or principal (other than a taxable termination or a direct skip) from a trust to a skip person. Generally, skip persons are individuals who are two or more generations below the transferor.

A trust can be a skip person in two instances. First, a trust can be a skip person if all interests in the trust are held by skip persons. A trust can also be a skip person if (1) no person holds an interest in the trust, and (2) at no time after the transfer may a distribution (including distributions on termination) be made to a nonskip person.

The amount of the taxable distribution is the value of the property received by the transferee (recipient) reduced by any expense incurred by the recipient in connection with the determination, collection, or refund of the GST tax imposed on the distribution.

The recipient of a distribution is liable for the GST tax on includable taxable distributions. If the trust pays any of the GST tax, the tax payment is treated as an additional taxable distribution. The trustee is required to report the inclusion ratio of the taxable distribution, as explained below.

Inclusion Ratio

The *inclusion ratio* is defined as one minus the *applicable fraction*. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust. (For 2009, each transferor is allowed a $3.5 million lifetime exemption, which is the same as the estate tax exclusion amount.) The denominator of the applicable fraction is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax recovered from the trust attributable to the transfer, and (2) the gift or estate tax charitable deduction, if any, allowed for the property. When computing the inclusion ratio, the applicable fraction must be rounded to the nearest one-thousandth (.001) before subtracting it from one.

Example 1L-1 Determining the inclusion ratio.

In 2009, Harold White transferred property worth $5 million to a newly created irrevocable trust for the benefit of his grandson, Hal. Harold allocated the full $3.5 million GST tax exemption to the trust. The applicable fraction is $3.5 million/$5 million, or .7. The inclusion ratio is .3 (1 − .7). Thus, 30% of any taxable distribution from the trust is subject to the GST tax.

Notification of a Distribution from a Generation-skipping Transfer Trust

The trustee of any trust that makes a GST taxable distribution is required to file Form 706-GS(D-1) to report the distribution to the recipient and the IRS. Form 706-GS(D-1) is an information return that provides the recipient with the amount of the taxable distribution and the inclusion ratio of the trust. The recipient, who is liable for the tax, uses the information to compute the GST tax due on the distribution. The recipient of a taxable distribution from a trust must file Form 706-GS(D) to report the distribution and compute the GST tax payable. The return must be filed on or before April 15 following the calendar year when the distributions were made (or later, by filing for an extension of time on Form 7004). However, distributions with an inclusion ratio of zero do not have to be reported on Form 706-GS(D).

Filing Requirement. The trustee is required to file Form 706-GS(D-1) for each skip person that received a taxable distribution during the year. This form must be filed even if the inclusion ratio applicable to the distribution is zero.

Due Date. The trustee must file Form 706-GS(D-1), Copy A, with the IRS and send Copy B to the distributee on or before April 15 of the year following the calendar year in which the distribution was made. There is no provision for obtaining an extension of time to file Form 706-GS(D-1).

Filing Location. Copy A of Form 706-GS(D-1) should be filed with the Internal Revenue Service Center, Cincinnati, OH, 45999.

Example 1L-2 Reporting taxable distributions to the distributee.

In 2003, Ted Dancer transferred $300,000 to an irrevocable trust for the benefit of his son, Bob. Pursuant to the trust agreement, the trustee is required to pay all of the trust's income annually to Bob for life. The trustee also has the power to invade principal for the benefit of Bob's son, Ken (Ted's grandson) for his health, education, maintenance, or support. At Bob's death, the balance in the trust will be distributed to Ken. At the time of the transfer to the trust, Ted allocated $200,000 of his GST tax exemption to the trust. Thus, the trust's inclusion ratio is .333 [1 − ($200,000 ÷ $300,000)]. On May 8, 2009, the trustee distributed $7,500 to Ken to cover his living expenses. The trustee distributed an additional $1,500 on December 15 to cover the GST tax on the May 8 transfer.

Partial Terminations of a Trust

If a property interest (e.g., an income interest) in a trust terminates because of the death of a lineal descendant of the transferor, and a specified portion of the trust's assets are distributed to at least one skip person (or at least one trust for the exclusive benefit of a skip person), the distribution is considered a *taxable termination*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Larry and Joe are the beneficiaries of the Louisa Mae Estate. They each are entitled to 50% of the estate, and the separate share rule applies. In the first year, the estate has $50,000 of DNI. The executor decides to distribute $75,000 to Larry and postpone distributions to Joe until the next year. What are the resulting tax consequences?

    a. The estate is entitled to a $75,000 deduction.

    b. Larry includes $50,000 in his net income.

    c. Joe will receive his portion tax-free.

    d. Larry and the estate must each pay tax on $25,000.

22. Which of the following qualifies as a separate share?

    a. A charitable donation.

    b. Disproportionate distributions.

    c. A specific bequest.

    d. A pecuniary bequest determined as of the decedent's death.

23. Upon Robert's death, his wife, Martha, finds that she has been disinherited under the terms of Robert's most recent will. Martha invokes her spousal elective share. Under local law, the spousal elective share is interest only. Which of the following is true about Martha's inheritance?

    a. Martha's portion of the estate does not qualify as a separate share.

    b. Martha's share is considered a separate share but does not carry out DNI.

    c. The amount of Martha's DNI is equal to that distributed to the other beneficiaries.

    d. Martha's spousal elective share may contain two or more separate shares.

24. If an estate elects to use the 65-day rule, which of the following applies?

    a. Funds must be received by the beneficiary for the distribution to qualify.

    b. An amount under this election is considered made in the prior tax year for all purposes.

    c. The election is limited to the estate's amount of fiduciary accounting income.

    d. If the election is made, all distributions made by the estate will be affected.

25. The Jefferson Family Trust has $25,000 of taxable interest income and $15,000 of tax-exempt interest income. The trust has $8,000 in fiduciary fees, which are determined to be indirect expenses. The trust distributes all of the current income to the beneficiary. Calculate the distribution deduction for the trust using a reasonable method for allocating the indirect expenses.

    a. $12,000.

    b. $17,000.

c. $20,000.

d. $32,000.

26. Which of the following items will reduce fiduciary accounting income but not DNI, thus, creating "phantom" income for the beneficiaries?

    a. All losses subject to the passive activity loss rules.

    b. All interest expenses that are considered nondeductible interest.

    c. All interest expenses that are subject to the investment interest limitation.

    d. An addition to the accounting reserve for depreciation in excess of tax depreciation.

27. In the context of the generation-skipping transfer (GST) tax, define *taxable distribution*

    a. One minus the applicable fraction (numerator: a trust's allotted amount of the GST tax exemption; denominator: the value of the transferred property with certain reductions).

    b. A trust's property interest terminates because of the death of a lineal descendent of the transferor and a specified portion of the estate transfers to a skip person.

    c. Any distribution of income or principal from a trust to a skip person (other than a taxable termination or a direct skip).

    d. "Proper" payments of income that are not required to be distributed currently and both discretionary and required distributions of principal.

28. Jeff transfers $500,000 into an irrevocable trust for the benefit of his son, Steve, in 2007. Under the trust agreement, the trustee is required to pay all of the trust's income to Steve in annual distributions for life. The trustee is also given the power to invade principal for the benefit of Steve's daughter, Bailey, if funds are needed for her health, education, maintenance, or support. At Steve's death, the balance in the trust will be distributed to Bailey. At the time of Jeff's transfer to the trust, he allocated $300,000 of his GST tax exemption to the trust. In 2009, the trustee distributes $10,000 to Bailey to pay for medical expenses that were not covered by insurance. What amount of this distribution is subject to the GST tax?

    a. $0.

    b. $4,000.

    c. $6,000.

    d. $9,800.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Larry and Joe are the beneficiaries of the Louisa Mae Estate. They each are entitled to 50% of the estate, and the separate share rule applies. In the first year, the estate has $50,000 of DNI. The executor decides to distribute $75,000 to Larry and postpone distributions to Joe until the next year. What are the resulting tax consequences? **(Page 160)**

    a. The estate is entitled to a $75,000 deduction. [This answer is incorrect. The distribution deduction is limited to DNI. Under the separate share rule, DNI must be calculated separately for each beneficiary.]

    b. Larry includes $50,000 in his net income. [This answer is incorrect. This would be true if the estate was not subject to the separate share rule.]

    c. Joe will receive his portion tax-free. [This answer is incorrect. If the estate was not subject to the separate share rule, Joe would receive his portion tax-free in the next year because Larry would be liable for the taxes currently on the entire distribution.]

    d. Larry and the estate must each pay tax on $25,000. [This answer is correct. Under the separate share rules, Larry will incur tax on $25,000 and the estate will incur tax on the $25,000 not distributed.]

22. Which of the following qualifies as a separate share? **(Page 160)**

    a. A charitable donation. [This answer is incorrect. Charities are not allocated any DNI; thus, the separate share rule does not apply to charitable donations.]

    b. Disproportionate distributions. [This answer is correct. Though disproportionate distributions can be problematic to account for, beneficiaries that receive them can still qualify as separate shares. The fiduciary must use a "reasonable and equitable method" to determine the value of each share and the allocations of income to each.]

    c. A specific bequest. [This answer is incorrect. The bequest of a specific property or a specific sum of money that is payable in three installments or less does not carry out DNI and, therefore, is not considered a separate share.]

    d. A pecuniary bequest determined as of the decedent's death. [This answer is incorrect. This type of pecuniary bequest is not a separate share, but one that is not determinable based on all the facts known at the decedent's death could be a separate share, if it is entitled to income and a share of appreciation/depreciation.]

23. Upon Robert's death, his wife, Martha, finds that she has been disinherited under the terms of Robert's most recent will. Martha invokes her spousal elective share. Under local law, the spousal elective share is interest only. Which of the following is true about Martha's inheritance? **(Page 160)**

    a. Martha's portion of the estate does not qualify as a separate share. [This answer is incorrect. Martha's spousal elective share will be subject to the separate share rules in this situation.]

    b. Martha's share is considered a separate share but does not carry out DNI. [This answer is correct. Because it is entitled to neither income nor appreciation/deprecation, Martha's spousal elective share does not carry out DNI. The initial payment of the share is considered nondeductible personal interest.]

    c. The amount of Martha's DNI is equal to that distributed to the other beneficiaries. [This answer is incorrect. Martha's share's portion of DNI is zero.]

    d. Martha's spousal elective share may contain two or more separate shares. [This answer is incorrect. This is true of a revocable trust that elects to be treated as part of the estate, not a spousal elective share.]

24. If an estate elects to use the 65-day rule, which of the following applies? **(Page 166)**

    a. Funds must be received by the beneficiary for the distribution to qualify. [This answer is incorrect. Funds must only be "properly credited" by the 65-day time limit to be considered made in the prior tax year under the election. Funds do not necessarily need to have been received by the beneficiary.]

    b. An amount under this election is considered made in the prior tax year for all purposes. [This answer is correct. Under IRC Sec. 663(b), the amount elected to be treated as if in the prior tax year will be treated as such for all purposes.]

    c. The election is limited to the estate's amount of fiduciary accounting income. [This answer is incorrect. The maximum amount of the election is limited to the greater of the estate's fiduciary accounting income or DNI reduced by amounts that were paid, credited, or required to be distributed during the tax year.]

    d. If the election is made, all distributions made by the estate will be affected. [This answer is incorrect. Either some or all of the distributions made in the first 65 days of the tax year can be designated as covered by the election by the estate.]

25. The Jefferson Family Trust has $25,000 of taxable interest income and $15,000 of tax-exempt interest income. The trust has $8,000 in fiduciary fees, which are determined to be indirect expenses. The trust distributes all of the current income to the beneficiary. Calculate the distribution deduction for the trust using a reasonable method for allocating the indirect expenses. **(Page 167)**

    a. $12,000. [This answer is incorrect. This is the tax-exempt portion of DNI (the tax-exempt interest income, $15,000, minus a portion of the indirect fees determined by a reasonable method, $3,000).]

    b. $17,000. [This answer is incorrect. To get this result, all of the indirect fees were allocated to the taxable portion of DNI ($20,000). This is not a reasonable method of allocating the indirect fees—some of the fees must also be allocated to the tax-exempt interest income.]

    c. $20,000. [This answer is correct. The portion of the fiduciary fees allocated to taxable income as an indirect expense is $5,000 using the following method: $8,000 − ($15,000/$40,000 × $8,000). Therefore, the trust's distribution deduction is $20,000, which is the taxable portion of DNI minus the taxable portion of the fees ($25,000 − $5,000).]

    d. $32,000. [This answer is incorrect. This is the entire available DNI amount ($40,000 − $8,000), but the tax-exempt must be taken into account to determine the trust's distribution deduction.]

26. Which of the following items will reduce fiduciary accounting income but not DNI, thus, creating "phantom" income for the beneficiaries? **(Page 169)**

    a. All losses subject to the passive activity loss rules. [This answer is incorrect. Losses that are suspended at the fiduciary level under the passive activity loss rules will reduce fiduciary accounting income without reducing DNI. This can occur if the losses are charged against the fiduciary accounting income under the terms of local law or the fiduciary's governing instrument.]

    b. All interest expenses that are considered nondeductible interest. [This answer is incorrect. Only nondeductible interest expenses at the fiduciary level will reduce fiduciary accounting income without reducing DNI. An example of such expenses is a payment to the IRS on income tax deficiencies.]

    c. All interest expenses that are subject to the investment interest limitation. [This answer is incorrect. Only such expenses at the fiduciary level will reduce fiduciary accounting income without reducing DNI. Another item that is a concern in this area is expenses that are subject to the 2% of AGI floor at the fiduciary level.]

    d. An addition to the accounting reserve for depreciation in excess of tax depreciation. [This answer is correct. Another item that can reduce fiduciary income without reducing DNI is an addition to the accounting reserve for depreciation under the Uniform Principal and Income Acts (new or revised) in excess of depreciation allowed for tax purposes.]

27. In the context of the generation-skipping transfer (GST) tax, define *taxable distribution*. **(Page 171)**

    a. One minus the applicable fraction (numerator: a trust's allotted amount of the GST tax exemption; denominator: the value of the transferred property with certain reductions). [This answer is incorrect. In the context of the GST tax, this is the definition of the *inclusion ratio*. Trustees are required to report the inclusion ratio of a taxable distribution.]

    b. A trust's property interest terminates because of the death of a lineal descendent of the transferor and a specified portion of the estate transfers to a skip person. [This answer is incorrect. This is the definition of a *taxable termination*.]

    c. Any distribution of income or principal from a trust to a skip person (other than a taxable termination or a direct skip). [This answer is correct. Generally, a skip person is an individual that is two or more generations below the transferor. In two instances, a trust can be a skip person.]

    d. "Proper" payments of income that are not required to be distributed currently and both discretionary and required distributions of principal. [This answer is incorrect. This is the definition of a *Tier 2 distribution*, which can be made by an estate or a complex trust.]

28. Jeff transfers $500,000 into an irrevocable trust for the benefit of his son, Steve, in 2007. Under the trust agreement, the trustee is required to pay all of the trust's income to Steve in annual distributions for life. The trustee is also given the power to invade principal for the benefit of Steve's daughter, Bailey, if funds are needed for her health, education, maintenance, or support. At Steve's death, the balance in the trust will be distributed to Bailey. At the time of Jeff's transfer to the trust, he allocated $300,000 of his GST tax exemption to the trust. In 2009, the trustee distributes $10,000 to Bailey to pay for medical expenses that were not covered by insurance. What amount of this distribution is subject to the GST tax? **(171)**

    a. $0. [This answer is incorrect. It is possible that the inclusion ratio for a generation-skipping distribution will be zero, but that is not the case in this scenario.]

    b. $4,000. [This answer is correct. The trust's inclusion ratio is .4 {1 − (300/500)}, which means 40% of the $10,000 distribution to Bailey is subject to the GST tax.]

    c. $6,000. [This answer is incorrect. To get this answer, the inclusion ration was improperly calculated, resulting in the answer that 60% of the distribution to Bailey is subject to the GST tax.]

    d. $9,800. [This answer is incorrect. To get this answer, the wrong numerator ($10,000 instead of $300,000) was used when calculating the inclusion ratio.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T41TG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. What is the Internal Revenue Code's term for the maximum amount of taxable income required to be included in the beneficiaries' gross income and the maximum amount a fiduciary can claim as an income distribution deduction?

   a. Fiduciary accounting income.

   b. Distributable net income.

   c. Tax-exempt income.

   d. Taxable income.

2. The Charleston Family Trust is set up to pay Sue Charleston's college expenses. In 2009, the trust pays $10,000 for Sue's tuition and $7,000 for Sue's room, board, and textbooks. The trust's DNI for 2009 is $13,000. There was no tax-exempt trust income. What is the trust's distribution deduction for 2009?

   a. $7,000.

   b. $10,000.

   c. $13,000.

   d. $17,000.

3. Logan's will specifically states that a cash sum of $50,000 should be distributed to his granddaughter, Cleo, within two years of his death (2009). In 2009, the estate has taxable DNI of $125,000. The trustee distributes the $50,000 to Cleo in 2009. No other distributions were made during the year. How will the distribution deduction be affected?

   a. The estate can deduct $50,000.

   b. Cleo can deduct $50,000.

   c. The estate can deduct $75,000.

   d. No distribution deduction is allowed.

4. The Baker Trust requires all income to be distributed currently. Additionally, it makes no distributions of principal in excess of a given year's required income, and it is not allowed a charitable contribution deduction. What type of trust is it?

   a. A simple trust.

   b. A complex trust.

   c. A simple trust with Tier 1 distributions.

   d. A complex trust with Tier 1 and 2 distributions.

5. The Wood Family Trust is a complex trust. In 2009, it received dividend income of $9,000 and taxable interest income of $20,000. The trust paid a fiduciary fee of $6,000. Calculate the trust's DNI for 2009.

   a. $20,000.

   b. $23,000.

   c. $29,000.

   d. $35,000.

6. Assume the same details as the question above. In 2009, the trustee made a $29,000 discretionary distribution to the beneficiary, which was permitted by the trust instrument. Calculate the trust's 2009 DNI.

   a. $20,000.

   b. $23,000.

   c. $29,000.

   d. $35,000.

7. Which of the following modifications would be made to an estate's taxable income to compute DNI?

   a. All capital gains would be excluded from DNI.

   b. No deduction would be allowed for distributions to beneficiaries.

   c. Net tax-exempt interest would be excluded from DNI.

   d. Gains from disposing of qualified small business stock would be excluded from DNI.

8. In 2009, the Levenweld Estate's fiduciary accounting income is greater than its DNI. Who receives the deduction for principal expenses in this situation?

   a. The income beneficiary.

   b. The estate.

   c. The executor.

   d. Under these circumstances, the deduction is lost.

9. A trust receives the following in 2009:

Interest income:	$	20,000
Qualified dividends:		40,000
Long-term capital gains:		80,000
Trustee's fees:		60,000

   Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal.

   a. DNI: $0; Income: $60,000; Principal: $20,000.

   b. DNI: $0; Income: $120,000; Principal: $100,000.

   c. DNI: $40,000; Income: $100,000; Principal: $40,000.

   d. DNI: $60,000; Income: $0; Principal: $20,000.

10. The Thompson Testamentary Trust is a complex trust. The trust instrument states that $30,000 must be provided to Anne each year and any remaining income can be distributed to Alan, given to charity, or accumulated. The trust had $50,000 of taxable interest income in 2009. There are no other income items or trust expenses. The trustee distributes $30,000 to Anne, and, at his discretion, also distributes $10,000 to Alan and $45,000 to charity. What is the total amount of Tier 1 distributions?

    a. $10,000.

    b. $30,000.

    c. $40,000.

    d. $55,000.

11. Assume the same details as in the question above. What amount of the distributions would be tax-free?

    a. $0.

    b. $10,000.

    c. $30,000.

    d. $40,000

12. In which of the following instances would capital gains be included in DNI?

    a. When the capital gains are not permanently set aside, paid, or used for charitable purposes.

    b. When the capital gains are allocated to principal under the governing instrument's terms.

    c. When the capital gains are not credited, paid, or required to be distributed to a beneficiary.

    d. When the capital gains are distributed by the fiduciary as allowed by the governing instrument.

13. The Brinkman Family Trust terminates in 2009. All the stocks are sold, and all funds from the year's income and the capital gains are distributed equally to the two beneficiaries, Erin and Jamie. The capital gain was allocated to principal. What is the result of this action?

    a. The capital gain is included in DNI and taxed to the trust.

    b. The capital gain is excluded from DNI and taxed to the trust.

    c. The capital gain is included in DNI and taxed to Erin and Jamie.

    d. The capital gain is excluded from DNI and taxed to Erin and Jamie.

14. Alicia is the beneficiary of a simple trust. The trust agreement specifies that all income must be distributed currently to Alicia during her lifetime. In 2009, the trustee contacted Alicia as a notification of current available funds, but the trustee never actually distributed the funds. What are the consequences of this scenario?

    a. The trust is rendered ineligible for an income distribution deduction.

    b. The trust will lose its status as a simple trust.

    c. Alicia must file a protest to ensure that she eventually receives the distribution.

    d. Alicia must report income from the missed distribution on her Form 1040.

15. When the word *income* is unmodified in the Internal Revenue Code in conjunction with the income taxation of estates and trusts, what type of income is being referred to?

    a. Taxable income.

    b. Distributable net income.

    c. Gross income.

    d. Fiduciary accounting income.

16. Which of the following statements about *fiduciary accounting income* is most accurate?

    a. It is contributed directly to the trust or estate by a donor.

    b. Expenditures associated with it are charged to principal.

    c. It is a common law, not an income tax concept.

    d. Its provisions can never depart fundamentally from local law.

17. The Hershfield Testamentary Trust is a simple trust with the following income and expenses in 2009:

Business income:	$	15,000
Qualified dividends:		45,000
Tax-exempt interest income:		30,000
Long-term capital gain (allocated to principal):		10,000
Tax depreciation expense:		2,000
Other business expenses:		7,000
Trustee fee allocated to income:		2,000
Trustee fee allocated to principal:		1,000

    Compute the trust's available distribution deduction.

    a. $30,000.

    b. $51,000.

    c. $80,000.

    d. $81,000.

18. The Allen Trust is a complex trust. Its trust document allows income distributions subject to the trustee's discretion. In 2009, the trust has DNI and fiduciary accounting income of $15,000 consisting of dividends worth $5,000, $12,000 of taxable interest income, and $2,000 of trustee fees. Which of the following actions would be allowed in this scenario?

    a. The trustee can elect to accumulate the $15,000

    b. The trust takes a $19,000 deduction.

    c. The trustee is required to distribute $15,000 to the beneficiaries.

    d. The trust becomes a simple trust for the year.

19. The Jade Bell Trust is a complex trust. Under the trust instrument, a $5,000 income distribution is required for a specific charity each year, and any remaining income can be distributed to Allison at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2009, the trustee distributes $5,000 to charity and $7,500 to Allison. The trust also has the following items of income and expense:

Qualified dividends:	$	5,000
Taxable interest:		5,000
Tax-exempt interest:		5,000
Business income:		10,000
Business depreciation expense:		1,500
Other business expenses:		1,000
Trustee fee (allocated to income):		2,500

Calculate the trust's taxable portion of DNI for 2009.

a. $20,000.

b. $15,000.

c. $11,500.

d. $3,500.

20. Which of the following distributions would **never** be considered "other amounts properly paid or credited or required to be distributed" (OAPC) for an estate or trust?

i. Income required to be distributed currently

ii. Support obligation payments

iii. A charitable distribution

iv. Specific gifts and bequests under IRC Sec. 663(a)

v. A discretionary distribution made by a trustee

a. i. and iv.

b. ii. and v.

c. ii., iii., and iv.

d. i., ii., iii., iv., and v.

21. Which of the following is true about the separate share rule?

a. Only trusts can be subject to the separate share rules; estates do not qualify.

b. Trustees have the ability to apportion income to beneficiaries at their discretion.

c. Each separate share can only have one beneficiary.

d. A beneficiary can be the beneficiary of multiple shares.

22. Tabitha's will divides her estate between an outright gift to her husband, Calvin, and a bypass trust. Cal receives 75% of the estate, and the bypass trust receives the other 25%. In the current year, the estate distributes $4 million—$3 million to Calvin and $1 million to the bypass trust. DNI for the year was $120,000 ($250,000 of taxable interest and $130,000 of deductions). Calculate the amount of taxable income of the estate for the year.

    a. $0.

    b. $30,000.

    c. $90,000.

    d. $120,000.

23. Aaron designates his estate as the beneficiary of his IRA. He dies in 2009. The date of death value of his estate after payment of debts and expenses is $1.7 million. The $300,000 from the IRA is included in the estate's gross income and allocated to principal. The estate consists of two separate shares for Esther and Ethan. Aaron's will specifies that Ethan's share must be funded first by the IRA. Both Esther and Ethan receive a distribution of $100,000 in 2009. How should the income in respect of a decedent (IRD) from the IRA be allocated?

    a. To the estate.

    b. To Esther.

    c. To Ethan.

    d. Split between Esther and Ethan.

24. Under IRC Sec. 663(b), an estate elects to have all distributions considered credited or paid on the last day of the tax year immediately prior. When must distributions have been made to qualify for this election?

    a. Within 65 days following the close of the estate's tax year.

    b. Within 90 days of the decedent's date of death.

    c. Within 30 days following the close of the beneficiary's tax year.

    d. Within 45 days of the beneficiary's receipt of the funds.

25. In 2009, the Keith Clinton Estate had $30,000 of taxable interest income and $20,000 of tax-exempt interest income. There were no executor fees or other trust expenses. The executor distributed $60,000 to the sole beneficiary during the year. Compute the estate's distribution deduction for the year.

    a. $20,000.

    b. $30,000.

    c. $50,000.

    d. $60,000.

26. When could an estate have "phantom" income (i.e., income that beneficiaries never receive, but that they must pay taxes on)?

    a. When the estate makes a "Holloway adjustment" to fiduciary accounting income.

    b. When a portion deemed paid from tax-exempt income reduces a charitable deduction.

    c. When the estate has a mandatory allocation of indirect expenses.

    d. When fiduciary accounting income is reduced by certain expenses/losses but DNI is not.

27. Jim transfers property worth $10 million into a newly created irrevocable trust to benefit his granddaughter, Kaylee. He allocates the full $3.5 million generation-skipping transfer (GST) tax exemption to the trust. Calculate the amount of any taxable distribution from the trust that will be subject to the GST tax.

    a. 20%.

    b. 35%.

    c. 65%

    d. 80%.

28. The Pine Trust makes a GST taxable distribution in 2009. Which of the following is true?

    a. The distributee must file Form 706-GS(D-1).

    b. The grantor must pay the applicable GST tax.

    c. The trustee can file for an extension to file Form 706-GS(D-1).

    d. If the inclusion ratio was zero, the distribution is not reported on Form 706-GS(D).

Lesson 2: Property Distributions

Introduction

Property distributions are also called "in-kind" distributions and are governed by different rules than those prescribed for cash distributions. Although cash is generally considered property, for purposes of this discussion, property distributions consist only of non-cash, or "in-kind" distributions. Lesson 1 covered the general rules for dealing with distributions.

This lesson distinguishes between distributions of specific property (i.e., specific bequests) and distributions of property that are not specific bequests. This is important because specific bequests are governed by IRC Sec. 663(a)(1), rather than IRC Secs. 661 and 662 (the general distribution rules). Thus, the estate or trust is not entitled to an income tax deduction for the distribution, and the beneficiary does not include the distribution in his or her income. In contrast, property distributions that are not considered specific bequests are subject to the general distribution rules of IRC Secs. 661 and 662, entitling the estate or trust to a distribution deduction and requiring the inclusion of income for the beneficiary.

Practitioners should be familiar with the amount of the distribution deduction to the estate or trust, the amount of income recognition by the beneficiary, the recipient's basis in the property distributed, the holding period of the property in the recipient's hands, and the rules for gain recognition by the estate or trust upon distributing appreciated property.

Estates make three types of distributions: (1) specific, (2) pecuniary, and (3) residuary. Specific bequests are those that are specifically identified in the governing instrument and payable to a beneficiary in three or fewer installments. Pecuniary bequests include gifts of a specific dollar value, which can be based on either a fixed dollar amount or a formula. Residuary bequests refer to the particular fraction or percentage of the estate after the payment of the specific and pecuniary bequests, any debts, and expenses. Trusts make two types of distributions: (1) income and (2) principal.

Fiduciaries may make a variety of in-kind distributions, depending on the circumstances. Some examples include:

1. A fiduciary may be required under the terms of the governing instrument to distribute a specific asset.

2. A fiduciary may distribute property to satisfy a requirement to distribute a certain monetary (pecuniary) value to a beneficiary. The pecuniary amount in question could be explicit (e.g., $100,000 of value) or based on a variety of formulas (e.g., the minimum marital distribution amount necessary to reduce the taxable estate to zero).

3. A fractional amount of trust principal or a fraction of the residuary estate may be involved (e.g., "One-half of the remaining trust principal is to be distributed to my son, John, upon reaching the age of 40.").

4. The fiduciary may have the discretion to distribute property in-kind as he or she sees fit or under powers granted in the governing instrument.

The property being distributed may have appreciated (fair market value greater than tax basis) or depreciated (fair market value less than tax basis). The property may be subject to some form of cost recovery (depreciation, depletion, amortization). If depreciable property is distributed, it may have depreciation recapture potential that is carried over to the beneficiary.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the tax effects of property distributions and determine when distributions of specific property are considered specific bequests and, thus, are not eligible for the distribution deduction.
- Develop a strategy for dealing with distributions of property that are not specific bequests.

- Assess and compute gain or loss recognition related to distributions in lieu of specific property or dollar amounts, distributions of property in lieu of income, and distributions of depreciated property.
- Determine the tax implications of distributions of installment obligations, partnership interests, and S corporation stock.

An Overview of the Tax Effects Related to Property Distributions

Generally, no gain or loss is recognized when a fiduciary distributes property (an "in-kind" distribution) to beneficiaries. For estates and complex trusts, the value of property distributed (i.e., paid, credited, or required to be distributed) is the smaller of the (1) fiduciary's adjusted basis in the property immediately before the distributions, plus any Section 643(e)(3) gain elected to be recognized by the fiduciary on the distribution or (2) fair market value of the property. The beneficiaries receive property with carryover basis and holding period. This general rule applies to bequests of specific property, discretionary distributions, and distributions to satisfy the rights to a share of trust principal or a share of a residuary estate. Discretionary distributions are usually treated as "other amounts paid or credited" on Schedule B of Form 1041.

The exceptions to this general rule include the following:

1. Distributions of property in satisfaction of a pecuniary bequest (e.g., specific dollar amount based on an estate tax formula). These distributions require recognition of gain and, for estates, loss.

2. Distributions of property in satisfaction of the beneficiary's right to receive a specific dollar amount or a specific asset other than the asset distributed. These distributions trigger gain, but not loss.

3. Distributions of property in lieu of income. These distributions result in recognition of gain, but not loss.

4. Distributions of property when the fiduciary elects to recognize gain under IRC 643(e)(3). When the election is made, gain is recognized by the estate or trust, causing a step-up in basis to the beneficiary, as if the property had been sold to him or her at FMV.

5. Distributions of special-use valuation property (for which a lower-than-FMV valuation was claimed on Form 706) to qualified heirs. In that case, the gain is limited to the difference between the FMV (without regard to the special-use valuation) as of the date of transfer and the FMV (without regard to the special-use valuation) as of the decedent's death (or alternate valuation date, if elected).

In each of the above situations, there are also specific rules regarding whether DNI is carried out to the beneficiary causing him or her to recognize income and allowing the estate or trust to claim an income distribution deduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Define *residuary distribution*.

    a. An in-kind distribution made by the fiduciary as he/she sees fit.

    b. Distribution of a fraction of the estate after all other debts and bequests are settled.

    c. Distribution of property that is specifically identified by the estate's governing instrument.

    d. Distribution of gifts of a specific dollar value, either a fixed amount or a formula.

30. The value of property distributed by an estate (other than in satisfaction of a pecuniary bequest) is the smaller of the estate's adjusted basis in the property immediately before distributions are made plus Section 643 gain the fiduciary elects to recognize, or which of the following?

    a. The fair market value (FMV) of the property.

    b. The FMV of the property as of the decedent's death

    c. The carryover basis of the property.

    d. The value recorded on Schedule B of Form 1041.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. Define *residuary distribution*. **(Page 185)**

    a. An in-kind distribution made by the fiduciary as he/she sees fit. [This answer is incorrect. This is an example of the types of in-kind distributions that fiduciaries may be required to make; however, this is not the definition of a residuary distribution.]

    b. Distribution of a fraction of the estate after all other debts and bequests are settled. [This answer is correct. After the payment of specific bequests, pecuniary bequests, and any expenses or debts, the bequest of a percentage or fraction of the remaining estate is called a residuary distribution.]

    c. Distribution of property that is specifically identified by the estate's governing instrument. [This answer is incorrect. This is a *specific distribution*, which is one of the other types of distributions that fiduciaries make.]

    d. Distribution of gifts of a specific dollar value, either a fixed amount or a formula. [This answer is incorrect. Fiduciaries make three types of distributions. This is the definition of a *pecuniary bequest*.]

30. The value of property distributed by an estate (other than in satisfaction of a pecuniary bequest) is the smaller of the estate's adjusted basis in the property immediately before distributions are made plus Section 643 gain the fiduciary elects to recognize, or which of the following? **(Page 186)**

    a. The fair market value (FMV) of the property. [This answer is correct. The value of property paid, credited, or required to be distributed by an estate or a complex trust is the smaller of the property's FMV or the value listed above.]

    b. The FMV of the property as of the decedent's death. [This answer is incorrect. The difference between FMV as of the date of transfer and FMV as of the decedent's death is the amount of gain recognized on distributions of special-use valuation property.]

    c. The carryover basis of the property. [This answer is incorrect. However, beneficiaries of an estate will receive property with both the carryover basis and the holding period.]

    d. The value recorded on Schedule B of Form 1041. [This answer is incorrect. Discretionary distributions made by an estate are generally treated on Schedule B of Form 1041 as "other amounts paid or credited."]

Considerations for Distributing Specific Property

General Rules

A gift or bequest of specific property or a specific sum of money explicitly required by the terms of a will or trust instrument to be paid or credited to a beneficiary in three or fewer installments is generally not allowed as a distribution deduction to an estate or trust and is not included in the beneficiary's gross income. To qualify as a gift or bequest of specific property or sum of money, the amount of money or the identity of the property must be ascertainable under the terms of the decedent's will as of the date of death or under the terms of an *inter vivos* trust instrument at its inception. An amount that, under the terms of the governing instrument, can be paid only from the income of the estate or trust is not a specific bequest (since the amount of estate or trust income cannot be determined as of the date of the decedent's death or for *inter vivos* trusts, at the time of the trust inception).

No gain or loss is recognized on the distribution of the specific property, unless (1) the distribution is in satisfaction of a right to receive a specific dollar amount or (2) the property distributed is substituted for the specific property bequeathed. The election to recognize gain under IRC Sec. 643(e)(3) does not apply to specific bequests. However, if under the terms of the will or trust instrument, the gift or bequest is to be paid or credited in more than three installments, the distribution is treated under the general distribution rules of IRC Sec. 643(e)(2) (i.e., distribution deduction at the fiduciary level and income inclusion to the beneficiary equal to the lesser of the adjusted basis or FMV of the property).

Example 2B-1 Distribution of specific property has no tax effect.

Bill Parker died in 2007. Bill's last will and testament bequeathed his Rolls Royce to his great niece, Bonnie. In 2009, the executor distributed the Rolls Royce to Bonnie, but made no distributions of cash or other property. The estate has taxable DNI of $100,000 for 2009. The Rolls Royce had a basis to the estate of $150,000 and a FMV of $175,000 at the time of distribution.

The $25,000 appreciation between the date of death (or alternate valuation date) and the date of distribution is not taxed to the estate or Bonnie in 2009. Bonnie receives the Rolls with a basis of $150,000 and a long-term holding period. No income distribution deduction is allowed to the estate, and the receipt of the auto does not increase Bonnie's gross income for 2009, even though the estate had undistributed taxable DNI for that year. The distribution is not required to be reported on Schedule B (Form 1041).

Interest Paid on Distributions. If a specific bequest of money is not distributed promptly, some state laws require the estate to pay interest. If interest is paid under these circumstances, the interest income should be reported to the recipient by the estate. Issuing a Form 1099-INT to the recipient is this course's recommendation for reporting the interest. The IRS's position is that such interest expense is nondeductible by the estate. In certain jurisdictions, however, statutory interest (required by the governing instrument or local law) may be deductible as an administration expense under IRC Sec. 2053(a)(2), rather than an income distribution deduction under IRC Sec. 661. Interest paid to a surviving spouse is not deductible in a will contest when the spouse elects against the will to receive the fraction of the estate allowed by the state's elective share statute. The electing spouse is not entitled to receive any estate income, but must receive interest income on the elective share from the date the court order directed that the elective share be paid. Such interest is considered nondeductible personal interest expense of the estate.

Property or Property Value Must Be Specifically Identified

For a property transfer to be considered a specific bequest, the identity of the specific property or the specific amount of the property value must be ascertainable in the governing instrument as of the date of death or the inception of the trust. If the will or trust instrument provides that the bequest of money or property is to be based upon a fraction of the decedent's adjusted gross estate, the bequest does not qualify as a specific bequest since the identity of the property and the amount of money are subject to administration expenses and other charges, which cannot be known as of the decedent's death. For example, if a will bequeaths a personal residence to an individual, the distribution of the residence qualifies as a specific bequest since the property can be specifically identified at the date of death. In contrast, if the will bequeaths sales proceeds of the residence to a beneficiary, the distribution would not be a specific bequest since neither the sales price nor the sales expenses would be known at the date of death. A bequest of specific property is not disqualified solely because the distribution is subject to a condition, such as the beneficiary reaching a certain age.

Distributions of the following items are *not* considered specific bequests and are subject to the general distribution rules discussed later in this lesson:

1. An amount that can be paid or credited only from the income of an estate or trust, whether from income for the year of payment or from income accumulated from a prior year.

2. An annuity or periodic gifts of specific property in lieu of or having the effect of an annuity.

3. A residuary estate or trust principal.

4. A gift or bequest that is required to be paid in more than three installments under the terms of the governing instrument, regardless of the actual number of installments actually made.

A bequest of unspecified assets with a fair market value specified in a decedent's will is considered a bequest of a "specific sum of money" under IRC Sec. 663(a). Consequently, the estate is not allowed a distribution deduction when it pays the bequest, and the beneficiary does not include any amount in gross income. In addition, the distribution of unspecified property with a specific dollar amount (i.e., a pecuniary bequest) causes the estate to recognize gain or loss in an amount equal to the difference between the property's fair market value (FMV) at the time of distribution and its adjusted basis to the estate. The losses will be allowed under IRC Sec. 267(b)(13) because the related party rules for estates and beneficiaries do not apply to property distributions in satisfaction of pecuniary bequests.

Example 2B-2 Distribution of unspecified property in satisfaction of a beneficiary's right to receive a specific dollar amount.

The Karla Willow Estate bequeaths $100,000 to Joyce Willow, payable in cash or property. The executor distributes shares of stock to Joyce when the stock was valued at $100,000 (basis $80,000).

Because the distribution was of unspecified property (either cash or property was distributable), the estate must recognize a capital gain of $20,000 ($100,000 FMV − $80,000 basis) on the satisfaction of Joyce's bequest with appreciated property. However, no distribution deduction is available to the estate upon paying the bequest, and Joyce does not include any amount from the distribution in her gross income since it falls within the specific bequest exception to the normal distribution rules of IRC Secs. 661 and 662.

Bequests Payable in Installments

To be treated as a specific bequest, the distribution must be *required* to be paid in three or fewer installments. Thus, if the bequest is required to be paid in four or more installments, each payment will be an "other amount paid or credited," which carries out DNI to the distributee. If no time of payment or crediting is specified in the instrument, the bequest is considered as required to be paid in a single installment. In addition, all gifts and bequests payable at any one specified time (e.g., when the beneficiary turns 35) are taken into account as a single installment.

Personal-use property, such as household effects and automobiles, are disregarded for purposes of the three-or-fewer-installments rule. Specifically devised real property, the title to which passes directly to the devisee under state law, is also disregarded.

When determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust are treated as separate entities.

Example 2B-3 Property bequeathed in three or fewer installments.

Joe Johnson died in 2009. Under the terms of Joe's will, $10,000 cash, household furniture, a watch, an automobile, 100 shares of IBM stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to his son, Sam, under local law) are bequeathed or devised outright to Sam. The will also provides for the creation of a trust for the benefit of Sam, the terms of which require the trustee to distribute $50,000 cash and 100 shares of AT&T stock to Sam when he reaches 25 years of age, $100,000 cash and 200 shares of AT&T stock when he reaches 30 years of age, and $200,000 cash and 300 shares of AT&T stock when he reaches 35 years of age.

The furniture, watch, automobile, and farm are excluded in determining whether any gift or bequest is required to be paid or credited to Sam in more than three installments. These items qualify for the exclusion for specific bequests under IRC Sec. 663(a)(1), regardless of the treatment of the other items of property bequeathed to Sam.

The $10,000 cash, the IBM stock, the grain, and the cattle bequeathed outright to Sam are considered paid in a single installment. Likewise, the assets required to fund the trust are considered as required to be paid or credited (to the trust) in a single installment, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The cash and stock required to be distributed by the trust to Sam when he is 25 years old are considered as required to be paid in one installment under the trust. Likewise, the distributions to be made by the trust to Sam when he is 30 and 35 years old are each considered as one installment under the trust.

Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under IRC Sec. 663(a)(1). Similarly, the three distributions by the trust also qualify as specific bequests. However, if the recipient of the specific bequest is entitled to the income on the property, such income (not principal) on the bequeathed property is considered a separate share and is subject to DNI carryout.

Example 2B-4 Property bequeathed in more than three installments.

Assume the same facts as in Example 2B-3, except another distribution of a specified sum of money is required to be made by the trust to Sam when he turns 40. This distribution would also qualify as an installment, totaling four installments under the terms of the trust agreement. None of the gifts to Sam under the trust would qualify for the specific bequest exclusion under IRC Sec. 663(a)(1). However, the distributions from the estate (i.e., the furniture, watch, automobile, and farm) would still qualify for the exclusion.

Example 2B-5 Property bequeathed in more than three installments, but paid all at once.

Sarah Jones died on March 19, 2009. According to the terms of her will, 5,000 shares of XYZ stock was to be paid to her niece, Kate, over five years after Sarah's death. However, because she needed the funds for college, the executor distributed all 5,000 shares to Kate on December 10, 2010.

Although the property is specifically identified, Sarah's will does not require the distribution to be payable in three or fewer installments, and thus, the distribution does not qualify as a specific bequest under IRC Sec. 663(a)(1). The fact that the executor actually distributed the stock in three or fewer installments is irrelevant. Thus, the distribution is not excluded from the DNI carryout rules of IRC Secs. 661and 662.

Because the will provides that the bequest is payable in more than three installments, the bequest is subject to DNI carryout regardless of whether the bequest is entitled to income.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following distributions would be considered a bequest of specific property or sum of money, assuming all are explicitly required by the terms of the trust instrument or will?

    a. George receives a sum of money from his father's estate that is paid out in three installments.

    b. Bob receives a sum of money from an *inter vivos* trust that must be paid from the trust's income.

    c. Charlie receives a boat from his mother's estate instead of an equivalent specified sum of money.

    d. Reggie elects to recognize gain on a distribution under IRC Sec. 643(e)(3).

32. Harold died in 2007, and in his will, he left his vacation home to his grandson, Carl. The vacation home is distributed to Carl by the executor in 2009. No other property or cash distributions were included. The estate has taxable DNI of $150,000 in 2009. The vacation home had a basis to the estate of $200,000 and a FMV of $275,000 when it was distributed to Carl. Which of the following best illustrates one of the consequences of this distribution?

    a. The estate takes an income distribution deduction of $275,000 to offset DNI.

    b. Carl must pay taxes on the $75,000 of appreciation on the property.

    c. The estate must pay taxes on the $75,000 of appreciation on the property.

    d. Carl has a basis of $200,000 in the vacation home.

33. Assume the same details as in the question above. Must Harold's estate pay interest on the vacation home because it was not distributed promptly upon Harold's death?

    a. Yes.

    b. No.

    c. It depends on the state in which Harold's estate is based.

34. Assume the same details, but with these additions. Harold bequeaths $25,000 to his nephew, Mark, to be paid out in four installments. Upon Mark's request, the executor pays the bequest in one installment. Harold bequeaths an additional $25,000 to his niece, Shelia, but Shelia takes the payments in the four installments. Considering all of the bequests, which of Harold's beneficiaries meets the installment requirements for treatment as a specific bequest?

    a. Carl.

    b. Shelia.

    c. Mark.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following distributions would be considered a bequest of specific property or sum of money, assuming all are explicitly required by the terms of the trust instrument or will? **(Page 189)**

    a. George receives a sum of money from his father's estate that is paid out in three installments. [This answer is correct. Property or cash distributions required by the will must be paid to a beneficiary in three installments or less to qualify for tax treatment as a distribution of specific property. If the payment were made in more than three installments, the general distribution rules of IRC Sec. 643(3)(2) would apply.]

    b. Bob receives a sum of money from an *inter vivos* trust that must be paid from the trust's income. [This answer is incorrect. The amount of income cannot be determined as of the date of the *inter vivos* trust's inception; therefore, this is not a specific bequest.]

    c. Charlie receives a boat from his mother's estate instead of an equivalent specified sum of money. [This answer is incorrect. Because the boat was not the specific property bequeathed to Charlie by the will, this distribution does not qualify for the favorable tax treatment of distributions of specific property.]

    d. Reggie elects to recognize gain on a distribution under IRC Sec. 643(e)(3). [This answer is incorrect. The election to recognize gain on a distribution under IRC Sec. 643(e)(3) is not allowable for specific bequests.]

32. Harold died in 2007, and in his will, he left his vacation home to his grandson, Carl. The vacation home is distributed to Carl by the executor in 2009. No other property or cash distributions were included. The estate has taxable DNI of $150,000 in 2009. The vacation home had a basis to the estate of $200,000 and a FMV of $275,000 when it was distributed to Carl. Which of the following best illustrates one of the consequences of this distribution? **(Page 189)**

    a. The estate takes an income distribution deduction of $275,000 to offset DNI. [This answer is incorrect. Because this is a distribution of specific property, the estate cannot claim a distribution deduction, despite the undistributed taxable DNI.]

    b. Carl must pay taxes on the $75,000 of appreciation on the property. [This answer is incorrect. The appreciation amount will not be taxed to Carol in 2009.]

    c. The estate must pay taxes on the $75,000 of appreciation on the property. [This answer is incorrect. The estate is not responsible for paying taxes in 2009 on the property's appreciation.]

    d. Carl has a basis of $200,000 in the vacation home. [This answer is correct. Neither Carl nor the estate must pay taxes on the $75,000 of appreciation on the vacation home. However, Carl's basis in the vacation home is limited to the basis that it had to the estate at the time of Harold's death.]

33. Assume the same details as in the question above. Must Harold's estate pay interest on the vacation home because it was not distributed promptly upon Harold's death? **(Page 189)**

    a. Yes. [This answer is incorrect. However, if the estate did have to pay interest on the vacation home, the estate must report it to Carl.]

    b. No. [This answer is incorrect. Any interest paid by the estate can be reported on Form 1099-INT.]

    c. It depends on the state in which Harold's estate is based. [This answer is correct. State law governs interest in this situation. The IRS maintains that such interest is not deductible by the estate.]

34. Assume the same details, but with these additions. Harold bequeaths $25,000 to his nephew, Mark, to be paid out in four installments. Upon Mark's request, the executor pays the bequest in one installment. Harold bequeaths an additional $25,000 to his niece, Shelia, but Shelia takes the payments in the four installments. Considering all of the bequests, which of Harold's beneficiaries meets the installment requirements for treatment as a specific bequest? **(Page 189)**

   a. **Carl. [This answer is correct. The bequest of the vacation home is personal-use property and is disregarded for the three-installments-or-fewer rule. Because an estate and a trust are considered separate entities when determining the number of installments to a beneficiary, his trust qualifies under the installment rule.]**

   b. Shelia. [This answer is incorrect. A bequest taken in more than three installments does not qualify to be treated as a specific bequest.]

   c. Mark. [This answer is incorrect. It is Harold's will and not the executor of the estate that determines if the bequest is specific or not. Even though Mark received his bequest in one installment, it will not be treated as a specific request.]

Considerations for Property Distributions That Are Not Specific Bequests

General Rules

Unless a property distribution from an estate or trust qualifies as a gift or bequest of specific property, a property distribution is generally treated as an "other amount paid or credited" on Schedule B of Form 1041. Therefore, such distributions carry out DNI to the beneficiaries, resulting in an income distribution deduction at the fiduciary level and an income inclusion amount for the beneficiary, subject to the DNI limitations of the separate shares.

Simple Trusts. For simple trusts, the distribution deduction and income inclusion amount equal the income required to be distributed currently, and the trust must recognize gain on the distribution for the excess of FMV of the property over its adjusted basis. This rule also applies to Tier 1 distributions of complex trusts.

Estates and Complex Trusts. For in-kind distributions, the amount considered distributed for an estate or a complex trust's distribution deduction and the beneficiary's income inclusion generally is the lesser of the adjusted basis of the property in the hands of the beneficiary (usually the carryover basis from the estate or trust) or the fair market value (FMV) of the property at the time it was distributed. The estate or trust generally does not recognize gain or loss on the distribution unless the property is distributed in satisfaction of a pecuniary bequest. However, if a Section 643(e)(3) election (discussed later in this lesson) is made, gain but not loss is recognized, and the distribution deduction, income inclusion amount, and the basis of the property to the beneficiary is equal to the property's FMV.

Example 2C-1 Discretionary distribution of property.

In 2009, the Samuel Smith Family Trust generated $30,000 of taxable DNI for the year. Fiduciary accounting income was also $30,000. The trust instrument follows the general rule that capital gain is excluded from fiduciary accounting income. The only distribution to a beneficiary during the year was a discretionary distribution to Al Smith of 100 shares of BT&T common stock. The trust had a tax basis of $1,000 for these shares, and the FMV of the shares on the date of distribution was $25,000.

Since the distribution is not a mandatory income distribution or a distribution of a stated dollar amount, no gain or loss is recognized by the trust on distribution of stock. The basis in the shares to Al is $1,000. The trust's holding period "tacks on" to Al's. The trust's distribution deduction is $1,000 since basis is less than FMV. Al will include $1,000 in gross income.

Variation: If the FMV of the shares had been $500, the tax basis of the shares in Al's hands would still have been $1,000 (a carryover basis since the trust recognizes no gain or loss on the distribution). Similarly, the trust's holding period carries over to Al. However, Al will include $500 in gross income (instead of $1,000), and the trust is entitled to a $500 distribution deduction, i.e., the lesser of the stock's basis to the beneficiary or FMV.

Pecuniary (specific dollar amount) bequests based on a formula are not considered specific bequests. (See the discussion of pecuniary formula bequests later in this lesson.) Additionally, the distribution of a residuary estate or principal of a trust is not considered a specific bequest, and as such, is generally deductible by the estate or trust and taxable to the beneficiary (up to its separate share of taxable DNI).

An estate's distribution of real estate will not carry out DNI if title to the real estate automatically vests in the distributee immediately upon the death of the decedent, which is typically the case in most states.

Distributions of Property with Recapture Potential

When the fiduciary distributes depreciable property to beneficiaries for which no gain or loss is recognized and the basis carries over, any depreciation recapture potential remains with the property.

Example 2C-2 No depreciation recapture when basis carries over to beneficiary.

Assume the same facts as in Example 2C-1, except the discretionary distribution consisted of Section 1245 recapture property with a basis of $1,000, a FMV of $25,000, and potential Section 1245 recapture of $24,000.

The distribution does not trigger the recapture amount, since no gain or loss is recognized. However, the recapture potential remains with the property in the hands of the beneficiary.

Election to Recognize Gain on Property Distributions

Estates and trusts generally may elect to recognize gain (but not loss) on the distribution of property (except for specific bequests), causing a step-up in basis to the beneficiary as if the property had been sold to the distributee at FMV. Losses are disallowed according to the related party rules of IRC Secs. 267(b)(6) and (13). Although the related party rules do not disallow losses of an *estate* upon distributions in satisfaction of pecuniary bequests, gain or loss recognition is *required* rather than *elective* for pecuniary bequests. Thus, the election under IRC Sec. 643(e) does not apply for such gains or losses. Gains and disallowed losses must be determined for each separate property distributed.

The election to recognize gain generally covers *all* distributions of property other than specific bequests made during the tax year and distributions in satisfaction of pecuniary obligations, such as rights to income. However, the election is not available for the distribution of claims to receive IRD. When the election is made, the distribution deduction and income inclusion amounts are the FMV of the property distributed.

Example 2C-3 Election to recognize gain upon distribution of property.

The facts are the same as in Example 2C-1, in which stock with a FMV of $25,000 and a basis of $1,000 was distributed, except the trustee elects under IRC Sec. 643(e)(3) to recognize gain on the stock distribution as if the shares were sold.

As a result of the Section 643(e)(3) election, the trust will recognize a capital gain of $24,000 (FMV − basis). The beneficiary will have a $25,000 (trust's $1,000 basis plus $24,000 gain recognized) basis in the shares, and the trust is allowed a distribution deduction of $25,000 (not to exceed DNI). Since capital gains are allocated to principal, DNI does not include the $24,000 gain on this discretionary distribution. The beneficiary would include $25,000 in gross income from the trust (not to exceed DNI) even though he received no cash. Because there has been a deemed sale of the trust property, the trust's holding period is not tacked onto to the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquisition (i.e., date of distribution).

In reporting the deemed sale, the gain can be reported on Schedule D (Form 1041), since it pertains to capital gain assets, along with a description of the property and a Section 643(e)(3) election notation. To avoid IRS matching problems [since the Section 643(e)(3) gains will not be reported on a Form 1099], some practitioners prefer to report the gain on an attached statement, rather than on Schedule D, with the amount carried to the appropriate line on page 1 of Form 1041 (line 4 for capital gains). A disclosure statement regarding the election to recognize the gain should be attached to the return.

Variation: If the trustee had been required by the governing instrument to sell the stock and distribute the proceeds to the beneficiary, the gain would be included in DNI.

Example 2C-4 Discretionary distributions of appreciated and depreciated property in the same year.

On June 30, 2009, the Agerton Family Trust made the following discretionary property distribution to Bee:

Description	Basis	FMV	Gain/Loss
100 shares ABC Corp stock	$ 2,000	$ 2,500	$ 500
50 shares XYZ Corp stock	2,200	1,500	(700)
250 shares LQ Corp stock	1,500	3,000	1,500
Total	$ 5,700	$ 7,000	$ 1,300

The trustee makes the Section 643(e)(3) election. Capital gains are allocated to principal. The trust has $20,000 of DNI (all taxable) for 2009. Bee is one of the two beneficiaries of the Family Trust entitled to receive

50% of the value of the trust property. Because there is more than one beneficiary and the separate share rule of IRC Sec. 663(c) applies, the maximum amount of DNI that can be reported to Bee for 2009 is $10,000 ($20,000 x 50%). Bee was the only beneficiary to receive a distribution in 2009, and the property distribution is the only distribution for the year.

Although the trust has a realized net gain of $1,300, it must recognize gain of $2,000 ($500 from ABC Corp and $1,500 from LQ Corp). The $700 loss from XYZ Corp is not recognized due to the related party rules. Since capital gain is allocated to principal, the trust will pay the tax on the $2,000 gain and will charge them against Bee's share of the trust. The trust will have a distribution deduction of $7,000 for the FMV of the property distributed.

Bee will include $7,000 in gross income and receive a tax basis of:

ABC Stock	$ 2,500
LQ Stock	3,000
XYZ Stock:	
For gain purposes:	2,200
For loss purposes:	1,500

If Bee sells XYZ stock for an amount between $1,500 and $2,200, no gain or loss is recognized. The fiduciary should provide the basis information and holding period to Bee as a memo item on Schedule K-1 and in a separate letter to make sure the beneficiary and the preparer, if any, of the beneficiary's income tax return have this basis information. Since the Section 643(e)(3) election was made, there has been a deemed sale of the trust property, which results in a new holding period Bee, beginning on the date of acquisition (distribution of the stock).

Variation: If the Section 643(e)(3) election is not made, the trust would not recognize the $2,000 gain. The trust would have a distribution deduction of $5,000 ($2,000 + $1,500 + $1,500). Bee would include $5,000 in gross income and will have the following basis:

ABC Stock	$ 2,000
XYZ Stock	2,200
LQ Stock	1,500

Because the Section 643(e)(3) election was not made, there is no deemed sale. Thus, the trust's holding period of the stock will tack onto Bee's holding period.

Example 2C-5 Election to recognize loss on discretionary property distributions is not available.

In 2009, the James Harlan Estate made a discretionary distribution of property with a $5,000 basis and a $3,000 FMV. The estate cannot make a Section 643(e)(3) election to recognize a $2,000 capital loss on the distribution since the election is only to recognize gains.

Variation: If the distribution had been made in satisfaction of a pecuniary bequest, rather than a discretionary distribution, a Section 643 election would still not have been available because gains or losses of estates making pecuniary distributions are *required* rather than *elective*. In that case, such losses are not disallowed by the related party rules.

Making the election to recognize gain is beneficial if the fiduciary has a capital loss carryforward with no other opportunity to use it in the near future, or if the fiduciary sold a capital asset at a loss in the current year and would otherwise be limited to an annual $3,000 capital loss deduction. Because capital gains are generally principal and thus, not carried out to the beneficiary (except in the final year), the election is usually not appropriate if the beneficiary has a current year capital loss (or a capital loss carryforward) with which to offset the gain from the beneficiary's sale of the distributed asset. Therefore, a prudent fiduciary will not make the election without consulting with the income beneficiary, or others as necessary, to obtain all information relevant to the decision whether to elect.

Since the result of the election is to treat the property as if it were sold, any gain (but not loss) on the distribution of depreciable property from a trust or an estate to a beneficiary would be ordinary income. However, if the distribution of the depreciable property was made in satisfaction of a pecuniary bequest, the gain would be Section 1231 gain, rather than ordinary income, since the related party rules do not apply to an estate's distributions in satisfaction of pecuniary bequests.

The election to recognize gain under IRC Sec. 643(e)(3) does not apply to specific bequests.

Formula Pecuniary Clauses

A *pecuniary bequest* is a fixed dollar amount (e.g., "I bequeath $100,000 to my daughter, Beth") and is often expressed in terms of a formula. A formula pecuniary clause in the governing instrument is a common technique using a verbal description to determine the amount of money or value of property to be distributed to a beneficiary (such as a formula designed to fund a marital deduction bequest). A formula pecuniary bequest is a bequest for which neither the identity of the property nor the amount to be distributed is ascertainable under the terms of the decedent's will as of the date of death or under the terms of an *inter vivos* trust instrument at its inception. Thus, pecuniary formula bequests do not qualify as specific bequests under IRC Sec. 663(a)(1) and, as such, are governed by the general distribution rules of IRC Secs. 661 and 662.

The same provisions apply to disclaimed amounts of pecuniary formula bequests, even if the disclaimer results in a specific dollar amount being disclaimed. Since the amount being disclaimed cannot be ascertained at the date of death, it cannot qualify as a specific bequest.

When appreciated property is used to fund the pecuniary formula clause, the estate or trust generally recognizes gain; however, the estate's or trust's distribution deduction and the beneficiary's income inclusion are limited by the beneficiary's separate share of DNI. When depreciated property is used to fund a pecuniary formula clause, an estate recognizes loss due to a special exception to the related party rules. Loss recognition is not available to trusts due to related party rules, however.

Under the separate share rule, if the formula pecuniary bequest is not entitled, according to the governing instrument or local law, to share in fiduciary accounting income and appreciation/depreciation of estate assets, there will be no carryout of DNI to the distributee upon funding the bequest. However, if the formula pecuniary clause (or local law) entitles the separate share to receive fiduciary accounting income, the estate or trust receives a distribution deduction under IRC Sec. 661(a), and the beneficiary must include the distribution amount in income under IRC Sec. 662(a)(1), as limited by his or her separate share of DNI.

The actual funding of the formula pecuniary bequest can occur in a variety of ways. Three common funding methods are (1) true worth pecuniary bequests, (2) fairly representative pecuniary bequests, and (3) minimum worth pecuniary bequests. All three funding methods are considered separate shares regardless of whether they are entitled to share in income and appreciation/depreciation of assets. However, actual funding of the bequests with principal is not subject to DNI allocation according to the separate share rule. Distributions of DNI are limited to the bequest's separate share of DNI if the bequest is entitled to share in income.

<u>True Worth Pecuniary Funding.</u> True worth pecuniary funding, the most commonly used method, values assets distributed in kind at their date-of-distribution values, rather than their date-of-death (or alternate valuation date) values on Form 706. The fiduciary has the freedom to select particular assets to fund a true worth pecuniary bequest. This method can easily trigger gain or loss since the in-kind asset distribution in satisfaction of a pecuniary bequest is a taxable event. The required gain or loss recognition depends on the amount of appreciation or depreciation in asset values that has occurred between the date of distribution and the date of death. Because these distributions made by the estate are in satisfaction of a pecuniary bequest, the related party rules do not apply and thus, losses must be recognized.

Example 2C-6 True worth pecuniary bequest funding.

Sam Hood died in 2009. His will contained the following provisions:

> If my wife, Anne, survives me, I give to her the lowest pecuniary amount that, if permitted as a federal estate tax marital deduction, would produce the lowest federal estate tax liability for my estate.

The above clause is a formula pecuniary clause. The will further states:

> My executor is directed, using his absolute discretion, to choose the particular assets (including cash if he so decides) to be used to satisfy the marital deduction bequest and to distribute them outright to my wife, Anne, if she survives me. However, my executor may not select any asset for this purpose that does not qualify for the federal estate tax marital deduction. All assets selected are to be valued at their FMV as of the date distributed.

The language in the above clause indicates the marital bequest is a true worth pecuniary bequest since the assets to be distributed are to be measured based on date-of-distribution values. The will further provides that the decedent's son, David, is entitled to all the estate assets remaining after the funding of the marital deduction (the residuary estate). The estate incurred no expenses, and it owed no state inheritance tax. The decedent never made any taxable gifts.

The estate consisted of two assets, undeveloped land valued at $1.6 million and common stock of an international oil company valued at $2.4 million on the date of death. Accordingly, the Form 706 showed no estate tax due. A gross estate of $4 million less a marital deduction of $500,000 equals a taxable estate of $3.5 million. The resulting estate tax of $1,455,800, in the absence of prior taxable gifts, is completely sheltered by the applicable credit amount, producing zero estate tax liability.

The land had not appreciated in value between the Form 706 valuation date and the date of distribution, but the stock was worth $2.55 million on the date of distribution, over a year after the timely Form 706 was filed. The stock paid $29,000 in ordinary dividends prior to its distribution in 2010. The estate tax closing letter, accepting the Form 706 as filed, has been received from the IRS. The executor funded the marital bequest by distributing stock worth $500,000 (date-of-distribution value) to Anne. The balance of the stock, the land, and the $29,000 in cash from the dividends were distributed to David, who inherited the residuary estate.

The preparer of the estate's final Form 1041 for 2010 confirms that the distribution to Anne is not a specific bequest under Reg. 1.663(a)-1(b)(1) because the marital bequest was not of a specific sum of money and the identity of the specific property was not ascertainable as of the date of death. However, because the will did not specify whether the pecuniary bequest was entitled to participate in estate income, state law must be consulted. In Sam Hood's jurisdiction, pecuniary bequests are not entitled to participate in estate income.

The number of shares Anne received was affected by the appreciation or depreciation in value between the Form 706 valuation date and the date of distribution. Since assets in-kind (shares worth $500,000 on the date of distribution) were distributed to Anne in satisfaction of a pecuniary bequest, the distribution of the stock is treated as if the estate had distributed $500,000 cash to Anne, who then used the cash to purchase the stock from the estate. The estate has a long-term capital gain of $29,412 in connection with the stock distribution to Anne [($500,000 ÷ $2.55 million) × $150,000 appreciation].

In addition, the distribution of stock to Anne (a formula pecuniary bequest) and the distribution of the residuary estate to David carry out the estate's DNI of $58,412 ($29,000 from the ordinary cash dividends collected by the estate plus the $29,412 capital gain). [Capital gains and losses are usually not included in DNI, but the gain in this example is included in DNI since the estate terminated and distributed all of its assets in 2009.] The DNI is allocated entirely to David because the distribution made to Anne was in satisfaction of a pecuniary bequest that was not entitled to participate in estate income. Thus, Anne's separate share of DNI was zero. However, if this had not been the estate's final tax year, the $29,412 capital gain realized upon funding Anne's share would be taxed to the estate, rather than to David, reducing his separate share of the residual available for future distribution.

Variation: If Sam's will or local law had entitled Anne, as beneficiary of the pecuniary bequest to participate in the income of the estate, the DNI would have been allocated to both Anne and David according to each separate share.

Fairly Representative Pecuniary Funding. The fairly representative pecuniary funding method values each asset at its income tax basis (typically the Form 706 value) with the additional requirement that the assets distributed "fairly represent" the appreciation and depreciation in the value of all assets available for distribution that has occurred between the Form 706 valuation date and the date the assets are distributed. The requirement that the assets distributed fairly represent the appreciation and the depreciation that has occurred restricts the combination of assets that the fiduciary can select to satisfy the bequest. However, in contrast to the true worth pecuniary method, use of the fairly representative pecuniary funding method does not produce gain or loss. The distribution is a taxable event, but the amount of gain or loss recognized is zero because the amount distributed is measured by the basis (not FMV) of the property.

Example 2C-7 Fairly representative pecuniary bequest funding.

Assume the same facts as in Example 2C-6, except the language in the will describing the marital deduction bequest calls for the "fairly representative" method of funding the marital deduction pecuniary bequest:

> My executor is directed to select and distribute to my wife, Anne, provided she survives me, sufficient assets to fund my estate's federal estate tax marital deduction, using for valuation purposes the adjusted income tax basis of each asset selected. My executor must choose the assets to be distributed in satisfaction of the federal estate tax marital deduction bequest in such a way that they have an aggregate FMV fairly representative of the appreciation or depreciation in value of all assets available for distribution as of the date(s) of distribution.

The preparer of the final 2010 estate income tax return determines that the executor funded the marital deduction bequest in late 2010 by distributing 12.5% [($4 million − $3.5 million applicable exclusion amount) ÷ $4 million] of the land and 12.5% of the stock to Anne. Using (for valuation purposes) the adjusted income tax basis of the assets as shown on Form 706, the executor distributed to Anne land with a basis and FMV at the date of distribution of $200,000 [$1.6 million × ($500,000 ÷ $4 million)] and stock with a basis of $300,000 [$2.4 million × ($500,000 ÷ $4 million)] and a FMV at the date of distribution of $318,750 ($2.55 million × 12.5%). The FMV of the stock distribution to Anne is $18,750 more than basis ($318,750 − $300,000) since the $2.4 million in stock on Form 706 was worth $2.55 million at the date of distribution. In a sense, the marital deduction is overfunded.

David, the residuary beneficiary, received the balance of the land and stock and the $29,000 of dividend income the estate received in 2010.

No gain or loss is recognized on distribution since the assets distributed "fairly represent" the overall appreciation or depreciation in assets after the Form 706 valuation date. Thus, the basis and FMV of the assets distributed reflect the degree of appreciation or depreciation of all the estate assets taken together. Contrast this result with the consequences of the true worth pecuniary funding method of Example 2C-6.

Like the true worth funding method, a formula pecuniary bequest funded using the fairly representative method is a separate share that generally does not carry out DNI unless the bequest is eligible to share in income. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI. However, the amount of DNI is likely to be less than in the case of true worth funding. In this example, DNI is only $29,000 (the dividends received by the estate), as compared to the DNI of $58,412 in Example 2C-6, which included $30,000 of capital gain (since this was the final year of the estate). All $29,000 of DNI is allocated to David since the distribution made to Anne was a pecuniary bequest that was not entitled to participate in estate income. Thus, Anne's separate share of DNI was zero.

Minimum Worth Pecuniary Funding. The minimum worth pecuniary funding method values each asset at the lesser of its date-of-distribution value or its basis for federal income tax purposes. The fiduciary has the freedom to select particular assets to fund a minimum worth pecuniary bequest, in contrast to the restrictions placed on the fiduciary by the fairly representative pecuniary funding method. Since the minimum worth pecuniary funding method values each asset at the lesser of its date-of-distribution value or its basis for federal income tax purposes, the minimum worth pecuniary funding method cannot result in the recognition of gain, but the distribution will cause any loss to be recognized. The losses will be allowed under IRC Sec. 267(b)(13), because the related party rules for estates and beneficiaries do not apply to property distributions in satisfaction of pecuniary bequests.

Example 2C-8 Minimum worth pecuniary bequest funding.

Assume the same facts as in Example 2C-6, except the funding provision in the will for the pecuniary marital deduction has language calling for a minimum worth pecuniary marital deduction bequest:

> My executor shall choose and distribute the assets constituting the marital deduction bequest to my wife, Anne, if she survives me, by using for valuation purposes the lesser of the asset's adjusted basis for federal income tax purposes or the value of the asset at the date(s) of distribution.

Using this method, assets cannot be valued higher than their basis. Therefore, no gain can be recognized. However, if a loss (i.e., depreciated asset) exists and is distributed using this funding method, an income tax loss will be recognized. The potential to overfund the marital deduction also exists since an appreciated asset is measured at the lower of its market value or income tax basis. This funding approach, like the true worth pecuniary method, affords complete flexibility in asset selection.

Like the true worth and fairly representative funding methods, the minimum worth funding mechanism does not carry out DNI for funding the bequests with principal. Although the bequest is considered a separate share, it is only subject to DNI allocation if the bequest is entitled to income. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI. The separate share amount of DNI carried out to Anne (-0-) and David ($29,000) is identical to the amount in Example 2C-7, since the distribution of $500,000 is the same, and the estate has no assets that depreciated between the Form 706 valuation date and the date of distribution, and no capital gain is triggered by the distribution.

Variation: If we assume, in this example, that the stock had depreciated $150,000 (rather than appreciated $150,000) between the Form 706 valuation date and the date of distribution, stock valued at $500,000 would be distributed to Anne. The remaining stock and the land would be distributed to David. A loss would be recognized based on the decline in value of the stock. The loss would be a long-term capital loss, which would be allocated to David, since this was the final year of the estate.

Fractional Share Clauses

A less commonly used alternative to the formula pecuniary clauses is the fractional share clause. A fractional share clause describes a fraction, rather than an amount in money or value, that must be calculated (such as a fraction of the residuary estate qualifying for the marital deduction) to determine the portion of the residuary estate a particular beneficiary will receive.

A fractional share clause is either funded on a pro rata basis (e.g., 25% of each asset in the residuary estate to pass to a certain beneficiary), or the executor selects particular assets or portions thereof (if a *non-pro rata distribution* is authorized by the will or state law) to be distributed using date-of-distribution values.

Gains are generally not recognized by the fiduciary using a fractional share clause. However, the Section 643(e) election is available to recognize such gains. The fiduciary's distribution deduction (and the beneficiary's income inclusion) is the lesser of the adjusted basis or fair market value of the assets distributed, limited by the beneficiary's separate share of DNI. The beneficiary has a carryover tax basis in the property distributed. However, the fiduciary can elect to recognize gain (but not loss) on the distribution under IRC Sec. 643(e)(3). Losses cannot be recognized by the fiduciary since the distributions are not in satisfaction of pecuniary bequests. Additionally, gain must be determined for each separate asset.

Example 2C-9 Fractional share of estate is not a specific bequest.

Claude Barrow died in 2008. His will provided that, after payment of all taxes, debts, and expenses of administration, half of his adjusted gross estate was to be distributed to his surviving spouse, Maude. In 2009, the executor made distributions of cash and property with a stepped-up basis and FMV of $700,000 in satisfaction of the bequest. Taxable DNI in 2009 was $20,000. No other distributions were made that year.

The distributions of cash and property to Maude do not qualify as specific bequests because the distributions represent a fractional share of the residuary estate. Therefore, the distributions carry out Maude's separate share of DNI on Schedule K-1, and she will include the $10,000 (50% of taxable DNI) in her gross income for 2009. The estate will claim a distribution deduction of $10,000 on Schedule B (Form 1041). The undistributed DNI of $10,000 will be taxed to the estate.

Residuary Bequests from an Estate

A *residuary bequest* is a distribution of the remaining estate after the specific and pecuniary bequests have been made. (For trusts, the income beneficiaries receive the trust accounting income while the trust exists. When the trust terminates, the remainder beneficiaries receive the remaining trust principal. These distributions of the remaining trust assets are referred to as Tier 2 distributions, rather than residuary bequests.) Residuary bequests carry out DNI to the beneficiaries under the general rule of IRC Sec. 643(e)(2), as limited by the separate share rule of IRC Sec. 663(c). The estate does not recognize gain or loss on the distribution.

However, if a will divides the residuary of an estate among multiple beneficiaries, distribution to each beneficiary of other than the appropriate fractional share of each asset is treated as a series of taxable exchanges among the beneficiaries unless the executor is given the discretion to make non-pro rata distributions in satisfaction of the fractional shares of the residue to the beneficiaries. A *nonprorata distribution* is an in-kind distribution of 100% of selected estate assets, rather than a pro rata portion of all assets. For example, rather than distributing a one-half interest in each asset to two equal residual beneficiaries, the executor may, if authorized by the governing instrument and local law, exchange one beneficiary's estate assets for a comparable value of the other beneficiary's estate assets.

Example 2C-10 Nonprorata distribution of estate residue.

Josh Montoya and his sister, Bridget, are each the beneficiary of an undivided one-half interest in the residuary estate of their deceased mother, Donna. Donna's estate terminated in 2009 and issued its final Schedules K-1 to the beneficiaries. Josh's Schedule K-1 and Donna's will, along with a copy of the estate tax closing letter from the IRS, are included with the material Josh sent to his tax return preparer in February 2010.

A review of the will and local law does not indicate the executor had the power to make nonprorata distributions of the residuary assets of the estate, although the preparer locates a provision that states, "I devise my residuary estate to my children, Josh and Bridget, share and share alike." Except for a variety of relatively small items and cash actually divided equally, the residuary estate consisted of two principal assets that were distributed by the estate.

The first asset was a securities portfolio of publicly held stocks valued on the December 15, 2009, date of distribution at $2 million and having an income tax basis of $1.9 million ($100,000 of net appreciation from the FMV used on Donna's Form 706, which was filed in February 2009). The second asset was an unimproved tract of land also valued on the date of distribution at $2 million, but with an income tax basis of only $400,000. (Development of a new industrial park adjacent to the tract was announced shortly after the estate tax closing letter was received from the IRS. On December 1, 2009, the executor received two identical cash offers to purchase the tract for $2 million, one from the developer of the industrial park and the other from a real estate speculator. Both offers are open until March 15, 2010.)

A letter included with Josh's tax organizer material indicates that Josh and Bridget requested, and the executor agreed, that Josh receive 100% of the land and Bridget receive 100% of the securities portfolio. Bridget's stock certificates and Josh's quit-claim deed to the land from the estate were mailed to the new owners on the December 15, 2009 distribution date. Bridget likes the stocks in the portfolio and wants to retain them. Josh intends to arrange a partnership with the developer of the industrial park and to contribute the land to the partnership.

Since the executor had no power to make a nonprorata distribution of the residuary estate, for income tax purposes, Bridget is deemed to have sold her one-half interest in the land for Josh's one-half interest in the securities portfolio on December 15, 2009, and vice versa. Since IRC Sec. 1031 (like-kind exchange treatment) does not apply, Josh has $50,000 of 2009 net long-term capital gain to recognize from his transaction (sale of his half interest in the securities portfolio with a basis of $950,000 for $1 million in value), and Bridget has $800,000 of 2009 net long-term capital gain to recognize from her transaction in 2009 (sale of her half interest in the land with a basis of $200,000 for $1 million in value).

Due to the deemed sales, Bridget's basis in the stock portfolio is $1,950,000, and Josh's basis in the land is $1.2 million (the combined basis before the transaction, $2.3 million increased by the amount of the $850,000 of total gain recognized by the parties).

Distributions of Property to Satisfy Claims

Gain is recognized at the fiduciary level when an estate or trust distributes property to satisfy other claims against the fiduciary. It does not matter whether the claim is that of a beneficiary or of a third-party creditor.

Example 2C-11 Property distributed to satisfy a claim against the trust.

In 2009, the trustee of the ABC Trust paid off an unfavorable purchase money mortgage on trust real estate held by an unrelated party using stock with a FMV of $1.2 million (the principal amount of the mortgage) and a basis to the trust of $1 million. The trust recognizes a $200,000 gain as if it had sold the stock and used the proceeds to pay the claim. The gain is reported on Schedule D (Form 1041) because the property was distributed to satisfy a claim against the trust.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following is one of the general rules for property distributions that are not specific bequests?

    a. Such property distributions are treated as "other amounts paid or credited" on Schedule B of Form 1041.

    b. A simple trust's distribution deduction is the lesser of the property's FMV on the distribution date or its adjusted basis in the beneficiary's hands.

    c. An estate's income inclusion and distribution deduction amounts are equal to income that is required to be distributed currently.

    d. When depreciable property is distributed to beneficiaries with no recognized gain or loss and the basis carries over, an estate retains all recapture potential.

36. The Mocha Trust has 150 shares of Chai Corp. stock with an FMV of $10,000. The trust has a $2,000 basis in the stock. In 2009, the trustee distributes the stock to Mike, the sole beneficiary, and makes the IRC Sec. 643(e)(3) election to recognize gain on the distribution as if the stock were sold. The capital gains are allocated to principal. Which of the following most accurately describes one of the consequences of these actions?

    a. The trust recognizes capital gain of $10,000.

    b. Mike will have a $10,000 basis in the stock.

    c. The gain from the transfer is reflected in DNI.

    d. The trust is allowed a distribution deduction of $10,000.

37. What type of pecuniary bequest values assets that are distributed in kind at their date-of-distribution values, not their date-of-death values?

    a. Minimum worth pecuniary bequests.

    b. Fairly representative pecuniary bequests.

    c. True worth pecuniary bequests.

    d. Formula pecuniary bequests.

38. Lawrence's will calls for a *nonprorata distribution* of the assets between his two residuary beneficiaries, Nikki and Jessica. Which of the following best describes how Lawrence's assets will be distributed?

    a. In an in-kind distribution of 100% of selected estate assets to each beneficiary.

    b. By distributing one-half of all the assets to each beneficiary.

    c. After Nikki's bequests are satisfied, Jessica receives remaining principal.

    d. A fractional share of the estate is calculated for each beneficiary.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following is one of the general rules for property distributions that are not specific bequests? **(Page 196)**

    a. Such property distributions are treated as "other amounts paid or credited" on Schedule B of Form 1041. [This answer is correct. Unless it is considered a specific bequest, a distribution of property made by an estate or trust would be considered an "other amount paid or credited" and reported as described. This type of distribution carries out DNI to beneficiaries, resulting in a distribution deduction for the estate or trust.]

    b. A simple trust's distribution deduction is the lesser of the property's FMV on the distribution date or its adjusted basis in the beneficiary's hands. [This answer is incorrect. A complex trust, rather than a simple trust, would use this amount for its distribution deduction or its income inclusion amount.]

    c. An estate's income inclusion and distribution deduction amounts are equal to income that is required to be distributed currently. [This answer is incorrect. An estate would not use this amount for its income inclusion amount or its distribution deduction. Among other entities, this amount would be used for a complex trust's Tier 1 distribution.]

    d. When depreciable property is distributed to beneficiaries with no recognized gain or loss and the basis carries over, an estate retains all recapture potential. [This answer is incorrect. In such a situation, any available depreciation recapture would remain with the distributed property.]

36. The Mocha Trust has 150 shares of Chai Corp. stock with an FMV of $10,000. The trust has a $2,000 basis in the stock. In 2009, the trustee distributes the stock to Mike, the sole beneficiary, and makes the IRC Sec. 643(e)(3) election to recognize gain on the distribution as if the stock were sold. The capital gains are allocated to principal. Which of the following most accurately describes one of the consequences of these actions? **(Page 196)**

    a. The trust recognizes capital gain of $10,000. [This answer is incorrect. The trust would recognize capital gain of $8,000 ($10,000 of FMV − $2,000 basis).]

    b. Mike will have a $10,000 basis in the stock. [This answer is correct. Mike's basis in the stock after the distribution is equal to the trust's $2,000 basis in the stock plus the $8,000 gain recognized on the distribution.]

    c. The gain from the transfer is reflected in DNI. [This answer is incorrect. Capital gains would be allocated to principal, so DNI will not reflect the gain from the discretionary stock distribution.]

    d. The trust is allowed a distribution deduction of $10,000. [This answer is incorrect. The trust's distribution deduction is dependent on how much DNI is available. The $10,000 FMV of the stock is the maximum amount of the trust's distribution deduction, but if DNI is less than $10,000, the trust's distribution deduction will be less.]

37. What type of pecuniary bequest values assets that are distributed in kind at their date-of-distribution values, not their date-of-death values? **(Page 196)**

    a. Minimum worth pecuniary bequests. [This answer is incorrect. When this method is used, each asset is valued at the lesser of its date-of-distribution value or its basis for federal income tax purposes. Use of this method cannot result in gain recognition.]

    b. Fairly representative pecuniary bequests. [This answer is incorrect. In this type of bequest, each asset is valued at the income tax basis with an additional requirement that assets are distributed so they "fairly represent" appreciation and depreciation in the value of all assets available for distribution occurring between the Form 706 valuation date and the date assets are distributed.]

c. True worth pecuniary bequests. [This answer is correct. This is the most common method used to fund formula pecuniary bequests. The fiduciary has freedom to select particular assets to fund the bequest.]

d. Formula pecuniary bequests. [This answer is incorrect. This type of pecuniary bequest is one in which neither the amount nor the identity of the property to be distributed is ascertainable under the terms of the will or trust document. Formula pecuniary bequest is an umbrella term that includes the type of bequest described in the question above.]

38. Lawrence's will calls for a *nonprorata distribution* of the assets between his two residuary beneficiaries, Nikki and Jessica. Which of the following best describes how Lawrence's assets will be distributed? **(Page 196)**

a. In an in-kind distribution of 100% of selected estate assets to each beneficiary. [This answer is correct. When making this type of distribution, the executor of Lawrence's estate has the power to exchange one beneficiary's assets for a comparable value of the other's. Therefore, if Lawrence had a stock portfolio and a piece of real estate with the same value, Nikki could receive the real estate and Jessica could receive the stocks, instead of each receiving one-half of each asset.]

b. By distributing one-half of all the assets to each beneficiary. [This answer is incorrect. This would be a prorata portion of all the proceeds of Lawrence's estate, which is not what is called for by his will in this scenario. When a prorata distribution is used, exchanges of property between Nikki and Jessica would be taxable distributions.]

c. After Nikki's bequests are satisfied, Jessica receives remaining principal. [This answer is incorrect. This would be true if Lawrence bequeathed either specific or pecuniary bequests to Nikki and made a bequest of the residuary of the estate to Jessica. However, that is not the case in this scenario.]

d. A fractional share of the estate is calculated for each beneficiary. [This answer is incorrect. If Lawrence's will stated that a fractional share clause be used to fund pecuniary bequests to Nikki and Jessica, this would be done to determine the portion of the estate each beneficiary would receive. Fractional share formulas can be done on a prorata or a nonprorata basis. However, this is not what Lawrence's will describes in this scenario.]

Considerations for Distributions in Lieu of Specific Property or Specific Dollar Amount

Gain Recognition Rules

If a property distribution is in satisfaction of specific property other than that which is actually distributed or a required dollar amount of income, gain but not loss is recognized at the fiduciary level. (See illustrations in Examples 2D-1 and 2D-2, respectively.) Although Reg. 1.661(a)-2(f) provides the authority for gain and loss recognition, this regulation has not yet been updated for the related party rules in IRC Sec. 267. These rules deny loss recognition for transactions between an estate or trust and its beneficiaries, except in the case of an estate making a property distribution to satisfy a pecuniary bequest. A property distribution substituted for other specific property or a required dollar amount is not considered to be in satisfaction of a pecuniary bequest; thus, loss recognition is denied.

The transfer is treated as a distribution of cash in an amount equal to the property's FMV, followed by a deemed sale of the property to the beneficiary for the cash. In such cases, the beneficiary acquires a basis equal to the FMV of the property on the date of the transfer. However, when a loss is disallowed because of the related party rules, future gain from the sale of the property need be recognized only to the extent such gain exceeds previously unrecognized losses.

If the property distributed to satisfy a specific dollar obligation is a capital asset, the gain will be a capital gain to the fiduciary. If the property is ordinary income property or has an ordinary income component, ordinary income will be generated by the distribution unless it is a distribution made by an estate in satisfaction of a pecuniary bequest. If the property actually distributed is income in respect of a decedent (IRD) or a claim to IRD, IRC Sec. 691 controls.

Even though capital gain or loss or ordinary recapture income is generated, the property distribution generally will not carry out DNI to the beneficiary unless the distribution is made to satisfy a specific dollar obligation of *income* (i.e., a Tier 1 distribution). The fiduciary is not entitled to a distribution deduction nor does the beneficiary recognize income on amounts that, under the terms of the governing instrument, are properly paid or credited as a bequest of a specific sum of money or of specific property and paid or credited in three or fewer installments. Therefore, unless the will provides that a specific bequest is to be satisfied in more than three installments, satisfaction of the bequest with different property than that specified in the governing instrument will not carry out DNI to the beneficiary.

Example 2D-1 In-kind distribution satisfying beneficiary's right to other property.

In 2009, the executor of the A. L. King Estate distributed 100 shares of Acme Corp. common stock, with a basis of $20,000 and a FMV on the date of distribution of $25,000, to satisfy a specific bequest of $25,000 cash. The beneficiary agreed to accept the Acme stock in lieu of cash. There were no other distributions in 2009.

The DNI for 2009 is $75,000. State law requires the estate to follow the common practice of allocating capital gains to principal.

The estate must recognize $5,000 gain on the transaction since the property distribution is in satisfaction of a specific-dollar bequest. The $5,000 gain is a capital gain since the stock distributed is a capital asset and is shown on Schedule D as if the stock had been sold to a third party. However, if ordinary income property had been distributed in satisfaction of the $25,000 pecuniary bequest, capital gain treatment would still apply, since an estate's distribution in satisfaction of a pecuniary bequest is not subject to the related party rule requiring ordinary income treatment.

The beneficiary's tax basis in the property received is its FMV ($25,000), which is equal to the $20,000 tax basis of the estate plus the $5,000 of gain recognized by the estate. Because there has been a deemed sale of the estate property, the estate's basis is not tacked onto the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquisition (i.e., date of distribution).

A Schedule K-1 from the estate to the beneficiary is not required because the $25,000 in cash was a specific bequest that does not carry out DNI from the estate. However, the preparer should make sure the beneficiary is informed of his/her tax basis in the shares and the date his/her holding period begins.

If property is distributed in satisfaction of a beneficiary's right to receive a specific dollar amount of income (e.g., a Tier 1 distribution of a complex trust or a required income distribution of a simple trust), which is not the same as a pecuniary bequest, gain (but not loss) must be recognized by the fiduciary.

Example 2D-2 In-kind distribution satisfying beneficiary's right to a specific dollar amount of income.

The Mabel Huffman Trust is to pay $50,000 from current income each year to Cindy (i.e., a Tier 1 distribution). The excess of the annual $50,000 of current income is to be accumulated and distributed to Cindy's younger brother, Todd, when Todd reaches age 21. (Since all income is not required to be distributed currently, this is a complex trust.) The trustee distributes shares of stock worth $50,000 (basis of $25,000) in satisfaction of the specific dollar amount.

The distribution of the stock is treated as if the trustee had distributed $50,000 to Cindy, who in turn purchased the stock from the trustee with the cash at fair market value. The transfer of the stock in satisfaction of the beneficiary's right to receive $50,000 of current income results in a $25,000 capital gain to the trust ($50,000 − $25,000). Cindy's basis in the stock is the price she is deemed to have paid for it ($50,000). The Trust's holding period does not tack onto Cindy's holding period. Instead, it begins on the date of the stock distribution to her. In addition, the trust is allowed an income distribution deduction of $50,000, and Cindy must include $50,000 in gross income on her personal income tax return.

Variation: If the trustee had distributed stock that had depreciated in value to Cindy, the trust would not be allowed to deduct the loss on distribution due to the related party loss rule of IRC Sec. 267(b)(6).

Considerations for Distributions of Property in Lieu of Income

Gain Recognition Rules

If the fiduciary distributes property in satisfaction of the beneficiary's right to receive income, the estate or trust will be treated as having sold the property for its fair market value on the date of distribution. The fiduciary is deemed to have distributed cash in an amount equal to the trust income required to be distributed currently to the beneficiary who, in turn, is deemed to have used the cash to purchase the asset from the fiduciary.

If the property has appreciated in value, gain must be recognized by the estate or trust. However, if the property has depreciated in value, loss recognition by a trust or estate is disallowed by the related party rules except by an estate in satisfaction of a pecuniary bequest. Because distributions of property in substitution of a beneficiary's right to receive income are not considered to be in satisfaction of a pecuniary bequest, loss recognition is disallowed by the related party rules.

Example 2E-1 Property distributed in satisfaction of beneficiary's right to receive income when the property's FMV does not exceed DNI.

The preparer of the 2009 Form 1041 for the William Jefferson Family Trust determines from the trust document that the income beneficiary, George, was entitled to an income distribution of $100,000 in 2009. The trust had ordinary income of $100,000 and no tax-exempt income for that year. Fiduciary accounting income was also $100,000. The trust document allocates all capital gains to principal.

The trustee's records indicated that George was willing to accept 1,000 shares of ABC Corp. common stock with a FMV of $100,000 and a tax basis in the hands of the trust of $80,000 in satisfaction of his right under the trust instrument to receive $100,000 of income for 2009. No other distributions were made that year.

The trust will have a $20,000 capital gain. The capital gain will be reported on Schedule D as if the stock in ABC Corp. had been sold to a third party. George will have a $100,000 tax basis in the stock and a holding period that begins on the date of distribution. In addition, George will report income of $100,000, and the trust will have a distribution deduction of $100,000.

To trigger the gain, the trust does not have to be a simple trust required to distribute $100,000 of trust accounting income. The trust in this example could also have been a complex trust with at least $100,000 of fiduciary accounting income that was *required* to distribute $100,000 of income in 2009 (i.e., a Tier 1 distribution), the trustee having discretion to accumulate or distribute the excess. The key points are the distributee's *right* to receive income and the distribution of property in satisfaction of that right.

If the asset distributed had been a machine with a basis of $80,000, a FMV of $100,000 and $20,000 of potential Section 1245 recapture, the distribution would have triggered recapture income to the trust which is reported on Form 4797. Satisfaction of the beneficiary's right to $100,000 of income by distributing the machine is treated as a distribution of $100,000 cash to the beneficiary, who in turn is deemed to use the cash to purchase the machine from the fiduciary at its FMV.

When cash is distributed along with property to satisfy a beneficiary's right to income, the property is only considered to satisfy the income distribution to the extent the cash is insufficient to satisfy the required income distribution.

Example 2E-2 Cash and property distributed to satisfy required income distribution.

Assume the same facts as in Example 2E-1 , except the trustee distributes $40,000 cash along with the 1,000 shares of ABC Corp. to George. The $40,000 cash is considered first in satisfying the $100,000 required income distribution, leaving $60,000 of stock value to fulfill the rest of the $100,000 income distribution. The remaining $40,000 of stock value is a distribution of principal. Only the appreciation attributable to the stock used to meet the required income distribution must be recognized by the trust. The $80,000 basis must be allocated between the income and principal distributions. The income distribution would be 60% ($60,000/$100,000) while 40% ($40,000/$100,000) would be allocated to the distribution of principal.

The trust recognizes a gain of $12,000 [$60,000 − $48,000 (60% × $80,000)] on the transfer of stock to George. If the trust does not make a Section 643(e)(3) election, George will have a basis of $92,000 [$60,000 + $32,000 (40% × $80,000)] in the stock. If the trust makes a Section 643(e)(3) election, George will have a $100,000 basis in the stock, but the trust will recognize an additional gain of $8,000 ($40,000 − $32,000).

When gains are included in trust accounting income, using appreciated property to satisfy a required income distribution creates additional problems. The gain recognized will increase accounting income, causing the need for an additional distribution. The required income distribution can only be satisfied by distributing cash or property that does not produce a gain includable in accounting income.

Example 2E-3 Gains included in trust accounting income results in larger required income distribution.

Assume the same facts as in Example 2E-1, except that the trust documents allocate capital gains to income. When the trustee transfers the 1,000 share of stock to George, the $20,000 realized gain increases the accounting income, thus requiring an additional $20,000 distribution to George. Either cash or property that does not generate capital gain should be distributed to George to prevent increasing the accounting income, which will result in additional required distributions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. When Sue dies, she bequeaths a stock portfolio to Bobby. Bobby requests a distribution of an equivalent amount of cash instead, and the executor agrees. Which of the following would occur?

    a. The estate will be able to recognize any loss that results from the transfer.

    b. The transfer is treated as a cash distribution followed by a deemed sale of the property.

    c. Bobby will receive DNI from the resulting distribution.

    d. The fiduciary is entitled to an income distribution deduction on the transaction.

40. Which of the following could occur when property is distributed in lieu of a beneficiary's right to receive income?

    a. If the property has appreciated in value, the beneficiary recognizes the gain.

    b. A complex trust distributes property in lieu of a Tier 2 distribution of income.

    c. A combination of cash and property is distributed in lieu of the income.

    d. The fiduciary is deemed to have purchased the property.

41. The Bates Estate sells a parcel of land on the installment method. After collecting 11 payments, the obligation is distributed to one of the estate's beneficiaries, Lena, to satisfy a pecuniary bequest. Due to current interest rates at the time of the distribution, the note's FMV is lower than its unrecovered basis. What are the consequences of these actions?

    a. The estate can deduct the difference between the note's FMV and unrecovered basis.

    b. Lena's basis in the note is limited to the FMV at the time of the distribution.

    c. The estate must recognize income in respect of a decedent (IRD) on the transaction.

    d. The cash method of accounting must be used to report the sale.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. When Sue dies, she bequeaths a stock portfolio to Bobby. Bobby requests a distribution of an equivalent amount of cash instead, and the executor agrees. Which of the following would occur? **(Page 208)**

    a. The estate will be able to recognize any loss that results from the transfer. [This answer is incorrect. This was not a pecuniary bequest, so loss recognition on the transfer would be denied.]

    b. The transfer is treated as a cash distribution followed by a deemed sale of the property. [This answer is correct. The transfer will be treated as a cash distribution in the amount of the stock portfolio's FMV. This is followed by a deemed sale of the property to Bobby for cash.]

    c. Bobby will receive DNI from the resulting distribution. [This answer is incorrect. Because this distribution was not made to satisfy a specific dollar obligation of income (i.e., a Tier 1 distribution), no DNI will be carried out to Bobby.]

    d. The fiduciary is entitled to an income distribution deduction on the transaction. [This answer is incorrect. Bobby would not recognize income on this distribution, and neither would the fiduciary be entitled to a distribution deduction in this transaction.]

40. Which of the following could occur when property is distributed in lieu of a beneficiary's right to receive income? **(Page 209)**

    a. If the property has appreciated in value, the beneficiary recognizes the gain. [This answer is incorrect. In this situation, the gain would be recognized by the estate or trust. Lost recognition, however, is disallowed by the related-party rules.]

    b. A complex trust distributes property in lieu of a Tier 2 distribution of income. [This answer is incorrect. To make a distribution in lieu of a beneficiary's right to receive income, the trust must be required to distribute fiduciary accounting income to the beneficiary. This is not the case with a Tier 2 distribution of a complex trust. Examples of this situation are (1) a simple trust required to distribute current income and (2) a required Tier 1 distribution made by a complex trust.]

    c. A combination of cash and property is distributed in lieu of the income. [This answer is correct. This can happen; however, in this situation, the property will only be considered to satisfy the income distribution to the extent that the cash does not.]

    d. The fiduciary is deemed to have purchased the property. [This answer is incorrect. When this type of distribution is made, the fiduciary is deemed to have made a cash distribution in an amount equal to the required income, and the beneficiary is then deemed to have used that cash to purchase the asset from the fiduciary.]

41. The Bates Estate sells a parcel of land on the installment method. After collecting 11 payments, the obligation is distributed to one of the estate's beneficiaries, Lena, to satisfy a pecuniary bequest. Due to current interest rates at the time of the distribution, the note's FMV is lower than its unrecovered basis. What are the consequences of these actions? **(Page 209)**

    a. The estate can deduct the difference between the note's FMV and unrecovered basis. [This answer is correct. Because this is a pecuniary bequest, the estate can make the deduction. The deduction could not be made under an IRC Sec. 643(e)(3) election.]

    b. Lena's basis in the note is limited to the FMV at the time of the distribution. [This answer is incorrect. Lena's basis in the note would be equal to its predistribution basis.]

c. The estate must recognize income in respect of a decedent (IRD) on the transaction. [This answer is incorrect. If property was sold on the installment basis before a decedent's death, unrecognized gain at death is IRD. If the obligation were sold by the estate, the estate would then recognize IRD.]

d. The cash method of accounting must be used to report the sale. [This answer is incorrect. If an executor sells property on an estate's behalf, the installment method of accounting is used to report the gain, unless the fiduciary elects out of installment reporting.]

Considerations for Distributions of Depreciated Property

Because of the related-party loss limitation rules of IRC Sec. 267, trusts and those estates not selling or exchanging the property in satisfaction of a pecuniary bequest should generally sell loss assets to a third party and obtain immediate recognition of the loss rather than distribute the loss property to a beneficiary, provided there is no desire to retain the specific property indefinitely.

If a trust beneficiary does take a distribution of depreciated property and later disposes of the property in a taxable transaction, gain is recognized only to the extent it exceeds the loss previously disallowed to the trust. If the property is depreciated or declines in value while held by the beneficiary, any subsequent loss is based on the fair market value (FMV) of the property at the time of the original distribution from the trust to the beneficiary.

Example 2F-1 Distribution of loss property by a trust.

The income beneficiary of XYZ Trust had the right to a 2009 income distribution of $100,000. The trustee satisfied that right by distributing stock in ABC Corporation with a value of $100,000 and a tax basis of $130,000. The trust's distribution deduction is $100,000, and the income beneficiary includes $100,000 in gross income (provided there is at least $100,000 in DNI).

Satisfaction of a right to income by distributing property to a beneficiary is treated as if the cash were distributed and the beneficiary used the cash to purchase the property. However, the trust cannot recognize the loss in this situation due to the related party rules. The trust's disallowed loss is $30,000.

If the beneficiary later sells the stock for an amount between $100,000 and $130,000, he or she will recognize no gain or loss since gain is recognized only to the extent it exceeds the loss disallowed the trust. A sale for $140,000 would produce $10,000 of gain to the beneficiary. A sale for $90,000 would produce only $10,000 of loss, based on the property's FMV when the original distribution is made from the trust.

Considerations for Distributions of Installment Obligations

Transfer of Fiduciary's Installment Obligation

If an executor or trustee sells property on behalf of an estate or trust on the installment basis, the installment method of accounting must be used to report the gain, unless the fiduciary affirmatively elects out of installment reporting. If the fiduciary subsequently distributes the installment note to the beneficiary, the distribution is a taxable disposition of an installment obligation, causing accelerated gain recognition at the fiduciary level to the extent the fair market value of the installment obligation exceeds the basis of the obligation.

Example 2G-1 Distribution of installment note to beneficiary.

The trustee of the Ben Lucas Testamentary Trust sold a parcel of appreciated land for $100,000 on the installment basis in 2008. The land had a basis to the trust of $60,000. The trust received a $28,000 down payment and took a note for the remaining $72,000. The note called for 36 monthly payments of $2,000, plus interest at a fair market rate. In 2009, after receiving 10 payments, the trustee distributed the note to Betty, the trust beneficiary.

The distribution of the installment note to Betty is a taxable disposition of an installment obligation to the trust. Therefore, the trust recognizes gain to the extent of the excess of the FMV of the note over its adjusted basis.

The adjusted basis of the note is calculated as follows:

Initial face value of the obligation	$ 72,000
Less payments received ($2,000 × 10)	(20,000)
Face value at time of distribution	52,000
Less income not yet reported ($52,000 × 40%, gross profit percentage)	(20,800)
Basis of the installment obligation at time of distribution	$ 31,200

Assuming the FMV of the note is $45,000, the gain on the distribution is $13,800 ($45,000 − $31,200).

Transfer of Installment Obligation Received from Decedent

When property was sold on the installment method before the decedent's death, any gain unrecognized at death is IRD and taxable upon collection. The step-up basis rules do not apply, so the estate's basis is the same as the decedent's. The estate will recognize income as payments are made, using the same gross profit percentage the decedent would have used as if the decedent had lived and collected the payments. Unlike the situation discussed in Example 2G-1, transferring the decedent's installment obligation to a beneficiary does not automatically trigger an acceleration of gain recognition.

If the installment obligation is sold, cancelled or transferred to the obligor, the estate will recognize IRD to the extent the FMV of the obligation or the amount received upon sale, whichever is greater, exceeds the decedent's remaining basis. When an installment obligation is transferred to satisfy the right to receive a specific dollar bequest or a Section 643(e)(3) election is made, the transfer is considered a sale, so the estate will recognize IRD to the extent of the excess of the installment obligation's FMV at the time of transfer over the decedent's basis in the item.

The FMV of the installment obligation at the date of transfer may be less than the decedent's basis (due to the discounted value of the right to receive payments over a period of time at the specified interest rate), which will result in a loss on the transfer. In that case, the loss would be deductible if the transfer was to satisfy a pecuniary bequest, but would not be deductible under a Section 643(e)(3) election due to the related party rule. The FMV on the date of transfer is based on the prevalent interest rates on that date, which might be significantly higher than those of the obligation.

Example 2G-2 Transfer of decedent's installment note results in sale treatment if made to satisfy a pecuniary bequest.

Jana sold land for $1.25 million, collecting a 20% down payment and a note for $1 million. The note required 10 annual payments with a stated interest rate of 6%. Jana's basis in the note was $100,000. At her death, she had collected five payments, so her unrecovered basis was $50,000 and the unrecognized capital gain was $450,000 ($1 million − $100,000 × 5/10). During estate administration, the executor collected two payments, leaving an unrecovered basis of $30,000 and an unrecognized capital gain of $270,000 ($1 million − $100,000 × 3/10).

If the note was distributed to a residuary beneficiary, the beneficiary would continue receiving payments and recognize capital gains as payments were collected. The beneficiary would take the unrecovered basis of $30,000 and recognize capital gains using Jana's gross profit percentage.

If the estate transferred the note to satisfy a pecuniary bequest or made a Section 643(e)(3) election, the estate recognizes a capital gain to the extent the note's FMV on the date of transfer exceeded the $30,000 unrecovered basis. The beneficiary would take a basis in the note equal to its predistribution basis, increased by any gain recognized by the estate. This is the same result as shown in Example 2G-1.

If the prevalent interest rates on the date of transfer caused the note's FMV to be less than $30,000, the estate could deduct the loss if the transfer satisfied a pecuniary bequest, but not under a Section 643(e)(3) election. The beneficiary's basis in the note would be equal to its FMV on the date of transfer, and he or she could use the disallowed loss to reduce any gain on a subsequent sale of the note.

Considerations for Distributions of Partnership Interests and S Corporation Stock

Distribution of Partnership Interests from an Estate or Trust

When an estate or trust distributes a partnership interest to a beneficiary, the following issues must be addressed:

1. Whether the distribution affects the partnership's existence; and
2. How the income is allocated between the fiduciary (estate or trust) and the beneficiary.

Neither of these issues can be addressed by the preparer of Form 1041. Instead, they are determined at the partnership level and reported on a Schedule K-1 (Form 1065) to the appropriate beneficiary. Before the partnership can correctly address each issue, the estate or trust must provide the relevant information to the partnership. By understanding how the partnership should account for these issues, the fiduciary will be able to collect and submit the necessary information to the partnership. In most cases, the same practitioner will not be preparing both the partnership and fiduciary tax returns, thus requiring communication between the fiduciary and the partnership to ensure proper tax reporting.

Partnership Existence. A partnership terminates for tax purposes if (1) 50% or more of the capital and profits interests are sold or exchanged within a 12-month period; (2) the partnership ceases doing business; or (3) the partnership ceases to have at least two partners. However, a partner's death and the subsequent transfer of the deceased partner's interest to the partner's estate or trust is not treated as a sale or exchange for this purpose. Thus, even a partnership with only two partners will not automatically terminate when a partner dies, since the decedent's estate or another successor-in-interest becomes a partner for tax purposes.

What the executor does with the partnership interest after the decedent's death may cause the partnership to terminate for tax purposes, however, if the decedent owned 50% or more of the partnership, and the executor sells the decedent's interest within a 12-month period, the partnership will terminate. (This is often referred to as a "technical termination.") A sale can occur when the executor sells the interest to a third-party, distributes the interest to satisfy a pecuniary bequest, or makes an election under IRC Sec. 643(e)(3) to recognize gain in the year the interest is distributed. If the partnership liquidates the decedent's interest, no sale is deemed to have occurred. As long as the partnership has at least two partners when the liquidation payments end, the partnership will not terminate for tax purposes. Distributing a partnership interest to satisfy a specific or residuary bequest [without a Section 643(e)(3) election] is not considered a sale, and thus, the partnership will not terminate. The same principles apply when a trust distributes a partnership interest.

Income Allocation. The tax year of a partnership closes with respect to a partner who dies during the year. The deceased partner's share of the partnership's income (or loss) earned up to the date of death is reported on the deceased partner's final individual tax return, and the estate reports the remaining income (or loss) on the estate's income tax return. Note that this Code Section applies only to tax years of a deceased *partner*, rather than to the *partnership* upon the partner's death or upon distributions of the deceased partner's interests made by an estate or trust to a beneficiary. The allocation of partnership income between an estate or trust and a beneficiary who acquires an interest in the partnership from the fiduciary depends on the type of distribution made by the estate or trust.

Specific Bequest. When a person dies, all of the decedent's assets are owned by the estate beneficiaries, subject to estate administration. The beneficiaries are entitled to receive the net assets (i.e., creditors must be paid before any distributions are made). If the estate has more assets than debts, the beneficiaries entitled to specific bequests receive their inheritances first. In addition, the beneficiary of a specific bequest is entitled to all income attributable to the specific bequest property. When the estate has sufficient assets so that a specific bequest is not needed for estate administration or to pay a decedent's debts, the executor can treat the bequest as a direct transfer from the decedent to the beneficiary, thus bypassing probate administration. All of the bequest's income from the decedent's date of death can be reported on the beneficiary's tax return, and none is reported on the estate's income tax return. Since the estate ignores specific bequests when computing its distribution deduction for the year, reporting the specific bequest income directly to the beneficiary and ignoring the income (for Form 1041 purposes) avoids potential DNI allocation issues and simplifies the reporting.

If a partnership interest is specifically bequeathed to a beneficiary, and it is certain that the beneficiary will receive the bequest, the fiduciary should notify the partnership of the beneficiary's address and inheritance. The partnership can contact the beneficiary to obtain the necessary identification information for issuing a Schedule K-1 (Form 1065) to the beneficiary. This will enable the partnership to allocate the partnership's post-death income entirely to the beneficiary, with no Schedule K-1 (Form 1065) issued to the estate.

If the size of debts makes it unlikely that the specific bequests can be made, the executor should notify the partnership of its tax identification number and address so a Schedule K-1 (Form 1065) and all partnership distributions can be sent to the estate, which will then report the partnership income on Form 1041. The estate should keep accurate records of the distributions received from the partnership, since these amounts belong to the beneficiary entitled to the specific bequest unless the estate needs the funds to pay the decedent's debts. None of these funds can be used by the executor to pay administration expenses or debts if other assets are available, even if other assets must be sold to generate cash. A lack of liquidity does not allow an executor to reduce a specific bequest. If it is later determined that the partnership interest can be distributed to the beneficiary, the executor should account for the distribution in the same manner as a residuary bequest, except that the distribution of the partnership interest itself must be ignored when allocating DNI.

If the transfer of the specific bequest property to the beneficiary is delayed while income from the property is received by the estate, the income is typically accounted for on the estate's Form 1041. A specific bequest is not a separate share or subject to the distribution rules. However, the income from a specific bequest property is a separate share, which is subject to the distribution rule. The income is reported on the estate's Form 1041 and offset by a distribution deduction to the beneficiary. These results are the same as the beneficiary's direct reporting of the income. If specifically bequeathed property is needed by the estate for administration purposes, the income from these assets is accumulated for future distribution under the separate share rules and may be subject to estate income tax during the meantime. Upon eventual distribution of the property and accumulated estate income, the amount distributed to the beneficiary will be tax-free, in accordance with the separate share rules.

For trusts, specific bequests are quite uncommon since such bequests would require immediate distribution of the property. In those uncommon situations of specific bequests by a trust, the trust would assign any of its rights in the property to the beneficiary, thus allowing the beneficiary to own the property directly. Mandatory income distributions are not considered specific bequests.

Pecuniary Bequests. An estate's distribution of noncash property to satisfy a pecuniary bequest is treated as a sale, requiring the estate to recognize gain or loss. When a trust distributes noncash property to satisfy a mandatory income or annuity distribution, the same result occurs except no loss is allowed due to the related party rules.

Since the distribution of noncash property to satisfy a pecuniary bequest is considered a sale, the partner's (i.e., the estate's) tax year ends on the date of the distribution to the beneficiary. The estate will recognize its share of the partnership income and loss from the beginning of the year until the date of distribution, and the beneficiary will report the remaining portion on his or her tax return. The fiduciary must notify the partnership of the pecuniary distribution so the partnership can make the proper allocation.

Residuary Bequests. Under the general rule, the distribution of noncash property as part of a residuary bequest does not result in a sale. However, when a Section 643(e)(3) election is made, a deemed sale results. A distribution of a partnership interest as a residuary bequest when a Section 643(e)(3) election is made would be accounted for in the same manner as a pecuniary bequest (i.e., gain, but not loss recognition). Normally, when a trust terminates and makes a distribution to the remainder beneficiaries, these distributions are accounted for in the same manner as residuary bequests. The same holds true for discretionary distributions of principal during the trust's existence.

The guidance for allocating partnership income when the estate has made a residuary bequest of a partnership interest is not clear. A conflict exists between Reg. 1.706-1(c)(3)(vi), Ex. 3 and Rev. Rul. 72-372, and no guidance has been issued to resolve the inconsistency. Although the entity in Ex. 3 of Reg. 1.706-1(c)(3)(vi) was an estate, in contrast to a trust in Rev. Rul. 72-372, it is unclear whether this entity distinction should account for the difference in how income is to be allocated. Since the ruling was issued after the regulations and referred to the same regulation in which the example is found, it is probably preferable to follow the approach used in the ruling (i.e., Approach Two). In either case, the partnership does not terminate, since no sale occurs. The two approaches are as follows:

1. *Approach One [based on Reg. 1.706-1(c)(3)(vi), Ex. 3].* When the partnership interest is distributed, all partnership allocations for the entire year are allocated to the beneficiary receiving the partnership interest.

2. *Approach Two (based on Rev. Rul. 72-372).* In the year the partnership interest is distributed, the partnership year closes as to the partner. Thus, the partnership must allocate income to the estate for the portion of the year the interest was owned by the estate, and the remaining portion is allocated to the beneficiary who receives the partnership interest.

Example 2H-1 Type of distribution from the estate or trust determines how partnership income is allocated.

Sally Jones was a 30% partner in the Mumford Partnership, a calendar year partnership, at the time of her death on September 30, 2009. All of the partnership's income or losses from January 1 to September 30 are reported on Sally's final Form 1040. The type of bequest determines how the post-death partnership activity is reported:

1. *Specific Bequest.* Sally's will made a specific bequest of her partnership interest to her daughter, Rosie, and there are sufficient other assets to pay estate debts. Sally's executor notifies the Mumford partnership of Sally's death and provides information regarding Rosie's direct inheritance of Sally's partnership interest and Rosie's address. The partnership will contact Rosie to obtain the necessary identification information, and at the end of 2009, will send Rosie a Schedule K-1 (Form 1065) allocating the partnership's income and loss from October 1 through December 31, 2009 to Rosie. The estate will not receive a Schedule K-1 from the Mumford Partnership.

2. *Pecuniary Bequest.* Instead of a specific bequest, Sally's will provided for a pecuniary bequest of $250,000 to be made to her daughter, Rosie. No estate distributions were made to Rosie in 2009, so the partnership income from October 1 to December 31, 2009 is reported on the estate's Form 1041. On April 30, 2010 the interest in Mumford Partnership, which had a fair market value of $250,000 on that date, was distributed to Rosie in satisfaction of her pecuniary bequest. The estate must report the distribution as a sale, with a sales price of $250,000. The estate notifies Mumford Partnership of the distribution. The partnership will allocate the partnership's income from January 1 through April 30, 2010 to the estate and its income from May 1 through December 31, 2010 to Rosie.

3. *Residuary Bequest.* Instead of any specific or pecuniary bequests, Sally's will provided that Rosie and her brother Fred are to be equal residuary beneficiaries. After paying all debts, the executor closes the estate on October 31, 2010 and distributes 50% of the assets to Rosie and 50% of the assets to Fred. Included in these assets is the Mumford Partnership interest. Both Rosie and Fred will hold 15% partnership interests in Mumford Partnership. Since no distributions were made in 2009, the partnership income from October 1 to December 31, 2009 is reported on the estate's Form 1041. In 2010, the estate notifies the partnership of its distribution of partnership interests to Rosie and Fred. The allocation of 2010 partnership income between the estate, Rosie, and Fred depends upon the approach used, as follows:

   a. *Approach One.* None of the partnership income for 2010 is reported by the estate. Instead, the income for the entire year is reported by Rosie and Fred. The estate, Rosie, and Fred should all receive Schedules K-1s from the partnership for 2010. Although the estate's 2010 Schedule K-1 (Form 1065) will not reflect any income or loss for the year, it will report the estate's zeroed out capital account on the capital account reconciliation. Rosie and Fred will each report 15% of the partnership's 2010 income on their individual tax returns.

   b. *Approach Two.* As of October 31, 2010 (the date the estate distributed the partnership interest to Rosie and Fred), the partnership year closes as to the estate. Thus, the partnership reports the estate's distributive share of partnership income earned through October 31, 2010 on a Schedule K-1 (1065) issued to the estate. On its 2010 Schedule K-1 from the partnership, the estate's capital account should be zeroed out on the capital account reconciliation. The partnership will also issue a Schedule K-1 to Rosie and Fred to report their share (15% each) of the income earned by the partnership from November 1 through December 31, 2010. The estate will include the partnership income earned through October 31, 2010 in its DNI for 2010. Since Rosie and Fred each received 50% of the total estate distributions, each would receive their separate 50% share of the estate's DNI.

Variation: Unless the fiduciary has the authority (according to state law and the governing instrument) to make nonprorata distributions, a deemed sale would occur if the executor exchanged the assets being distributed to Rosie and Fred. Assume Sally's estate consisted of the 30% Mumford Partnership interest and a building. Rosie preferred to receive the entire partnership interest, whereas Fred wanted the building. Because Sally's will allowed nonprorata distributions, the executor distributed the 30% partnership interest to Rosie and 100% of the building to Fred on October 31, 2010 and avoided sale treatment. (Effectively, the executor has exchanged Rosie's 50% ownership in the building for Fred's 15% share of Mumford Partnership.)

If Approach One is followed, the entire 30% share of the partnership income for 2010 is reported by the partnership to Rosie, with no allocation to the estate.

Approach Two would allocate 30% of the partnership income earned through October 31, 2010 to the estate and includable in DNI, which would be carried out by the estate to both Rosie and Fred in equal shares. From a cash flow perspective, this method seems unfair to Fred, since he will be subject to income taxes on his half of the estate's DNI for the partnership income even through he did not receive the partnership interest. However, when valuing the estate residue to determine the amount distributable to each beneficiary, the value of the partnership interest should include any taxable income earned by the partnership from January 1, 2010 through October 31, 2010. Because both beneficiaries share in this increase in the estate residue on an equal basis, using Approach Two seems to provide a more equitable allocation of income to both beneficiaries.

Gain Allocation for Liability Relief. When a partnership interest is transferred, the share of partnership liabilities allocable to the transferred interest is treated as a cash payment by the transferee (beneficiary) to the transferor (estate or trust). The debt is treated as part of the "purchaser's" (beneficiary's) cost and is part of the amount realized for determining the transferor's (estate or trust's) gain or loss. Thus, the share of partnership liabilities assumed by the beneficiary increases his or her tax basis in the distributed partnership interest.

If the estate or trust's basis in the partnership interest being distributed is negative (e.g., the partnership liabilities allocable to the interest exceed the estate or trust's share of the partnership basis of its assets), the estate or trust (the deemed "seller") must recognize gain equal to the negative capital account.

Distribution of S Corporation Stock from an Estate or Trust

Estates and certain trusts can be S corporation shareholders. While S corporations are not subject to the same termination rules as partnerships, the same issue of how the income should be allocated between the fiduciary and the beneficiary applies. Although a testamentary trust can own S corporation stock for two years (unless revocation of the S election is desired), the trust will distribute the stock to an eligible shareholder within the two year period to avoid the revocation. The same distribution issue will arise when the sole beneficiary of the QSST trust dies. Assuming no sole successor beneficiary exists to continue the QSST election, the trust must either make an ESBT election or distribute the stock to avoid a revocation.

S corporations pass through items of income or loss to the shareholders based on a per-share, per-day allocation method. In the year of death, the decedent is allocated a pro rata share of the corporation's pass-through items on Schedule K-1 (Form 1120S) for the portion of the corporation's tax year through the date of death. The remainder of the S corporation's tax year is allocated to the successor shareholder(s). Unlike partnerships, any form of transfer that changes share ownership results in a per-share, per-day allocation.

Specific Bequest. If a decedent specifically bequeathed S corporation stock to a beneficiary, and the beneficiary's bequest is certain to be made, the fiduciary should notify the S corporation of the beneficiary's address and inheritance. The S corporation can contact the beneficiary to obtain the necessary information to send the beneficiary a Schedule K-1 (Form 1120S), thus allowing the S corporation to allocate the corporation's after-death income totally to the beneficiary. No Schedule K-1 (Form 1120S) need be issued to the estate.

Pecuniary Bequests. The distribution of noncash property to satisfy a pecuniary bequest is a sale requiring the estate to report any gain or loss. When a trust distributes noncash property to satisfy a mandatory income or annuity distribution, the same result occurs except no loss is allowed under the related party rules (except for qualified revocable trusts electing under IRC Sec. 645 to be treated as part of the estate).

Since the distribution of noncash property to satisfy a pecuniary bequest is a sale, the estate's tax year ends on the date of the distribution. The estate will report its share of the S corporation income and loss from the beginning of the year until the date of distribution, and the beneficiary will report the remaining portion on the beneficiary's tax return. The fiduciary must notify the S corporation of the pecuniary distribution so the corporation can make the proper allocation.

Residuary Bequests. Under the general rule, the distribution of noncash property as part of a residuary bequest does not result in a sale. However, when a Section 643(e)(3) election is made, a deemed sale results. A distribution of S corporation stock as a residuary bequest when a Section 643(e)(3) election is made would be accounted for in the same manner as a pecuniary bequest, as discussed previously. Normally, when a trust terminates and makes a distribution to the remainder beneficiaries, the distributions are accounted for in the same manner as residuary bequests from an estate. (The same holds true for discretionary distributions of principal during the trust's existence.) Unlike distributions of partnership interests, the distribution of stock to a residuary beneficiary changes ownership, requiring a per-share, per-day allocation.

Example 2H-2 Type of distribution from the estate or trust determines how S corporation income is allocated.

Sally Jones owned 30% of the stock in ABC, Inc. (a calendar year S corporation) at the time of her death on September 30, 2009. All of the S corporation's income or losses from January 1 through September 30 are reported on Sally's final Form 1040. The type of bequest determines how the post-death S-corporation activity is reported.

1. *Specific Bequest.* Sally's will made a specific bequest of her stock to her daughter, Rosie, and there are sufficient other assets to pay Sally's debts. Sally's executor notifies ABC, Inc. of Sally's death and provides information regarding Rosie's direct inheritance of Sally's stock and Rosie's address. ABC Inc. will contact Rosie to obtain the necessary identification information, and, at the end of 2009, will send Rosie a Schedule K-1 (Form 1120S) allocating the S corporation's income and loss from October 1 through December 31, 2009 to her. The estate will not receive a Schedule K-1 from ABC, Inc.

2. *Pecuniary Bequest.* Instead of a specific bequest, Sally's will provided for a pecuniary bequest of $250,000 to be made to her daughter, Rosie. No estate distributions were made to Rosie in 2009, so the S corporation's income from October 1 to December 31, 2009 is reported on the estate's Form 1041. On April 30, 2010, the ABC Inc. stock, which had a fair market value of $250,000 on that date, was distributed to Rosie in satisfaction of her pecuniary bequest. The estate must report the distribution as a sale, with a sales price of $250,000. The estate notifies ABC Inc. of the distribution. The S corporation will allocate the S corporation's income from January 1 through April 30, 2010 to the estate and its income from May 1 through December 31, 2010 to Rosie.

3. *Residuary Bequest.* Instead of any specific or pecuniary bequests, Sally's will provided that Rosie and her brother Fred are to be equal residuary beneficiaries. After paying all debts, the executor closes the estate on October 31, 2010 and distributes 50% of the assets to Rosie and 50% of the assets to Fred. Included in these assets is the ABC stock. Both Rosie and Fred will become 15% shareholders in ABC. Since no distributions were made in 2009, the corporation income from October 1 to December 31, 2009 is reported on the estate's Form 1041. In 2010, the estate notifies ABC, Inc. of the distribution. The estate reports its distributive share of S corporation income earned through October 31, 2010, which will be included in its DNI for that year. Since Rosie and Fred each received 50% of the total estate distributions, each would receive 50% of the estate's DNI. They will report their share of income earned by ABC, Inc. from November 1 through December 31, 2010.

Variation: Unless the fiduciary has the authority (according to state law and the governing instrument) to make *nonprorata distributions*, a deemed sale would occur if the executor exchanged the assets being distributed to Rosie and Fred. Assume Sally's estate consisted of 30% of the stock in ABC, Inc. and a building. Rosie preferred to receive all of the stock, whereas Fred wanted the building. Because Sally's will allowed nonprorata distributions, the executor distributed 30% of the ABC Inc. stock to Rosie and 100% of the building to Fred on October 31, 2010 and avoided sale treatment. (Effectively, the executor has exchanged Rosie's 50% ownership in the building for Fred's 15% share of ABC Inc. stock.) In this case, Rosie would report the full 30% of the income earned by ABC Inc. from November 1 through December 31, 2010 since Fred is never considered an owner of the ABC Inc. stock.

Distribution of Encumbered Property

General Rules

If an estate or trust distributes in-kind property that includes debt for which the beneficiary will remain liable, the general rule of carryover of income tax basis from the fiduciary to the beneficiary applies. Furthermore, the fiduciary will not recognize gain or loss unless it meets any of five exceptions. Furthermore, the beneficiary will not have gain or loss recognition until he or she sells or otherwise disposes of the property. However, if the trust is a grantor trust, any debts of the trust that are secured by property in the trust will be considered an amount realized by the grantor when the trust terminates.

When Debt Exceeds Basis

When an estate or trust distributes in-kind property that includes a debt for which the beneficiary will remain liable, and the amount of debt exceeds the income debt basis, there is debt relief to the fiduciary. However, although partnership distributions of property that generate debt relief to the partnership require recognition of debt relief income under Subchapter K, fiduciary distributions of property generating debt relief do not require similar income recognition under Subchapter J.

Cancellation of indebtedness income need not be recognized by the estate or trust unless (a) there is a debtor/creditor relationship, and (b) the debt has been cancelled. For distributions of estate and trust property, the debt is typically not cancelled. Instead, it is usually assumed by the beneficiary. When that is the situation, the general rules of nonrecognition of gain or loss and carryover of basis and holding periods apply unless any of five exceptions are met. However, if the estate or trust has a debtor/creditor relationship for which the debt is actually cancelled, it will be subject to debt relief income at the fiduciary level under the normal rule of IRC Sec. 61(a)(12).

Reporting the Holding Period for Distributed Property

Upon distribution of in-kind property, fiduciaries should provide the beneficiary with information as to his or her tax basis and holding period of the property.

General Rules

<u>Inherited Property.</u> When an estate or trust distributes property to a beneficiary, according to a decedent's will or testamentary trust, the holding period of the property is generally considered long-term, regardless of how long it was held by the decedent. However, this general rule does not apply if there has been a taxable event upon distribution (i.e., a deemed sale of the property). See the discussion that follows.

<u>Specific Property Distributions from Inter Vivos Trusts.</u> When specific property is transferred from a complex *inter vivos* trust, the distribution is treated as a gift, resulting in a carryover basis from the trust to the beneficiary (IRC Sec. 1015). Because the beneficiary's basis is determined in whole or in part by referring to the trust's basis, the beneficiary's holding period includes that of the trust. However, if the beneficiary sells the property at a loss, and the trust's basis in the property exceeded its fair market value (FMV) at the date of distribution, the beneficiary's holding period begins on the day after the date of the distribution (IRS Pub. 17).

<u>Specific Bequests from Estates and Testamentary Trusts.</u> The holding period of specific bequests is the same as for inherited property, as described previously (i.e., automatically considered long-term, regardless of how long the property was held by the decedent).

<u>Discretionary Distributions of Property.</u> The holding period of discretionary distributions of in-kind property is the same as for specific property distributions from *inter vivos* trusts, as described earlier (i.e., trust or estate's holding

period is "tacked on" to the beneficiary's. However, this is not the case when an estate or trust elects to recognize gain under IRC Sec. 643(e)(3) on the distribution of property to the beneficiary. In that situation, the distribution is treated as a sale of the property to the beneficiary, causing the beneficiary's holding period to begin on the date of acquiring the property. Because the beneficiary is deemed to have purchased the property, his or her basis is not determined by referring to the estate or trust's basis, and IRC Sec. 1223(2) does not apply to tack on the transferor's holding period onto the beneficiary's.

Distributions Substituted for Specific Property or Dollar Amount. If the estate or trust distributes substituted property (i.e., other than that which is specified in the governing instrument), the transfer is treated as a distribution of cash in an amount equal to the property's FMV, followed by a deemed sale of the property to the beneficiary for the cash. In this situation, the estate or trust's holding period is not tacked onto the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquiring the substituted property (i.e., date of distribution). Because the beneficiary is deemed to have purchased the substituted property, his or her basis is not determined by referring to the estate or trust's basis, and IRC Sec. 1223(2) does not apply to tack the transferor's holding period onto the beneficiary's.

Pecuniary Bequests. The determination of whether the estate or trust's holding period "tacks on" to the beneficiary's is based upon whether there has been a taxable event resulting in a deemed sale by the estate or trust. If so, for example, when an estate satisfies a pecuniary bequest with appreciated property or there is a true worth formula pecuniary bequest funded at date-of-distribution value, the beneficiary's holding period begins upon the receipt of the property.

If, on the other hand, there has *not* been a taxable event resulting in a deemed sale (e.g., a fairly representative formula pecuniary bequest or a minimum worth funding pecuniary bequest, the basis in the property carries over to the beneficiary. Because the beneficiary's basis determined, in whole or in part, by referring to the estate or trust's basis), the estate or trust's holding period tacks onto the beneficiary's.

Residuary or Fractional Bequests. Unless the estate or trust makes a Section 643 election to recognize gain upon distribution, the estate or trust's holding period tacks onto the beneficiary's. However, as discussed previously, a Section 643 election is treated as a deemed sale, which causes the beneficiary's holding period to begin on the date of deemed purchase from the estate or trust.

Reporting the Generation-skipping Transfer

The trustee of any trust that makes a taxable distribution for generation-skipping transfer (GST) purposes is required to file Form 706-GS(D-1) to report the distribution to the distributee and the IRS. The distributee, who is liable for the tax, uses the information to compute the GST tax due on the distribution.

A taxable distribution can occur if property distributions are made to a "skip person."

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

42. Which of the following statements best describes the distribution of partnership interests from an estate or trust?

    a. The two issues that must be addressed are whether the partnership's existence is affected and how income will be allocated.

    b. The estate or trust that makes the distribution and the preparer of the Form 1041 will determine how the distribution affects the partnership.

    c. If the interest is specifically bequeathed to the beneficiary and receipt is certain, a Schedule K-1 (Form 1065) must be issued to the estate.

    d. If a trust terminates and distributes partnership interests to the remaindermen, the distributions will be accounted for as pecuniary bequests.

43. Joe owns 55% of the Miller-Stein partnership, a two-person partnership. He dies on March 15, 2009. Which of the following actions would make the partnership terminate for tax purposes?

    a. The transfer of Joe's partnership shares into his estate upon his death.

    b. Closure of the partnership's tax year upon Joe's death.

    c. A distribution of the partnership interest to satisfy a pecuniary bequest.

    d. A distribution of the partnership interest to satisfy a specific bequest.

44. Roy was a 35% partner in the Black Fog Partnership before his death. His will provides for a pecuniary bequest of $300,000 to be made to his son, Hank. No estate distributions were made to Hank in 2009. In 2010, the partnership income, worth $300,000, is distributed to Hank in satisfaction of the pecuniary bequest. How would this distribution be reported?

    a. The estate reports the distribution as a sale and notifies the partnership. Black Fog allocates the partnership income from before the distribution to the estate and after the distribution to Hank.

    b. The estate notifies the partnership. The partnership contacts Hank for identification information. At the end of the year, the partnership sends Hank a Schedule K-1 (Form 1065) allocating partnership income to Hank.

    c. Hank reports all partnership income for the year. Both the estate and Hank receive Schedules K-1 from the partnership, but the estate's reports its zeroed out capital account on the capital account reconciliation.

    d. The estate reports its distributive share of partnership income on a Schedule K-1. The partnership issues a Schedule K-1 to Frank reporting his share of the partnership income, as well. The estate includes partnership income in its DNI.

45. Which of the following statements best describes the relationship estates and trusts may have to S corporation stock?

    a. Only beneficiaries can be S corporation shareholders; estates and trusts cannot.

    b. A testamentary trust can own S corporation stock for five years.

    c. A per-share, per-day allocation results from any transfer that changes share ownership.

    d. S corporation shares can only be transferred by specific bequest.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

42. Which of the following statements best describes the distribution of partnership interests from an estate or trust? **(Page 215)**

    a. The two issues that must be addressed are whether the partnership's existence is affected and how income will be allocated. [This answer is correct. These two issues (whether the distribution will affect the existence of the partnership and how the income from the distribution will be allocated between the estate or trust and the beneficiary) must be addressed when an estate or trust distributes a partnership interest to a beneficiary.]

    b. The estate or trust that makes the distribution and the preparer of the Form 1041 will determine how the distribution affects the partnership. [This answer is incorrect. The determination must be made on the partnership level; therefore, the estate or trust will need to provide all relevant information to the partnership.]

    c. If the interest is specifically bequeathed to the beneficiary and receipt is certain, a Schedule K-1 (Form 1065) must be issued to the estate. [This answer is incorrect. In this situation, the estate would notify the partnership of the beneficiary's inheritance and address; then the partnership can contact the beneficiary for any needed identification and issue a Schedule K-1 (Form 1065) directly to the beneficiary. Therefore, the estate would not need a Schedule K-1 (Form 1065).]

    d. If a trust terminates and distributes partnership interests to the remaindermen, the distributions will be accounted for as pecuniary bequests. [This answer is incorrect. In this situation, the distributions would be accounted for as residuary bequests, not pecuniary bequests. Two approaches exist for dealing with this type of distribution.]

43. Joe owns 55% of the Miller-Stein partnership, a two-person partnership. He dies on March 15, 2009. Which of the following actions would make the partnership terminate for tax purposes? **(Page 215)**

    a. The transfer of Joe's partnership shares into his estate upon his death. [This answer is incorrect. Joe's estate will become a partner for tax purposes. The partnership will not terminate because it continues to have at least two partners.]

    b. Closure of the partnership's tax year upon Joe's death. [This answer is incorrect. When a partner dies during the year, the partnership's tax year closes with respect to that partner. This does not automatically cause the partnership to terminate.]

    c. A distribution of the partnership interest to satisfy a pecuniary bequest. [This answer is correct. Because this distribution was to satisfy a pecuniary bequest it is considered a sale. The partnership will terminate because over 50% was "sold" within a 12-month period.]

    d. A distribution of the partnership interest to satisfy a specific bequest. [This answer is incorrect. Since there is no Section 643(e)(3) election, this distribution does not qualify as a sale, so the partnership will not terminate.]

44. Roy was a 35% partner in the Black Fog Partnership before his death. His will provides for a pecuniary bequest of $300,000 to be made to his son, Hank. No estate distributions were made to Hank in 2009. In 2010, the partnership income, worth $300,000, is distributed to Hank in satisfaction of the pecuniary bequest. How would this distribution be reported? **(Page 215)**

    a. The estate reports the distribution as a sale and notifies the partnership. Black Fog allocates the partnership income from before the distribution to the estate and after the distribution to Hank. [This answer is correct. When an estate distributes noncash property in the satisfaction of a pecuniary bequest, it is treated as a sale. Thus, the estate recognizes gain or loss.]

b. The estate notifies the partnership. The partnership contacts Hank for identification information. At the end of the year, the partnership sends Hank a Schedule K-1 (Form 1065) allocating partnership income to Hank. [This answer is incorrect. This method would be used if the partnership interest had been given to Hank in a specific bequest.]

c. Hank reports all partnership income for the year. Both the estate and Hank receive Schedules K-1 from the partnership, but the estate's reports a zeroed out capital account on the capital account reconciliation. [This answer is incorrect. There are two approaches for allocating partnership income for a residuary bequest. This is one approach.]

d. The estate reports its distributive share of partnership income on a Schedule K-1. The partnership issues a Schedule K-1 to Frank reporting his share of the partnership income, as well. The estate includes partnership income in its DNI. [This answer is incorrect. This is the second of two approaches used to allocate partnership income for a residuary bequest.]

45. Which of the following statements best describes the relationship estates and trusts may have to S corporation stock? **(Page 215)**

a. Only beneficiaries can be S corporation shareholders; estates and trusts cannot. [This answer is incorrect. Both estates and trusts are allowed to be S corporation shareholders. There will be issues to resolve regarding allocation of income between the beneficiary and the fiduciary.]

b. A testamentary trust can own S corporation stock for five years. [This answer is incorrect. A testamentary trust can only own S corporation stock for two years (unless a revocation of the S election is desired).]

c. A per-share, per-day allocation results from any transfer that changes share ownership. [This answer is correct. The decedent gets a prorata share of the corporation's pass-through items on Schedule K-1 for the corporation's tax year until the date of death. The rest of the corporation's tax year is allocated to the decedent's successor.]

d. S corporation shares can only be transferred by specific bequest. [This answer is incorrect. S corporation shares can also be transferred by a residuary or a pecuniary bequest.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T41TG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

29. The Jensen Mallory Estate distributes all the shares of a certain stock to Jensen's brother, as identified in the will. The estate transfers the stock in one installment. What type of distribution is this?

    a. Specific.

    b. Pecuniary.

    c. Residuary.

    d. Nonprorata.

30. Match the following types of property distributions with the correct tax effects of the distribution.

1. A general in-kind distribution	i. The difference between the fair market value (FMV) on the date of transfer and the FMV on the decedent's death is recognized as gain.
2. Distribution to satisfy a pecuniary bequest	ii. No gain or loss is recognized.
3. Distribution to satisfy the beneficiary's right to receive a specific dollar amount/asset other than the asset distributed	iii. Recognition of gain and, for an estate, loss.
4. Distribution of property in lieu of income	iv. Recognition of gain, but not loss.
5. Distribution of special-use valuation property to qualified heirs	

    a. 1., iii.; 2., iv.; 3., ii.; 4. and 5., i.

    b. 1., i.; 2. and 3., ii.; 4., iv.; 5., iii.

    c. 1. and 5., iv.; 2., i.; 3., iii.; 4., ii.

    d. 1., ii.; 2., iii.; 3. and 4., iv.; 5., i.

31. In his will, Jared bequeaths his car to his sister, Samantha. The car is distributed to Samantha by the estate two months after Jared's death. What are the tax effects of the distribution?

    a. The value of the car becomes part of Samantha's gross income, and the estate takes an equivalent distribution deduction.

    b. The value of the car becomes part of Samantha's gross income, but the estate cannot take a distribution deduction.

    c. Samantha does not include the value of the car in her gross income, and the estate does not claim a distribution deduction.

    d. The distribution is treated as required by the distribution rules of IRC Sec. 643(e)(2).

32. Which of the following would be considered a specific bequest if required by a will?

    a. An annuity.

    b. A personal residence.

    c. A residuary estate.

    d. Income from the sale of stock.

33. Maeve's will bequeaths $50,000 to her nephew, Tom. The amount is payable in cash or property. The executor of Maeve's estate distributes stock to Tom to fulfill the request. The stock was valued at $50,000 at the time of the distribution, but the estate's basis in the stock was $40,000. What are the tax effects of this transaction?

    a. Tom includes the $50,000 in gross income.

    b. The estate receives a $50,000 distribution deduction.

    c. Tom recognizes a capital gain of $10,000.

    d. The estate recognizes a capital gain of $10,000.

34. To be treated as a *specific bequest*, a distribution must be required to be paid in how many installments?

    a. Five or fewer.

    b. Four or more.

    c. Three or fewer.

    d. Two or more.

35. Jackson Smith dies in 2009, and his will makes the following bequests. Which of the bequests meet the installment-payment requirement to be treated as a specific bequest?

    i. The distribution of a car, a residence, and piece of family jewelry to his daughter Rose.

    ii. The distribution of $300,000 in cash to a trust that will be distributed to his son, Mike, on his 25, 30, 35, and 40th birthdays.

    iii. The distribution of stock to his niece, Kathy, to be paid in five annual installments, if the executor distributes it all at one time so Kathy can purchase a new home.

    iv. The distribution of two kinds of stock and a sum of cash to a trust to be distributed to his nephew, Bill, on his 25th birthday.

    a. iii.

    b. i. and iv.

    c. i., ii., and iv.

    d. i., ii., iii., and iv.

36. The Adams Trust generates $45,000 of taxable DNI in 2009. Under the trust instrument, capital gain is excluded from fiduciary accounting income. Fiduciary accounting income for the year was $35,000. One discretionary distribution was made during the year—the trust distributed 50 shares of stock to John. The trust had a tax basis of $2,000 in the stock, and the stock's FMV on the distribution date was $5,000. In this scenario, what is the amount of the trust's distribution deduction?

   a. $2,000.

   b. $5,000.

   c. $30,000.

   d. $35,000.

37. The Alston Family Trust elects to recognize gain on the distribution of property. What are the consequences of this election?

   a. There will be no step-up in basis of the property to the trust.

   b. The trust must also elect to recognize losses on property distributions.

   c. The distribution amount becomes the FMV of the property distributed.

   d. The election includes all distributions of property, including specific bequests.

38. In which scenario would it be prudent for the trustee to make the Section 643(e)(3) election to recognize gain?

   a. The Meyers Trust has capital loss carryforward and several opportunities to use it during the current tax year.

   b. The Baker Trust sold a capital asset for a loss and will be limited to the annual $3,000 capital loss deduction.

   c. The Smith Trust would like the Section 643(e) election to apply to only one distribution of property during the trust's year.

   d. Dee, the beneficiary of the Jones Trust, has a capital loss carryforward that will offset her gain from selling stock distributed by the trust.

39. What type of formula pecuniary bequest is used when the will includes the following clause:

   > My executor will choose and distribute the assets that constitute the marital deduction bequest to my husband, Bob, should he survive me, by using, for valuation purposes, the lesser of the assets' adjusted basis for federal income tax purposes or their value of the asset at the distribution date(s).

   a. True worth.

   b. Fairly representative.

   c. Minimum worth.

   d. Fractional share.

40. Walter's will bequeaths $150,000 to Hugh. In lieu of that dollar amount, the executor offers to distribute a piece of real property to Hugh that has equivalent value. Hugh accepts the distribution. How would gain or loss be treated at the fiduciary level?

    a. Only gain would be recognized.

    b. Only loss would be recognized.

    c. Only capital gain or loss would be recognized.

    d. All gain or loss will be recognized.

41. The Breakwater Trust holds shares of MegaCo stock that are a loss asset in 2009. What disposition method would allow the trust to take advantage of the most loss recognition?

    a. Retaining the shares.

    b. Distributing the shares to a beneficiary.

    c. Selling the shares to a third party.

    d. A trust can never recognize loss due to the related-party rules.

42. The Davis Family Trust sells a piece of real estate for $200,000 on the installment basis in 2008. The land had a basis in the trust of $120,000. The trust received a down payment of $56,000 and took a note for the remaining $144,000. The note allowed 36 payments of $4,000 plus interest at a fair market rate. In 2009, after receiving 12 payments, the trustee distributes the note to Ray, a trust beneficiary. Calculate the gain on the distribution assuming that the note has a FMV of $80,000 when it is distributed to Ray.

    a. $22,400.

    b. $38,400.

    c. $48,000.

    d. $57,600.

43. The Estate of Michael Bower distributes a partnership interest to Michael's son, Frank. Which of the following determines whether this distribution will affect the partnership's existence?

    a. Frank.

    b. The estate.

    c. The partnership.

    d. The IRS.

44. Assume the same details as in the question above. If the Bower Estate has large debts to settle before bequests can be made, how will that affect the specific bequest of the partnership interest to Frank?

    a. Distributions from the partnership must be the first asset used to pay off debts.

    b. Partnership distributions can only be used to pay debts if the estate has a lack of liquidity.

    c. If other assets are available, partnership distributions cannot be used to pay estate debts.

    d. Partnership distributions can only be used to pay debts in a pecuniary bequest.

45. If a decedent owned S corporation stock, how can the estate dispose of that stock without it being considered a sale?

i. In satisfaction of a specific bequest

ii. In satisfaction of a pecuniary bequest

iii. In satisfaction of a general residuary bequest

iv. In satisfaction of a residuary bequest under a Section 643(e)(3) bequest

a. iv.

b. i. and iii.

c. ii. and iv.

d. i., ii., iii., and iv.

GLOSSARY

Beneficiary: The party for whose benefit a will, trust, insurance policy, or contract is created. The beneficiary may be an individual or an organization (e.g., charity, school, club, or business). The party may receive title to property by will or by equitable interest in a trust.

Capital gain/loss: Capital gain or loss is derived from the sale or exchange of capital assets. The transaction may result in short-term or long-term gain or loss. Short-term gain or loss results when an asset is held for one year or less. Long-term gain or loss results when an asset is held for more than one year.

Complex trust: All trusts that do not qualify as simple trusts during the year. They compute their distribution deduction under a tier system

Decedent: The deceased individual whose estate is being administered.

Deduction: An amount that may be subtracted to arrive at taxable income.

Distributable net income (DNI): The maximum amount of taxable income a fiduciary can claim as an income distribution deduction and the maximum amount required to be included in gross income of the beneficiaries.

Estate: A taxable entity that comes into being upon the death of a taxpayer. It consists of all the decedent's property and personal effects. The estate exists until the final distribution of its assets to the heirs and other beneficiaries. During the period of administration, the executor must usually file a return.

Executor: A person named in the will and empowered by the court to administer the decedent's estate, to act for the estate, and to carry out the terms of the will. An executor is empowered to marshal the assets and pay the debts of the estate and distribute the remaining assets as specified in the will. An executor is empowered to sell assets to pay debts. It is a fiduciary relationship. An executor has certain powers, duties, and liabilities, which are identical to those of administrators.

Fiduciary: One who holds a position of trust with respect to another party or its property. It is the fiduciary's duty to act selflessly for the benefit of another, with undivided loyalty, obedience, and diligence—with due care and in good faith. This is the primary duty of an agent to the principal, of a trustee to the trust, and of an executor to the estate.

Fiduciary accounting income: The income that comes from assets in an estate or trust. Expenditures closely associated with producing income are charged against the particular type of income. Expenditures closely associated with the assets in the body (or principal) of the trust, are generally charged to the particular asset (principal) and not against income.

Generation-skipping transfer (GST) tax: This tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor and on transfers involving trusts having beneficiaries in more than one generation below that of the transferor. It applies to direct skips, taxable distributions, and taxable terminations.

Indirect expenses: Deductions not directly attributable to a specific class of income, such as trustee fees. They may be allocated to any item of income included in DNI, as long as a "reasonable portion" is allocated to nontaxable income.

Partnership: A form of business in which two or more persons join their money and skills in conducting the business as co-owners. Partnerships are treated as a conduit and are not subject to taxation. Various items of partnership income, expenses, gains, and losses flow through to the individual partners and are reported on their personal income tax returns.

Pecuniary bequest: Gifts of a specific dollar value, which can be based on either a fixed dollar amount or a formula.

Residuary bequest: The bequest of a particular fraction or percentage of the estate after the payment of the specific and pecuniary bequests, any debts, and expenses.

S corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in Subchapter S of the Internal Revenue Code (IRC).

Separate share rule: If a single complex trust or an estate has two or more beneficiaries who have substantially separate and independent shares, their shares are treated as separate trusts or estates for the sole purpose of determining the amount of DNI allocable to each beneficiary.

Simple trust: Trusts that require all income to be distributed currently, make no distributions of principal in excess of the required income in a given year, and are not allowed a charitable contribution deduction for the year. A simple trust is allowed to deduct the amount of income required to be distributed currently, up to the amount of taxable DNI.

Specific bequest: Bequests that are specifically identified in the governing instrument and payable to a beneficiary in three or fewer installments.

Tax-exempt income: This includes tax-exempt interest, compensation for illness or injury, debt forgiveness income (Chapter 11 bankruptcy), and death benefits.

Tier 1 distributions: These include any amount required to be distributed that may be paid out of income or principal (such as an annuity), to the extent it is actually paid out of income for the tax year. The sum of Tier 1 and Tier 2 distributions, after adjusting for tax-exempt income and related expenses, is an allowed deduction for estates and complex trusts.

Tier 2 distributions: These include "proper" payments of income not required to be distributed currently and distributions of principal, whether required or discretionary. The sum of Tier 1 and Tier 2 distributions, after adjusting for tax-exempt income and related expenses, is an allowed deduction for estates and complex trusts.

Trust: A tax entity created by a trust agreement. This entity distributes all or part of its income to beneficiaries as instructed by the trust agreement. This entity is required to pay taxes on undistributed income.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 1—IRD and Deductions (T41TG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

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EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 1—IRD and Deductions (T41TG091)

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2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
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8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

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Self-study Course Evaluation

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Course Title: Companion to PPC's 1041 Deskbook—Course 1—IRD and Deductions Course Acronym: T41TG091

Your Name (optional): ______________________ Date: ______________

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 2—Distributions (T41TG092)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   T41TG092 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 2—Distributions (T41TG092)

CTEC Course No. 3039-CE-0222
Price $79

First Name: ______________________________

Last Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________________

Firm Fax No.: ______________________________

Firm Email: ______________________________

Express Grading Requested: ☐ Add $24.95

CTEC No.: ______________________________

Signature: ______________________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1041 Deskbook—Course 2—Distributions Course Acronym: T41TG092

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________