

# Estates and Trusts File the Same Return, But Use Different Rules

While trusts and estates receive similar income tax treatment, they are not identical.

This article explores the differences that the return preparer must be aware of when completing income tax returns for these taxpayers.

by LOUIS S. HARRISON, Attorney

**U**nder Section 6012(a), trusts and estates subject to administration must file a Fiduciary Income Tax Return, Form 1041, if they have at least \$600 in gross income for the tax year. They must file regardless of income if there is a non-resident alien beneficiary. Even if a trust does not have \$600 in gross income, however, it must still file if it has any taxable income. There is no similar taxable income filing requirement for estates, though this difference is more technical than real. If an estate has gross income of less than \$600, the \$600 personal exemption deduction that applies to estates saves it from having taxable income. If the estate's gross income is at least \$600, but its taxable income is zero because the income has all been carried out to the beneficiaries (such as in the termination year), a Form 1041 must still be filed.

**Estimated tax payments.** Unlike most trusts,

an estate (or a grantor trust that receives the residue of the probate estate under the grantor's will) need not make estimated tax payments in its first tax year. Section 6654(l) provides that an estate must comply with the estimated tax provisions only for tax years ending on or after two years after the decedent's death. For the estate's first tax year, and the second if that year ends before the second anniversary of the decedent's death, the entries on Form 1041 relating to estimated tax payments do not apply.

**Filing period.** While Section 645 requires that trusts use a calendar year, an estate may adopt any tax year as long as it ends within 12 months after the decedent's death. Under Section 441, the tax year ends on the last day of the applicable month.

The compression of tax rates by TRA '86 limited the fiduciary's ability to minimize taxes by using different marginal rates. Yet, even with the current two-tier system, objectives in selecting a tax year still include deferral (and perhaps acceleration) of tax, matching of income and deductions, and avoiding the bunching of income.

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If the estate selects a year other than the calendar year, the preparer must complete the line on Form 1041 noting when the fiscal year begins and ends. Section 6072(a) provides that the return is due on the 15th day of the fourth month following the end of the fiscal year.

### Distributions

**Simple trusts.** Under Section 651, simple trusts must provide for all income to be distributed currently, must not provide for funds to be distributed for charitable purposes, and must not distribute any principal during the tax year. Any trust that is not a simple trust is a complex trust. Under Reg. 1.651(a)-1, a trust may be a simple trust in one year and a complex trust in another year in which it makes discretionary principal distributions.

For a simple trust (and a complex trust from which all income must be distributed currently), Sections 651 and 661 allow deductions to the extent of taxable distributable net income (DNI) for trust accounting income for that year, whether or not the income was actually distributed to a beneficiary.

**Example.** A simple trust distributes no income to its sole beneficiary. The trust accounting income determined under state law is \$22,000, DNI for the year is \$18,652, and there is no tax-exempt interest. Even though no income is actually distributed, the accounting income is treated as having been distributed to the beneficiary. Thus, the trust's income distribution deduction, reflected on line 17 of Schedule B and line 18 of Form 1041, is \$18,652 (trust accounting income, to the extent of taxable DNI).

**Estates and complex trusts.** Basically, Sections 661 and 662 establish a two-tier structure for distributions from trusts and estates. Distributions required to be made from current income are first-tier distributions. While simple trusts may distribute only from current income, complex trusts, depending on their terms, can also make discretionary payments from income, principal, or both. These discretionary distributions that complex trusts actually make from income and principal during the year are second-tier distributions. Under Section 662, sec-

ond-tier distributions carry out taxable income only when actually made, and then only to the extent of DNI after all first-tier distributions are taken into account.

Regulation 1.661(a)-1 generally treats estates the same as complex trusts. Estates that distribute income or principal during the administration period are treated as having made second-tier distributions. Thus, they are entitled to income distribution deductions to the extent of DNI only if the property is actually distributed. For an estate, an income distribution deduction will not be allowed if the property distribution was not proper under state law.<sup>1</sup>

An estate, unlike a simple trust, can accumulate income for later distribution to beneficiaries without having the income deemed distributed to the beneficiaries as a first-tier distribution. If an estate makes no actual distributions during the year, the amount of currently distributable income, reflected on line 17 of Schedule B and line 18 of Form 1041, is zero. The estate can take no income distribution deduction and will be taxed on all income that it earns.

Because Reg. 1.665(a)-0A(d) specifically provides that the trust throwback rules do not apply to estates, the eventual distribution of any income that the estate has accumulated and that is taxed to the estate will not be thrown back to the beneficiaries on distribution.

**Spousal awards from estates.** Many states have probate acts under which a resident decedent's surviving spouse is entitled to a support allowance. The allowance, which is determined by the probate court, requires the estate to provide reasonable support for the spouse during the estate's administration period.

Because payments to creditors of a decedent or the estate to satisfy legally enforceable debts are not "amounts that are properly paid or credited or required to be distributed" for that year to beneficiaries, arguably spousal support awards should be treated the same and should not carry out taxable income. Section 661(a)(2) and Reg. 1.661(a)-2(c) indicate, however, that such an award is the same as any other amount properly paid, credited, or required to be distributed, so that it carries out income to the ex-

tent of available DNI.<sup>2</sup> Because of the treatment of the spousal allowance, a return preparer who is not the estate's attorney should monitor the estate closely to ascertain whether a spousal allowance award has been made.

**Specific bequests.** To the extent a trust beneficiary receives a discretionary or a mandatory distribution of a fraction (or other nonspecific amount) of the trust's FMV (e.g., half the FMV at age 25), even if the distribution is out of principal (such as distribution of specific shares of stock), the distribution carries out taxable income to the extent of the remaining DNI after all first-tier distributions, if any, have been satisfied.

Section 663(a)(1) exempts specific bequests of money or property that are payable in three or fewer installments from the rule that even principal distributions to the extent of DNI carry out taxable income. These distributions, generally made from an estate (or pour-over trust), do not carry out taxable income even if there is unused DNI. A specific testamentary bequest is not a second-tier distribution when it is paid and does not, therefore, carry out DNI.

If the specific gift or bequest of the specific sum of money will be paid or credited *only* from the income of the estate or trust, the gift or bequest then does carry out DNI. If, however, the estate can satisfy the specific bequest from either accumulated income or principal, then it does not carry out taxable income when made. Regulation 1.663(a)-1(b)(3) lists examples of how and when the specific bequest exception applies to distributions from estates and trusts.

**Real estate devises.** Under the rules of Section 663(a)(1), a specific devise of real estate does not carry out taxable income to the beneficiary. Moreover, Reg. 1.661(a)-2(e) provides that the term "any other amount properly paid or credited or required to be distributed" does

not include the value of any real estate interest that the decedent owned for which title passes under local law directly from the decedent to his or her heirs or devisees. This applies to all such distributions even if the property is part of the residuary estate.<sup>3</sup> This is in distinct contrast to most real estate distributions from a trust.

**Example.** A discretionary trust with DNI of \$18,000 for the year and no tax-exempt interest, distributes a farm valued at \$22,000 to a beneficiary during the year. The beneficiary receives no accounting income or other property. The income carried out, as set out on Schedule B, line 17, is \$18,000, the value of the distributed farm to the extent of DNI. By contrast, if title to the farm had passed to the beneficiary at death as part of the residuary estate, the income distribution deduction would be zero and no income would have been carried out.

**Interest on late bequest.** Interest that state law requires an estate to pay on a late payment of a specific bequest does not carry out DNI. Because the relationship between the estate and the beneficiary is in this situation more in the nature of a debtor and creditor, Sections 661 and 662 do not apply to the interest payment. The interest is, however, deductible by the estate under Section 163(a) and includable in the beneficiary's gross income under Section 61(a)(4), without regard to DNI.<sup>4</sup>

### Income in respect of a decedent

Income in respect of a decedent (IRD) is a concept affecting certain income and deductions in a manner generally unique to estates. IRD is income that accrued during the decedent's lifetime but was not reported by the decedent prior to decedent's death. Examples of IRD include accrued income for pre-death services, post-death bonuses, deferred compensation, income from the exercise of a stock option, dividends declared and payable to a shareholder of record before death, and accrued but unpaid interest.<sup>5</sup>

IRD is reportable when received and is taxed to the recipient. Section 691(c) allows an income tax deduction for the incremental increase in the estate tax attributable to IRD (other than to the estate tax attributable to the tax imposed on excess retirement accumulations by Section

### Citations

- 1 See *Murphy*, (DC Okla., 3/18/91).
- 2 See *Rev. Rul.* 75-124, 1975-1 CB 183.
- 3 See *Rev. Rul.* 68-49, 1968-1 CB 304.
- 4 See *Rev. Rul.* 73-322, 1973-2 CB 44.
- 5 Reg. 1.691(a)-2(b).
- 6 See Reg. 1.691(c)-1(d), Example (1).
- 7 See Reg. 1.691(a)-4(a).

4980A(d)). Regulation 1.691(c)-2(a) allows an estate a deduction to the extent it realizes such income. Under Section 67(b)(8), the 2% floor on miscellaneous itemized deductions does not apply to the Section 691(c) deduction.

**Deductions in respect of a decedent.** Certain expenses relating to a decedent's pre-death activities, that he or she could have deducted if the expenses had been paid before death, are deductions in respect of a decedent (DRD). Among the expenses that are allowed under Section 691(b) as DRD are unpaid business expenses, interest expenses, deductible taxes, depletion, and the credit for foreign taxes (but not unpaid alimony).

When completing Form 1041 for an estate, the preparer must consider the availability of the estate tax deduction for the increase attributable to IRD. That deduction also applies to trusts if IRD property has been distributed in a transaction not treated as a sale or exchange to the trust. The following example shows how the estate should calculate the deduction.

**Example.** An unmarried decedent has one beneficiary, B, and a taxable estate of \$4 million, including \$400,000 of IRD. The estate tax increase attributable to IRD property, after a 10.4% state death credit, is \$178,400, computed as follows:

Federal estate tax payable on taxable estate, including \$400,000 (after use of credits, including state death tax credit)	\$1,367,600
Federal estate tax payable on taxable estate, excluding \$400,000 (after use of credits, including state death tax credit)	<u>1,189,200</u>
Difference (Federal income tax deduction allowed for estate tax paid attributable to \$400,000 IRD)	<u>\$178,400<sup>e</sup></u>

The estate income tax return preparer must also know if the estate distributes IRD property to satisfy a pecuniary or specific dollar bequest, such as a bequest to a surviving spouse of a

marital deduction amount tied to a specific sum. In that case, the distribution may accelerate recognition of all income in the IRD, causing a potentially unexpected increase in the estate's taxable income. For example, as a result of Section 691(a)(2), when a right to receive future IRD is transferred to fund a pecuniary bequest, the estate may realize income before actually receiving the IRD.<sup>7</sup>

**Related parties**

In general, Section 267 disallows a deduction with respect to any loss from the sale of any

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property between related parties. Under Section 267(b), related parties include a fiduciary of a trust and a beneficiary of a trust.

**Example.** A trustee sells 4,000 shares of stock, with an aggregate basis of \$200,000, to a beneficiary of the trust for \$100,000. No capital loss can be listed on Schedule D. Under Section 267(d), the disallowed loss is added to the beneficiary's basis to the extent of any gain recognized in the future by the beneficiary from the beneficiary's subsequent sale of the property.

The term "related parties" does not include an estate and its beneficiaries. Therefore, if an estate held the stock and sold it at a loss to its beneficiary, the capital loss is taken on Schedule D.

**Multiple beneficiaries.** Under Section 663(c), if a trust has two or more beneficiaries and is administered in express and separate shares, the shares must be treated as separate trusts for determining DNI and in applying Sections 661 and 662.

Regulation 1.663(c)-3(f) specifies that separate share treatment does not apply to estates. Thus, the estate's income tax return preparer need not be concerned with dividing DNI among various beneficiaries if only one benefi-

ciary has received a distribution from the estate.

**Excess deductions.** If all of the allowable deductions on Form 1041 (interest, taxes, fiduciary fees, charitable deduction, return preparer fees, miscellaneous itemized deductions, and income distribution deduction) exceed an estate's total income in its final year, the excess deductions are carried out to the beneficiaries of the estate. While the same rule applies to trusts, there is an important distinction. If an estate terminates and distributes its property to a trust, the excess ordinary deductions are carried over to the trust but not necessarily to the trust beneficiaries (unless, for example, the trust also terminates in that calendar year). The trust takes such deductions into account as miscellaneous itemized deductions. Thus, the deductions reduce the trust's taxable income. The

trust, however, cannot carry the unused deductions over to a future tax year.

### Conclusion

The treatment of distributions from estates and trusts can, despite the use by trusts and estates of the same return, be considerably different. In addition, estates have latitude in selecting a taxable year, may defer payment of estimated tax, and can recognize loss when selling certain property to beneficiaries of the estate.

Careful planning in selecting a tax year, the making of distributions, and the payment of expenses continue to be important in reducing the overall taxes of the estate and the beneficiary. Trusts have fewer options but practitioners should be aware that some latitude is available here as well. ♦

## HOW WOULD YOU RULE?

### Do rental deductions depend on the recording of title?

Elaine owned a duplex, which she rented out, but sold to her parents when she relocated for a job assignment. The parents, deciding the purchase was unwise, later sold the property back to her under an installment contract that was never recorded. Although Elaine was still liable on her original mortgage, her parents retained title for security reasons.

Elaine continued to rent out the duplex and deduct the related expenses on the grounds that she was the owner for all practical purposes. An IRS agent objected, contending that since title was still in the name of Elaine's parents, they, not her, were entitled to any deductions.

May Elaine take rental expense deductions despite the unrecorded title?

**Answer:** Yes. (Olson, TCM 1991-325.)

**Rationale:** A sale occurs upon the transfer of benefits and burdens of ownership, rather than upon the satisfaction of the technical requirements for the passage of title under state law. Even though Elaine's purchase of the realty from her parents might not have satisfied the technical requirements for the passage of title under state law, there was a sale because she acquired the benefits and burdens of ownership. All the rights to the property had been transferred to Elaine subject to her parents' retention of legal title for security purposes. Thus, Elaine may deduct expenses incurred in connection with the property even though her title to it might have been invalid under state law. ♦