Advanced Form 1041 and Fiduciary Accounting

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I. Introduction

Numerous accounting and tax details must be considered by fiduciaries and their advisors in administering an estate or trust. As if their job were not onerous enough, the Tax Relief Act of 2010 acts as a grim reminder of the liability concerns that go along with the job. The executor’s choice in 2010 to either apply a $5 million estate tax exclusion or elect out of the estate tax and apply carryover basis instead may stretch the liability concerns to a new limit. As such, it will be more important than ever before that the fiduciary seek the best possible professional advice.

II. Carryover Basis

On December 17, 2010, Congress enacted the “Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (2010 Tax Relief Act), which made a number of very important, but temporary, changes to the estate, gift, and GST laws. First it extended all of the sunset provisions of EGTRRA by two years from December 31, 2010 to December 31, 2012. Then it reinstated the estate and GST tax retroactive to January 1, 2010 and repealed carryover basis (and its related provisions §§ 6018, 6075, 1040, 121(d)(11)). It also raised the estate and GST tax exemption to $5 million with a 35 percent rate (zero percent for GST transfers in 2010). But it granted a “special election” for those dying in 2010, which allows them to apply the zero estate tax and carryover basis rules that were in effect under EGTRRA before amendment by the 2010 Tax Relief Act. All of these changes and more sunset after December 31, 2012.

The election to apply a zero estate tax and carryover basis will have far reaching consequences. It means that the basis of property acquired from a 2010 decedent will not be adjusted to fair market value under § 1014, but rather will be determined “as if transferred by gift.” However, the basis rules for carryover basis property and gifted property are not exactly the same. Carryover basis property has a basis equal to the lesser of the decedent’s basis or the property’s fair market value on the date of the decedent’s death. Gifted property has the same basis as the donor’s, except when the donee sells the property at a loss, in which case the basis is the market value on the date of the gift.

Holding Period. Carryover basis also affects the holding period. The holding period for property, however acquired, includes the transferor’s holding period if the property has the same basis “in whole or in part” as the transferor. Thus, the decedent’s holding period generally “tacks.” However, where the basis is the fair market value of the decedent’s property because that amount is less than its basis on the date of the decedent’s death, the holding period probably does not tack. The IRS has ruled in other situations that where the transferee’s basis is limited to fair market value because it is less

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1 P.L. 111-312, H.R. 4853 (Dec. 17, 2010).
2 Id. at § 301(a).
3 Id. at § 302.
4 Id. at § 301(c).
5 Id. at § 304.
6 IRC § 1022(a)(1).
7 IRC § 1022(a)(2).
8 IRC § 1015(a).
9 IRC § 1223(2).
than the transferor’s basis, the holding period does not tack because the basis has not been determined “in whole or in part” by reference to the transferor’s basis under § 1223(2).\textsuperscript{10} The IRS will probably take the same position for carryover basis property. If so, property with a carryover basis equal to the fair market value on the decedent’s death must be held for more than a year after death to obtain long-term capital gain treatment.

A. Proving Up Basis

Under the carryover basis rules, the executor is required to determine the lesser of the decedent’s basis or its market value as of the date of death.\textsuperscript{11} Basis is determined on an asset by asset basis, which may be extremely difficult, if not impossible, to determine. The 1976 carryover basis rules allowed an executor to treat the basis of the decedent’s property as its market value on the date the decedent or last preceding owner acquired it where the basis was unknown.\textsuperscript{12} However, § 1022 has no such provision. Nor would it be helpful if the executor does not know that information either.

The gift tax rules provide that where the donee does not have the facts necessary to determine the basis of property, the IRS is required to obtain these facts from the donor or last preceding owner, or any other person cognizant of the facts.\textsuperscript{13} If the IRS cannot obtain the facts, the basis will be its fair market value as found by the IRS on the date or approximate date at which, according to the best information the IRS can obtain, the property was acquired by the donor or last preceding owner.\textsuperscript{14} The courts generally sustain the IRS’s determination of value where the IRS has reasonable support for its position.\textsuperscript{15} But the courts will not usually find that the taxpayer’s basis is zero simply because he cannot prove the fair market value at the time the donor acquired it. The courts will, however, rule that the basis is zero if the taxpayer has no basis information and cannot prove that he acquired the property by gift or inheritance.\textsuperscript{16}

While taxpayers are generally required to report \textit{income} consistently with information returns unless they assert a reasonable dispute, there is no such consistency requirement for basis reported on information returns.\textsuperscript{17} Therefore, the beneficiary may rely on the information return furnished by the executor or he can take an inconsistent position and prove his basis with his own information. If the beneficiary produces credible evidence, the burden of proof shifts to the IRS, assuming the taxpayer meets the other requirements of § 7491 (maintains records, cooperates with the IRS, etc.).\textsuperscript{18}

B. Basis Increases

Section 1022 contains several modifications to carryover basis. First, every decedent is allowed a $1.3 million basis increase.\textsuperscript{19} Nonresident aliens are allowed only $60,000.\textsuperscript{20}

\textsuperscript{10} Rev. Rul. 70-6, 1970-1 C.B. 172; Ltr. Rul. 8511093.
\textsuperscript{11} IRC § 1022(a)(2).
\textsuperscript{12} IRC § 1023(g)(3) (1976 Tax Reform Act).
\textsuperscript{13} IRC § 1015(a).
\textsuperscript{14} Id.; Reg. § 1.1015-1(a)(3).
\textsuperscript{15} Interlochen Co., Inc v. Comm’r, 232 F2d 873 (4th Cir. 1956).
\textsuperscript{16} Hodges v. Comm’r, TC Memo 2005-168 (July 11, 2005).
\textsuperscript{17} IRC § 6201(d).
\textsuperscript{18} IRC § 7491(a)(1); see also discussion at II.E.5. of this outline.
\textsuperscript{19} IRC § 1022(b)(2)(B).
\textsuperscript{20} IRC § 1022(b)(3)(A).
Next, an additional $3 million basis increase is allowed for certain property acquired by the surviving spouse.\(^{21}\) Third, the basis of the decedent’s property may be increased by any unused or unrecognized capital or net operating losses of the decedent.\(^{22}\) Nonresident aliens are not entitled to this basis increase.

Basis adjustments may not increase a property’s basis above its fair market value at decedent’s date of death.\(^{23}\) And certain property is simply not eligible for a basis adjustment, such as income in respect of a decedent under § 691, property acquired by gift within three years of the decedent’s death, property over which the decedent had a power of appointment, and certain foreign stock.\(^{24}\) The basis increases allowed under § 1022(b) and (c) will probably afford all but the largest estates a full step-up in basis.

1. Unused and Built-in Losses

   Section 1022 allows an extra basis increase for any unused net operating losses under § 172 or capital losses under § 1212(b) which would (but for the decedent’s death) be carried from the decedent’s last taxable year to a later taxable year. Ordinarily these losses would disappear. There is no guidance on how to calculate the decedent’s share of unused loss carryovers when the surviving spouse files a joint return with the decedent in the year of death and absorbs some of these losses with her income or gain after his death. Presumably rules similar to those under § 2053 would apply so that in the absence of evidence to the contrary, the decedent’s share of a joint loss carryover would be a fraction equal to the amount he would have incurred if he had filed a separate return divided by the combined loss carryover if both spouses had filed separate returns, as follows:\(^{25}\)

   \[
   \text{Decedent’s separate loss carryover} \times \frac{\text{Joint loss carryover}}{\text{Combined separate loss carryovers}} = \text{Decedent’s loss carryover}
   \]

   The estate is also allowed a basis increase for any losses that would have been allowable under § 165 if the decedent’s property had been sold at fair market value before the decedent’s death. Thus, a basis increase is allowed for any built-in losses on business or investment property on the date of the decedent’s death. This includes capital losses, which are covered under § 165(f), but presumably without the $3,000 annual limitation. This also covers passive losses under § 469, which are trade or business losses, and which are no longer considered passive when disposed of by death or in a fully taxable transaction with an unrelated party.\(^{26}\) However, built-in losses on personal assets such as homes and cars are lost.

   It may be desirable to assign built-in loss property as low a value as reasonably possible to maximize the loss that can be added to the basis of other property. This additional basis can be added to property most likely to be sold the soonest.

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\(^{21}\) IRC § 1022(c).
\(^{22}\) IRC § 1022(b)(2)(C).
\(^{23}\) IRC § 1022(d)(2).
\(^{24}\) IRC § 1022(f); §§ 1022(d)(1)(B)(iii), (C), (D).
\(^{25}\) Reg. § 20.2053-6(f).
\(^{26}\) IRC § 469(g)(1)(A), (g)(2).
2. Passive Losses

There is an apparent conflict among the statutes on how suspended passive losses are treated for decedents who die in 2010. Three different treatments are possible. First, § 469(j)(6) provides that when a passive activity is disposed of by gift, suspended passive losses are added to the basis of the passive loss property without limit as to its fair market value and the losses are not allowed as a deduction for any taxable year. Because carryover basis property acquired from a decedent in 2010 is treated “as transferred by gift,” § 469(j)(6) would seem to apply.

Second, suspended passive losses may create additional basis increases under § 1022(b)(2)(C)(ii) because they would have been allowable as a deduction under § 165 if the property had been sold at fair market value immediately before the decedent’s death. This additional basis can be added to the basis of any asset, but not in excess of the property’s fair market value at death.

Yet a third possible treatment for suspended passive losses is that they are deductible on the decedent’s final income tax return under § 469(g)(2) to the extent they exceed the increased basis allowed for the property at death. The increased basis at death is not restricted to basis determined under § 1014. But this treatment creates a circular problem because the passive loss allowed on the final income tax return depends on the step-up in basis allowed, which depends on the unused losses. To solve this circular problem, we need to know whether § 469(g)(2) or § 1022(b)(2)(C)(ii) applies first.

If § 469(g)(2) applies first, the passive losses are deductible in full on the decedent’s final income tax return. Losses that are not fully utilized on the final income tax return are lost. However, if § 1022(b)(2)(C)(ii) applies first, the unused passive losses are not deductible, but rather are allowed as additional basis that can be added to any of the decedent’s property not to exceed its fair market value.

Because specific statutes generally override more general statutes, it seems that § 469(g)(2) should apply first to allow a deduction of the suspended losses on the decedent’s final income tax return. Thus, they would not be available to increase the basis of other assets under § 1022(b)(2)(C)(ii). Commentators have brought this conflict to the attention of the IRS, who will hopefully clarify it soon.

3. Qualified Spousal Property

The basis of “qualified spousal property” is increased by $3 million. This increase is applied after the general basis increase is taken into account. Like the $1.3 basis increase, the spousal basis increase cannot increase the basis of the property above its fair market value as of the date of the decedent’s death. There are two types of qualified spousal property - outright transfer property and qualified terminable interest property. If property is sold before it is transferred to the spouse, it may not qualify for the $3 million spousal basis increase, even if the

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27 IRC §1022(c)(2)(B).
28 IRC §1022(c)(1).
29 IRC §1022(d)(2).
30 IRC §1022(c)(3).
proceeds are distributed to the spouse.

a. **Outright Transfer Property**

Outright transfer property is property acquired from the decedent by the surviving spouse. However, outright transfer property does not include a terminable interest, which is an interest that will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, and either 1) the interest in property passes or has passed, for less than an adequate and full consideration in money or money’s worth, from the decedent to any person other than the surviving spouse or the spouse’s estate, and by reason of that passing the person, or his heirs or assigns, may possess or enjoy any part of the property after the termination or failure of the interest passing to the surviving spouse, or 2) the interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by the decedent’s executor or by the trustee of a trust.

Examples of a terminable interest would include a life estate or an annuity for life or a term. Property will not be considered a terminable interest if it will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term. For example, employee stock options should not be considered a terminable interest merely because they expire at a certain time. Likewise, an interest passing to the surviving spouse is not considered a terminable interest if the spouse’s death will cause a termination or failure of the interest only if it occurs within 6 months after the decedent’s death, or as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or it occurs in the case of either event and 2) the termination or failure does not in fact occur.

b. **Qualified Terminable Interest Property**

“Qualified” terminable interest (QTIP) property is eligible for the $3 million spousal basis increase. This includes property that passes from the decedent and in which the surviving spouse has a qualifying income interest for life. A qualifying income interest for life means that the spouse is entitled to all of the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property and no person has a power to appoint any part of it to any person other than the surviving spouse, except upon the spouse’s death. An annuity is treated like an income interest in property, regardless of whether the property from which the annuity is payable can be separately identified. QTIP property can also include a specific portion of property determined on a fractional

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31 IRC § 1022(c)(4)(A).
32 Id.
33 IRC § 1022(c)(4)(B)(ii).
34 IRC § 1022(c)(4)(B).
35 IRC § 1022(c)(4)(C).
36 IRC § 1022(c)(5)(A).
37 IRC § 1022(c)(5)(B).
38 Id.
or percentage basis.\textsuperscript{39} QTIP property under § 1022 is defined the same way as QTIP property under § 2056(b), except no election is required.

C. Property Eligible for Basis Increases

Not all property of the decedent or his estate qualifies for a basis increase under § 1022. Only property that was acquired from the decedent and owned by him at the time of his death qualifies.\textsuperscript{40} Property is considered acquired from the decedent if it satisfies any one of the following conditions.\textsuperscript{41}

- It was acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent.\textsuperscript{42}
- It was transferred by the decedent during lifetime to a qualified revocable trust.\textsuperscript{43}
- It was transferred by the decedent during lifetime to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.\textsuperscript{44}
- It was any other property passing from the decedent by reason of death to the extent that the property passed without consideration.\textsuperscript{45} Property is not acquired from a decedent if it is property that constitutes income in respect of a decedent under § 691.\textsuperscript{46}

The following rules determine whether property is owned by the decedent and therefore eligible for the basis increase.

1. Jointly Held Property

If property was owned by the decedent and another person as joint tenants with right of survivorship (WROS) or tenants by the entirety, and the only other joint owner is the surviving spouse, the decedent is treated as owning only 50 percent of the property.\textsuperscript{47} In all other cases, if the decedent furnished consideration for the property, the decedent is treated as the owner of the portion that is proportionate to his consideration.\textsuperscript{48} If the decedent acquired the property by gift, bequest, devise, or inheritance along with any other joint tenant WROS and their interests are not specified or fixed by law, the decedent is treated as owning a fraction equal to the value of the property divided by the number of joint tenants WROS.\textsuperscript{49}

2. Qualified Revocable Trusts

The decedent is treated as owning property transferred to a qualified revocable trust (QRT) as defined in § 645(b)(1).\textsuperscript{50} A qualified revocable trust is “any trust (or portion thereof) which was treated under section 676 as owned by the decedent of

\begin{itemize}
  \item IRC § 1022(c)(5)(D).
  \item IRC § 1022(d)(1)(A).
  \item IRC § 1022(e).
  \item IRC § 1022(e)(1).
  \item IRC § 1022(e)(2)(A).
  \item IRC § 1022(e)(2)(B).
  \item IRC § 1022(e)(2)(C).
  \item IRC § 1022(f).
  \item IRC § 1022(d)(1)(B)(i)(I).
  \item IRC § 1022(d)(1)(B)(i)(II).
  \item IRC § 1022(d)(1)(B)(i)(III).
  \item IRC § 1022(d)(1)(B).
\end{itemize}
the estate referred to in subsection (a) by reason of a power of the grantor (determined without regard to § 672(e)).” Property is also considered as having been acquired from the decedent if it was transferred by the decedent to a QRT during his lifetime or to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust.51

This reference to § 645(b)(1) for property both “owned by” and “acquired from” the decedent has led some to question whether a QRT must make the § 645 election to be treated as part of the estate in order to qualify for the basis increases under § 1022. However, the Conference Report to the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836) contains no reference to the § 645 election in describing trust property that qualifies for the basis increase:

The decedent is also treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent’s life to the decedent or at the direction of the decedent.52

Because the legislative history suggests that all revocable trusts are eligible for the basis increase, it does not seem necessary that the trust make the § 645 election.

3. Community Property

The surviving spouse’s one-half share of community property is treated as “owned by and acquired from” the decedent if at least one-half of the community property interest is otherwise treated as owned by, and acquired from, the decedent.53 This provision essentially treats the surviving spouse’s one-half of the community property as if it were transferred outright to the spouse by the decedent, making it eligible for both the $1.3 and the $3 million spousal basis increases.

Allowing the surviving spouse’s half of community property to be eligible for the $3 million spousal basis increase is useful when the decedent does not transfer sufficient assets to the spouse to use all of the $3 million spousal basis increase. For example, if all the decedent’s assets pass to a non QTIP-trust, the executor may allocate the $3 million spousal basis increase to the surviving spouse’s half of the community property. Of course, doing so might cause the surviving spouse’s half of the community property to have a different basis than the decedent’s half, depending on how the executor allocates the $1.3 basis increase.

Community property is frequently divided in an equal but non-prorata division between spouses, or by the executor and the surviving spouse after one of the spouses dies. The IRS has held that such non-prorata divisions of community property are tax-free because they are in substance the same as a division in divorce, which would be tax free under § 1041, even if it consisted of income in

51 IRC § 1022(e)(2).
respect of a decedent (IRD). This rationale would allow non-prorata divisions to be tax-free even in non-community property jurisdictions.

In order for the surviving spouse’s share of community property to be eligible for the $3 million basis increase, one-half must be owned by the surviving spouse and the other half must be “owned by and acquired from” the decedent. If this test is applied to community property in the *aggregate*, then the surviving spouse’s community property that has been divided in an equal but non-prorata division should qualify for the spousal basis increase under § 1022(c). For example, the California Probate Code allows such “aggregate agreements” during the marriage or after the death of one spouse. But if § 1022(d)(1)(B)(iv) applies on a property by property basis, then the surviving spouse’s share of community property that was divided before death in a non-prorata division may not be eligible for the $3 million spousal basis increase. Perhaps the IRS will clarify whether the community half is measured on an aggregate or property by property basis.

Where the community property has not been divided in a non-prorata division before death, but the executor plans to do so during the estate administration, the executor would likely be required to allocate the basis increases before making the non-prorata division. For example, where all of the decedent’s property passes to a bypass trust, it is doubtful that the executor could exchange its low basis community property for the spouse’s high basis community property in order to allocate more of the $3 million spousal basis increase to the spouse’s half.

**D. Property Ineligible for Basis Increases**

In order to be eligible for the basis increases, property must be owned by and acquired from the decedent. Certain types of property that are not considered owned and acquired by the decedent are discussed below.

1. **Powers of Appointment**

   A decedent dying in 2010 is not treated as owning any property over which he holds a power of appointment. Thus, such property is not eligible for a basis increase. This is in stark contrast to § 1041, which includes property over which the decedent had a general power of appointment in the decedent’s estate and provides a stepped-up basis under § 1014.

2. **Property Acquired By Gift Within 3 Years of Death**

   Property acquired by the decedent by gift or by inter vivos transfer for less than adequate and full consideration during the 3-year period prior to the decedent’s death is not eligible for a basis increase. This restriction does not apply to property acquired by the decedent from the decedent’s spouse unless, during the 3-year period, the spouse acquired the property in whole or in part by gift or inter

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54 Ltr. Rul. 199925033; TAM 9422052.
56 IRC §1022(d)(1)(A).
57 IRC § 1022(d)(1)(B)(iii).
58 IRC §§ 2041, 1014(b)(9).
59 IRC § 1022(d)(1)(C)(i).
vivos transfer for less than adequate and full consideration.\textsuperscript{60}

This rule is similar to § 1014(e), which denies a stepped-up basis for property acquired from a decedent if the property was transferred by the recipient to the decedent within one year of the decedent’s death. This rule was intended to prevent donors from making death-bed gifts to a terminally ill person and inheriting the property shortly thereafter with a stepped-up basis. However, the three-year rule under § 1022(d)(1)(C) applies to all property acquired by the decedent within three years of death, not just property reacquired by the donor.

Built-in loss property acquired by gift within three years of death can, however, create additional basis increases under § 1022(b). Thus, if the decedent received a gift within three years of death and its value was less than its basis on his date of death, the built-in loss can be added to the basis of other eligible property.\textsuperscript{61}

3. **Stock of Certain Foreign Entities**

Eligible property does not include stock or securities of a foreign personal holding company, stock of a DISC or former DISC, stock of a foreign investment company, or stock of a passive foreign investment company unless it is a qualified electing fund with respect to the decedent.\textsuperscript{62} This is similar to the provision disallowing any step-up in basis for foreign personal holding company stock under § 1014(b)(5) for decedents dying between August 26, 1937 and January 1, 2005.

4. **Other Property Not Considered Owned by the Decedent**

Other property that may not be considered owned by the decedent and eligible for a basis increase are an interest in a QTIP trust and a qualified personal residence trust (QPRT) with no reversionary interest. Property in these trusts would ordinarily be included in the beneficiary’s estate if he died during the trust term under § 2044 and § 2036, respectively, and be entitled to a new basis under § 1014. But under § 1022, the trust property is not owned by the decedent and therefore is ineligible for a basis increase. The same would be true for GRAT property. But any remaining annuity payments due the estate might be treated as owned by the decedent and therefore eligible for a basis increase, except to the extent of IRD.

E. **Reporting Requirements**

The executor is required to make a return reporting all property (other than cash) acquired from the decedent if the fair market value of the property exceeds $1.3 million.\textsuperscript{63} The statute also requires the executor to report transfers of gifts that the decedent received within 3 years of death to the extent that they were required to be reported on a gift tax return, even though they are not eligible for a basis increase.\textsuperscript{64}

*Returns.* On December 16, 2010, the IRS released its second draft of Form 8939,

\textsuperscript{60} IRC § 1022(d)(1)(C)(i).

\textsuperscript{61} IRC § 1022(b)(2)(C)(ii).

\textsuperscript{62} IRC § 1022(d)(1)(D).

\textsuperscript{63} IRC § 6018(b).

\textsuperscript{64} IRC § 6018(b)(2) (for estates of decedents dying after 12/31/2009).
Allocation of Increase in Basis for Property Acquired From a Decedent. The lack of instructions has raised numerous questions about the form. Most noticeably, the title is misleading because the executor must report all non-cash property acquired from a decedent if the value exceeds $1.3 million, not just that to which basis increases are allocated. Commentators have asked whether the form should have a place to allocate the decedent’s unused GST exemption, or whether Form 706 should continue to be used for this purpose. Others have suggested that the form contain an affirmative election statement, given that it is revocable only with the IRS’s consent. Clarification is also needed on whether Schedules A and B, listing property acquired by each recipient, are intended to be provided to the recipient, or whether another form will be provided for that purpose. Executors also need guidance on amending the form. Form 8939 has much more detail than the 1977 Form 5970, Information Notice to IRS as Required by IRC Section 6039A(a), which simply notified the IRS that the estate had carryover basis property and had furnished all required information to the recipients.

Extensions. Form 8939 is due with the decedent’s final income tax return, or a later date as specified in regulations. If the decedent’s final income tax return is extended to October 15, 2011, this extends Form 8939. The 2010 Tax Relief Act granted an extension of the time for filing estate tax returns for those dying after December 31, 2009 and before December 17, 2010 to not earlier than nine months after enactment, or September 17, 2011. This 9 month extension appears to apply only to Form 706 and not Form 8939. This is because it applies to reports due under § 6018, as amended by the 2010 Tax Relief Act (which repealed § 6018 as it applies to carryover basis), without regard to the election to apply carryover basis. Therefore, executors wishing to extend Form 8939 should extend the decedent’s final Form 1040. Hopefully, the IRS will clarify the due date of Form 8939 and grant an additional extension of time for filing it under its authority to do so in § 6075(a) as § 6081(a). So far, IRS has indicated informally that it is willing to extend the filing date of Form 8939 past the extended due date of the decedent’s Form 1040.

Penalties. Any person required to furnish information on Form 8939 is subject to a penalty of $10,000 ($500 for failure to report appreciated property that the decedent acquired by gift within three years of death) for each such failure. It is not clear how these penalties will be applied or whether they are per return, per beneficiary, or per property. But there is a reasonable cause exception. There is also a $50 penalty for each failure to furnish a recipient of property acquired from a decedent information.

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66 IRC § 6018(b)(1) (before amendment by TRA 2010, P.L. 111-132 § 301(a)).
67 Reg. § 26.2632-1(a), (d).
68 See Form 5970 at Exhibit A attached to this outline.
69 IRC § 6075(a).
70 P.L. 111-132, § 301(d)(1)(A).
71 IRC § 6081(a); Reg. § 20.6081-1(a), (b).
72 IRC § 6716(a); compare this to § 6098A [repealed], which imposed a $100 penalty for each failure (maximum of $5,000) to report carryover basis property inherited from a decedent who died between January 1, 1977 and November 7, 1978.
73 IRC 6716(c).
about the basis as required under § 6018(c) and (e).\textsuperscript{74} Return preparers can also be subject to penalties under § 6694 if the information reported on Form 8939 affects an entry on the beneficiary’s return and constitutes a “substantial portion” of that return.\textsuperscript{75} If Form 8939 is placed in the same category as W-2s and Forms 1099, penalties would only apply if the preparer acted willfully to understate the tax liability on the beneficiary’s return.\textsuperscript{76} But if Form 8939 is placed in the same category as Forms 1065 and 1120-S, penalties could apply even if the preparer’s conduct was not willful or reckless.\textsuperscript{77} Fiduciaries are not considered tax return preparers.\textsuperscript{78}

\textit{Amendments.} Changes to the allocation of basis can only be made as provided by the Secretary.\textsuperscript{79} So far the IRS has provided no guidance. There is generally no statute of limitations on amending an information return. They can be amended at any time. However, if filed too late the IRS may not have time to adjust the recipient’s return if the inherited asset has already been sold and reported in a year that is closed under the recipient’s statute of limitations. The IRS ruled that where it received information returns after the taxpayer had filed his personal income tax return so that there was insufficient time to adjust his 1040, the statute of limitations for adjusting the individual’s return ran for three years from the individual’s return and not from when the IRS received the information returns.\textsuperscript{80} Therefore, a late filed amended Form 8939 may have no effect on the recipient’s tax return if the recipient’s statute of limitations has run on the return that reported a sale of carryover basis property.

\textit{Sales by the Estate.} Estates with carryover basis property may have hesitated to sell assets either because they had not yet determined the basis or because they believed they could avoid a gain by waiting to sell the asset until after § 1022 sunsets. However, the Joint Tax Committee’s Technical Explanation of the 2010 Tax Relief Act has clarified that once basis is determined under § 1022, it remains the basis for determining gain or loss on disposition of that asset for any future year:

an heir who acquires an asset from the estate of a decedent who died in 2010 and whose executor elected application of the 2010 EGTRRA rules has a basis in the asset determined under the modified carryover basis rules of section 1022. Such basis is applicable for the determination of any gain or loss on the sale or disposition of the asset in any future year regardless of the status of the sunset provision...\textsuperscript{81}

Thus, it appears that once the carryover basis election is made, it would apply to all future sales and exchanges of carryover basis property. Although not expressly stated, the same legislative intent would likely apply to exclude the gain on the sale of the

\textsuperscript{74} IRC § 6716(b).
\textsuperscript{75} Reg. § 301.7701-15(b)(3) (“Substantial portion” is a facts and circumstances test and may be determined by the size and complexity of the item or the understatement).
\textsuperscript{77} Id.
\textsuperscript{78} Reg. § 301.7701-15(f)(1)(x).
\textsuperscript{79} IRC § 1022(d)(3)(B).
\textsuperscript{80} FSA 19975105.
decedent’s residence under § 121(d)(11) and built-in gain at death on funding pecuniary bequests under § 1040. However, assets that are sold by the estate are probably not eligible for the $3 spousal basis increase, not having been transferred to the surviving spouse.

1. Methods of Allocating Basis Increase

Once the executor has determined the total basis increases available, § 1022 appears to provide the executor complete latitude on how to allocate them. In small estates where the basis increases will provide a full step-up to fair market value, it makes no difference how the executor allocates them. But in large estates where the appreciation greatly exceeds the basis increases, the executor has a difficult job.

The starting point for allocating basis increases is a list of each asset “owned by” and “acquired from” the decedent, showing its cost and fair market value. The list should exclude property ineligible for the basis increases, such as IRD, property over which the decedent held a power of appointment, property acquired by gift within three years of death, and certain foreign stocks.\footnote{IRC §§ 1022(f), 1022(d)(B)(iii), 1022(d)(C), 1022(d)(D).} The executor must track the basis on a property by property basis. For example, if the decedent used specific identification to track each block of securities, that basis carries over for each property. Next the executor should separate spousal and nonspousal property.

Once that is done, there are several ways the executor can allocate the total basis increase, varying from very simple to extremely complex. The more complex, the more impartial it may appear. One simple method is to divide the total basis increases among the beneficiaries on a per capita basis. Another simple method is to allocate the basis increases to the assets most likely to sell in the near future. Yet another simple method is to allocate the basis increases to ordinary income property or to property passing to beneficiaries in the highest income tax brackets or to those not likely to die soon.

A more complex approach is to allocate basis increases in proportion to each property’s value as it relates to the total value of all the assets available for a basis increase, not to exceed its fair market value. A variation of that method is to allocate the basis increases in proportion to each property’s appreciation as it relates to the total appreciation in all the assets available for a basis increase, not to exceed its fair market value.

And finally the executor could allocate the basis increases similar to how a partnership allocates basis adjustments when a partner dies and there is a § 754 election.\footnote{Reg. § 1.755-1(b).} This method would assume a hypothetical sale of all the estate assets at a price equal to the decedent’s basis plus his basis increases under § 1022. The hypothetical sales price is allocated to each asset in proportion to its fair market value. The hypothetical gain on each asset is the amount of basis increase allocated to it. This process would be done separately for spousal and nonspousal property.

If the governing instrument gives the executor broad powers to make tax elections and allocate basis in the best interest of all the beneficiaries, the executor should be
free from criticism for “unfair” allocations, absent gross negligence or breach of the duties of loyalty and impartiality.

2. **Information to the Beneficiary**

Within 30 days after furnishing the information to the IRS, the executor is required to furnish a written statement to the beneficiaries showing the executor’s contact information and the following additional information:

(1) the name and TIN of the recipient of the property,
(2) an accurate description of the property,
(3) the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
(4) the decedent's holding period for the property,
(5) sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
(6) the amount of basis increase allocated to the property, and
(7) such other information as the Secretary may by regulations prescribe.84

Failure to provide this information on a timely basis results in a $50 penalty per failure.85 It is not clear whether this means $50 per property or per beneficiary. There is no ceiling on the total penalty that can be imposed. However, the statute provides that no penalty will be imposed if the failure is due to reasonable cause.86

This reporting requirement forces the executor to make some quick decisions about who will receive the property. In most cases, Form 8939 will be due long before these decisions have been made. If the executor has identified specific recipients of property on Form 8939, he may be obligated to account separately for those assets until they are distributed. Hopefully the IRS will either allow an extension of the time to file Form 8939 or allow the executor to amend it if the distribution plan changes, values change, or assets are sold before they are distributed.

3. **Character of the Gain**

The requirement that the executor to furnish the beneficiary “sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income” deserves special mention. The character of property is generally determined by its use in the hands of the current owner, not the prior owner. Thus, inventory in the hands of the decedent may produce capital gains when sold by the beneficiary. In *Maley v. Commissioner*, the Tax Court held that the son was entitled to capital gain treatment when he sold wine inherited from his father’s vineyard.87 The character of the wine in the son’s hands is independent of his father’s use as an operator of the vineyard.

However, income in respect of a decedent (IRD) can produce ordinary income on

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84 IRC §§ 6018(c), (e).
85 IRC § 6716(b).
86 IRC § 6716(c).
sale or disposition by the beneficiary if it would have been ordinary income in the hands of the decedent, had he lived to collect it. Depreciable property also retains its ordinary income recapture potential under §§ 1245 and 1250 after a transfer in which the transferee’s basis is determined in whole or in part by the transferor’s basis. Thus the decedent’s depreciable property can produce ordinary income for the beneficiary under the carryover basis rules. Thus, the executor might be obligated to furnish the beneficiary depreciation schedules on the property so that the beneficiary can determine his potential recapture on sale of the property.

For example, assume the decedent used a house and a car in his business and bequeathed them to his son who used them for personal use. If the son sells the car, any gain is taxed as ordinary income to the extent of any depreciation taken on the car. If the son sells the house, any gain is taxed as ordinary income to the extent that the accumulated depreciation exceeds the straight-line amount. Any gain in excess of that is taxed at 25 percent to the extent of depreciation claimed. These rules cannot be avoided by converting depreciable property to personal use.

4. Who is Responsible for Reporting Basis

The Code places the burden on the executor to make and report the basis allocations. If the executor cannot file a complete return as to any of the decedent’s property, he must provide the IRS a description of the property and the name of the person holding legal title or a beneficial interest in the property and upon notice from the IRS, that person must file a return.

If there is no executor because the decedent’s property was held in a revocable trust, the trustee is responsible for filing the return because the term executor means “the executor or administrator of the decedent, or if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent.” Moreover, the EGTRRA Conference Report explains that “For transfers at death of any non-cash assets in excess of $1.3 million and for appreciated property [ ] received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) would report to the IRS...”

A decedent with property in both an estate and a revocable trust may have two different fiduciaries charged with allocating and reporting basis under § 6018. It is not clear how their authority would be divided, especially if they owe fiduciary duties to different sets of beneficiaries. The IRS may assign the authority to the fiduciary with the highest fair market value of assets.

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88 IRC § 691(a)(3); Reg. § 1.691(a)-3(a).
89 Reg. §§ 1.1245-3(a)(3); 1.1250-1(c)(1), (c)(2).
90 IRC § 1250(b)(1); Reg. § 1.1250-1(c)(1), (c)(2); IRC § 121(d)(6).
91 IRC § 1(h)(1)(D).
92 IRC § 121(d)(6).
93 IRC § 1022(d)(3).
94 IRC 6018(b)(4).
95 IRC § 2203.
5. The Duty of Consistency

The question arises whether a beneficiary must report basis consistently with Form 8939 filed by the executor under § 6018. Taxpayers are generally required to be consistent with information returns with respect to items of income unless they assert a reasonable dispute. However, there is no requirement that the beneficiary report basis consistently with information returns. Therefore, if the beneficiary has more reliable information about the basis of the decedent’s assets, he may challenge the basis reported by the executor. If the beneficiary produces credible evidence, the burden of proof shifts to the IRS. Trusts whose net worth exceeds $7 million are not eligible for the shift in burden of proof. Nonetheless, they may still produce credible evidence about the basis if they disagree with the Form 8939.

There is also a common law “duty of consistency,” which applies when (1) the taxpayer made a representation of fact or reported an item for tax purposes in one tax year; (2) the Commissioner acquiesced in or relied on that fact for that year; and (3) the taxpayer desires to change the representation previously made in a later tax year after the earlier year has been closed by the statute of limitations. In that case, the taxpayer must maintain a consistent position. Congress has attempted to codify the common law duty of consistency without success.

The Tax Court applied the duty of consistency in Janis v. Commissioner where the trustee had used a discounted basis of property for the Form 706, but used an undiscounted basis on Form 1041 when he sold it. The trustee argued that the undiscounted value was more accurate for income tax purposes. However, the Tax Court rejected the taxpayer’s position under the duty of consistency because he was both the executor and the beneficiary. But where the beneficiary and the executor are not the same person, the duty of consistency should not preclude the beneficiary from challenging the executor’s basis determination on Form 8939.

F. Liabilities in Excess of Basis

Section 1022(g) provides that in determining whether gain is recognized on the acquisition of carryover basis property from a decedent by the decedent’s estate or a beneficiary (other than a tax-exempt beneficiary), liabilities in excess of basis are disregarded. Similarly, liabilities in excess of basis are disregarded on the acquisition of property from the decedent’s estate by any beneficiary (other than a tax-exempt beneficiary). Absent this provision, the transfer of property encumbered by liabilities in excess of basis could cause the decedent or his estate to recognize gain.

Gain recognition is not avoided when encumbered property is transferred to a tax exempt entity. This prevents the decedent from borrowing against his low basis property shortly before death and bequeathing cash to family members and encumbered property with little or no value to charity. Tax exempt entities include a

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97 IRC § 6201(d).
98 IRC § 7491(a)(1).
100 Janis v. Comm’r, TC Memo 2004-117, aff’d 461 F.3d 1080 (9th Cir. 2006), aff’d on different grounds 469 F.3d 256 (2nd Cir. 2006).
101 IRC § 1022(g).
government entity, charitable entity exempt from tax under Chapter 1 (Income Taxes), any foreign person or entity, and any other person to whom property is transferred primarily for tax avoidance.  

The legislative history is silent on why Congress sought to relieve decedents and estates of gain recognized on the transfer of property with liabilities in excess of basis. The possibility for gain recognition existed even before the carryover basis rules if the § 1014 basis of property was less than the debt against it. Moreover, lifetime gifts of encumbered property can also cause the donor to recognize gain to the extent that the transferor is relieved of debt in excess of his basis. However, Congress may have sought to mitigate these harsh consequences at death because it is generally not tax-motivated and because such instances of gain would occur more frequently.

Section 1022(g) does not protect the estate or beneficiary from recognizing gain on a sale of the encumbered property. Therefore, the executor should consider allocating as much of the decedent’s basis increases as possible to property with liabilities in excess of basis in order to reduce the gain potential if the asset will be sold.

It is unclear whether § 1022(g) would prevent decedents with negative partnership capital accounts from recognizing gain. A negative capital account generally occurs when a partner’s share of partnership liabilities gives him enough tax basis in his partnership interest to deduct losses in excess of his capital account. Despite his negative capital account, he still has a positive tax basis in his partnership interest. But if he gifts the partnership interest during lifetime, he would recognize a $1,000 gain from relief of liabilities in excess of his basis. Presumably the same result would apply to a transfer at death. However, if § 1022(g) disregards partnership liabilities in excess of basis at death, there would be no gain at death. The statute uses the term liabilities broadly. Thus, perhaps the IRS will clarify that § 1022(g) includes partnership liabilities, preventing gain from a negative capital account at death.

G. Funding Pecuniary Bequests in 2010

Distributions of appreciated property to fund a pecuniary bequest generally cause the estate or trust to recognize taxable gain on the difference between the property’s fair market value and its basis. The distribution is treated as a deemed sale of the asset at fair market value. If the asset has a built-in loss, an estate, but not a trust, may deduct the loss. But for decedents dying in 2010, distributions of appreciated property in satisfaction of a pecuniary bequest cause gain recognition only to the extent of any post-death appreciation if the executor elects carryover basis. The beneficiary
acquires a carryover basis from the estate or trust increased by any gain recognized on the distribution.\textsuperscript{109} The beneficiary also takes a carryover holding period.\textsuperscript{110}

Absent § 1040, the estate could recognize a significant amount of gain on funding a pecuniary bequest with carryover basis property. The potential for gain recognition is particularly acute where a formula pecuniary bequest consists of the entire estate, as it often does for deaths in 2010. Pecuniary bequests are treated as a deemed sale by the fiduciary regardless of whether the size of the estate limits the bequest.\textsuperscript{111} For example, the will provides a formula pecuniary bequest of the largest amount that can pass free of estate tax. The largest amount in 2009 would have been $3.5 million. But the largest amount in 2010 will be the entire estate because there is no estate tax. The potential gain on such a large bequest could be staggering without § 1040. It could still be staggering if the assets appreciate significantly between the date of death and funding.

There was initial concern that after the sunset of § 1040, the estate would recognize gain on funding a pecuniary bequest with carryover basis property equal to the difference between its market value and basis. But the Joint Tax Committee seems to have calmed those fears in the Technical Explanation to the 2010 Tax Relief Act when it stated that the EGTRRA basis rules continue to apply to determine any gain or loss on the sale or disposition of any carryover basis asset in any future year regardless of the status of the sunset provisions.\textsuperscript{112} Although not expressly stated, it appears that this same legislative intent would apply to gain on funding pecuniary bequests with carryover basis property. Therefore, executors need not rush to fund pecuniary bequests for fear of § 1040 expiring.

H. Gain on the Decedent’s Principal Residence

Effective for decedents dying in 2010, § 121(d)(11) excludes up to $250,000 of gain on a sale of the decedent’s principal residence by the estate, an individual who acquired the residence from the estate, or a qualified revocable trust established by the decedent as defined in § 645(b)(1). The exclusion applies if the transferee and the decedent together met the 2 out of 5 year ownership and use tests under § 121(a).

Despite the repeal of § 121(d)(11) by the 2010 Tax Relief Act, it continues to apply with respect to property acquired from a decedent when the election to apply carryover basis is made, regardless of the status of the sunset provisions.\textsuperscript{113} Therefore, executors and beneficiaries need not rush to sell the decedent’s residence before the end of 2010 in order to exclude the gain under § 121(d)(11).

If the estate or successor incurs a loss on the sale of the decedent’s residence, it is not clear whether the loss would be a capital or personal loss. Property is generally investment property in the hands of the estate or beneficiary, which means a loss on sale should be a capital loss. However, if § 121(d)(11) treats the property as a personal

\textsuperscript{109} IRC § 1040(c).
\textsuperscript{110} IRC § 1223(2).
\textsuperscript{113} Id.
residence for all purposes where the decedent, his estate, or the beneficiary meet the 2 out of 5 year ownership and use test, the loss might be a nondeductible personal loss.

I. Comprehensive Example

The basis adjustments under § 1022 will probably afford most estates a complete step-up in basis, except for IRD and a few other assets. This is because the $1.3 and $3 million basis increases are in addition to the decedent’s existing basis, which most people have a fair amount of to begin with. Second the recipient of the decedent’s personal residence may exclude up to an additional $250,000 ($500,000 if married) of gain on its sale if the 2 out of 5 year ownership and use tests of § 121(a) are met. And third, there are additional basis increases for unused capital loss carryovers, net operating loss carryovers, and built-in losses under § 1022(b).

Example: Joe Brown died in 2010 with $10 million in assets in a non-community property state. His will leaves the residence and personal property to his wife Mary. It also gives the maximum amount needed to zero out the estate tax to a discretionary bypass trust for Mary and the rest to a QTIP-able trust. Mary is the primary beneficiary of the IRA. Joe’s executor elects out of the estate tax. Based on the will provisions and state law, the entire probate estate passes to the bypass trust because that is the maximum amount that can pass estate tax-free. Joe’s executor allocates the basis increases as follows:

<table>
<thead>
<tr>
<th></th>
<th>Decedent’s Basis</th>
<th>Decedent’s FMV</th>
<th>Built-in Losses</th>
<th>$1.3m Basis Increase</th>
<th>$3m Spousal Basis Increase</th>
<th>Adjusted Basis Under § 1022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residence</td>
<td>500,000</td>
<td>2,000,000</td>
<td>500,000</td>
<td>1,500,000</td>
<td>2,000,000</td>
<td></td>
</tr>
<tr>
<td>Vacation Home</td>
<td>500,000</td>
<td>1,200,000</td>
<td></td>
<td>--</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Stocks</td>
<td>2,000,000</td>
<td>1,500,000</td>
<td>($500,000)</td>
<td>--</td>
<td>$1,500,000</td>
<td></td>
</tr>
<tr>
<td>Family Partnership</td>
<td>2,000,000</td>
<td>4,000,000</td>
<td>500,000</td>
<td>1,300,000</td>
<td>$3,800,000</td>
<td></td>
</tr>
<tr>
<td>Joe’s IRA</td>
<td>-0-</td>
<td>1,100,000</td>
<td></td>
<td>--</td>
<td>-0-</td>
<td></td>
</tr>
<tr>
<td>Personal Property</td>
<td>500,000</td>
<td>200,000</td>
<td></td>
<td>--</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$5,500,000</td>
<td>$10,000,000</td>
<td>-0-</td>
<td>1,300,000</td>
<td>$1,500,000</td>
<td>$8,000,000</td>
</tr>
</tbody>
</table>

Even though the market value of Joe’s estate is $10,000,000, the maximum basis achievable is $8,000,000 after allocating the various basis increases under § 1022, due to several limitations. First, the executor cannot allocate any basis increase to the IRA because it is IRD under § 691.114 Second, he is not entitled to a basis increase for the built-in loss on the personal property because it would not be deductible under § 165 if

114 IRC § 1022(f).
sold by Joe during his lifetime.\textsuperscript{115} Third, he cannot use the full $3 million spousal increase because he did not transfer enough qualified spousal property to Mary. If Joe had lived in a community property state, his executor could have allocated the rest of his $3 million spousal basis increase to Mary’s half of the community property.

Note that Joe’s executor may have “wasted” part of the basis increase allocated to the residence because $250,000 of gain can be excluded if its owners met the 2 out of 5 year ownership and use test under § 121(a).\textsuperscript{116} Joe’s estate also has a potential $700,000 capital gain on sale of the vacation home and $200,000 on disposition of the family partnership. Because these assets pass to a pecuniary bypass trust, his estate will recognize gain on funding to the extent of any post-death appreciation in these assets if date of distribution value is used for funding.\textsuperscript{117} But the trust assets will be excluded from Mary’s gross estate when she dies because she does not own them and no QTIP election under § 2044 would have been made by Joe’s executor.

If Joe’s executor had chosen the estate tax instead of electing out, there would still be no estate tax on his death because the marital deduction would reduce his taxable estate to zero. But the executor would have funded a QTIP trust with $1.7 million, which is the balance after funding the nonprobate transfers, the specific bequests, and $5 million into the bypass trust.\textsuperscript{118} And this $1.7 million would be included in Mary’s taxable estate at her death. Therefore, Joe is better off electing out of the estate tax.

J. Special Election for Decedents Dying in 2010

The 2010 Tax Relief Act gives decedents dying in 2010 a choice to apply the $5 million estate tax exclusion with a fresh start basis under the new law or elect out of the estate tax and apply carryover basis instead.\textsuperscript{119} This new provision reads:

\textbf{Sec. 301(c) SPECIAL ELECTION WITH RESPECT TO ESTATES OF DECEDENTS DYING IN 2010}

Notwithstanding subsection (a), in the case of an estate of a decedent dying after December 31, 2009, and before January 1, 2011, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1986) may elect to apply such Code as though the amendments made by subsection (a) do not apply with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code). Such election shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide. Such an election once made shall be revocable only with the consent of the Secretary of the Treasury or the Secretary's delegate. For purposes of section 2652(a)(1) of such Code, the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection.

\textsuperscript{115} IRC § 1022(b)(2)(C)(ii).
\textsuperscript{116} IRC § 121(d)(11).
\textsuperscript{117} IRC § 1040.
\textsuperscript{118} $10 million gross estate less the $1.1 million IRA, less $2.2 million of specific bequests, less a $5 million estate tax exemption.
\textsuperscript{119} P.L. 111-312, H.R. 4853 (Dec. 17, 2010).
The stakes are high for an executor with a choice to apply either the $5 million exemption and adjusted basis or the zero estate tax and carryover basis. One commentator quipped “...there’s another word for an executor who gets to choose which beneficiaries get how much money: defendant.”\(^{120}\) Regardless of whether the executor elects out of the estate tax, the $5 million GST exemption is available to the decedent in 2010.\(^{121}\) However, many other factors need to be considered.

The statute provides no deadline for making the election. Rather, it is to be made “at such time and in such manner as the Secretary [] shall provide.” So far there is no guidance from the IRS on this. Perhaps the final version of Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent will contain a place for the election. The draft Form 8939 was released before choice was enacted. Once made, however, the election is revocable only with the IRS’s consent. Therefore, executors should carefully consider all the ramifications before making a choice. A few of those factors are discussed below.

1. Funding Consequences

The most problematic consequence of choosing between a default estate tax and electing out of it is the uncertainty about how it affects funding under the will or trust. It is not entirely clear how or whether the executor’s choice of law will affect the disposition of assets under the governing instrument. These are matters of state law, which will vary from state to state. But even if the funding implications were clear, the executor with a choice may have a dilemma. If he elects out of the estate tax, he might achieve a superior tax result, but skew the testator’s intent. If he chooses the default estate tax because it carries out the testator’s funding intent, he could cost the estate significant estate taxes.

A typical will employs formulas to minimize the estate tax. However, interpreting these formulas when the executor elects out of the estate tax may cause the entire estate to pass one trust or another.

For example, the will of a decedent who died in 2010 might provide:

“I leave the Marital Trust the smallest amount of property, if any, which, if allowed as a federal estate tax marital deduction, would result in the lowest possible federal estate taxes payable by reason of my death. I leave the rest to the Bypass Trust.”

A literal reading of this formula clause passes nothing to the Marital Trust because the smallest amount that would result in the lowest possible estate tax is zero, for any size estate. Changing just a few words in this formula, however, could pass everything to the Marital Trust.

In an attempt to address these unintended funding consequences, many states enacted statutory solutions for those dying in 2010 when there is no federal estate tax


and GST tax. For example, Florida passed a law that allows the trustee or executor to seek a judicial reformation based on the decedent’s intent if the decedent died during a period when no estate tax was in effect. Virginia passed a statute that interprets references to terms and code sections as if the decedent had died on December 31, 2009, if he died while there was no federal estate and GST tax. These statutes were intended to prevent unintentional overfunding of bequests caused by applying formulas that were designed to work when the estate and GST tax exemptions were $3.5 million.

However, it is not clear how these statutory fixes will apply given the executor’s choice to apply the estate tax or not. The enactment of a retroactive estate tax in 2010 may render these statutory fixes inoperable if they only apply when there is no estate tax. In that case, we are left with the same problem we had before of how to interpret the will if the executor elects out of the estate tax. On the other hand, the executor’s election out of the estate tax may invoke the statutory fix, given that no estate tax would apply to that estate. Moreover, it might apply a $3.5 million estate tax exemption in the funding formula. Legislatures did not anticipate a choice when they enacted these solutions. So it remains to be seen how they will be applied. Thus, it is critical that executors of 2010 deceents carefully examine how state law will impact their funding provisions.

On the other hand, the will or a codicil may have expressly provided for different dispositive schemes depending on when the testator died and which law applied. These various drafting alternatives may also create ambiguity if they did not anticipate that the executor would have a choice of law. Therefore, the executor might consider a family settlement agreement or a judicial construction of the instrument. Settlements and judicial constructions are less likely to cause adverse tax consequences when no estate tax applies because there is no concern about whether the disposition will qualify for the marital or charitable deduction.

2. Charitable Beneficiaries

A choice of law may adversely affect a charitable beneficiary, which necessarily involves the state attorney general. For example, assume the will leaves a specific bequest of low basis property to the testator’s children and the residue to charity. All estate taxes are paid out of the residue. If the estate taxes are zero, the charity will receive a large sum of money and the children will receive the low basis property with a significant income tax liability. On the other hand, if the executor elects to apply a $5 million exemption and a stepped-up basis, the estate taxes could wipe out the charitable residue, but the property will pass to the children with a stepped-up basis, eliminating the potential income tax liability on the appreciation. If the executor chooses to apply the estate tax, he should be prepared

122 Florida Statutes § 733.1051 and 736.04114; Idaho Code § 15-1-501; Indiana Code § 29-1-6-1(8); Maryland Code, Estates & Trusts, § 11-110; Nebraska L.B. 1047 (2010); Tennessee Code § 32-3-113; Utah Code § 75-3-917; Code of Virginia § 64.1-62.4; Revised Code of Washington chapter 11.108; Other states that have enacted similar laws include Delaware, District of Columbia, Georgia, Minnesota, Michigan, New York, North Carolina, Pennsylvania, South Carolina, South Dakota, and Wisconsin.
123 Florida Statutes § 733.1051 and 736.04114.
to show that his choice carries out the testator’s intent.

3. **Decedent’s Basis**

All estates of decedents dying in 2010, regardless of size, will need to determine the basis and fair market value of the decedent’s assets on his date of death, and possibly the alternate valuation date. Estates under $5 million will generally accept the default estate tax to obtain a stepped-up basis because they would not incur any estate tax or have any reporting requirements. About 3,000 estates that are worth over $10 million will generally elect out of the estate tax because the immediate estate tax savings will generally exceed the present value of any potential income tax from carryover basis.

But for about 6,000 estates worth between $5 and $10 million, the choice will not be so easy.\(^{125}\) They could have such a low basis that the potential income taxes under carryover basis would far exceed any estate taxes that would be due with an estate tax. Thus they might be tempted to accept the default estate tax. But the executor of a married decedent should also consider the potential estate taxes at the surviving spouse’s death. Even if there is no estate tax on the first death because of the marital deduction, the assets left to the surviving spouse outright or in a QTIP trust would be taxable in the surviving spouse’s estate. However, assets left in trust for the surviving spouse under a zero estate tax regime would be excluded from the surviving spouse’s estate because they are not owned by the surviving spouse and no QTIP election would have been made. Therefore, it may be worth electing out of the estate tax on the first death to avoid estate taxes at the second death, even if it means paying some income tax on carryover basis property.

4. **Buy-Sell Provisions**

Where the decedent owned a closely held business, the entity’s buy-sell agreement may mandate a sale or redemption on the death of the partner or shareholder. This can create an unexpected income tax burden on the surviving spouse or other beneficiaries if they have a low carryover basis in a highly appreciated business. The decedent may not have anticipated this extra tax burden when planning for his family in the will. Depending on all the facts and circumstances, the executor may wish to apply the estate tax and obtain a stepped-up basis to avoid the immediate income tax liability. But if the income tax is only 15 percent because the buy-sell agreement calls for a lump sum payment rather than an installment payout, it may be worth electing out of the estate tax, depending on the size of the estate and a host of other issues. The executor simply needs to calculate the tax under both options and address any conflicts of interest that arise if the executor personally benefits from his or her decision at the expense of the other beneficiaries.

5. **Valuation Discounts**

A large factor in the executor’s choice will be the availability of discounts. There are many sources of discounts such as family partnerships, fractional interests,

below market interest rate loans, single-member LLCs and other disregarded entities, corporations with built-in gains, self-cancelling promissory notes, and closely held entities with potential claims and expenses that reduce the entity’s value even though they may not be deductible under § 2053.

The executor should not overlook these fertile sources of discounts in evaluating whether to apply or elect out of the estate tax. Such discounts will determine the amount of estate tax under the default estate tax, which is needed to compare to the present value of the potential income tax with a carryover basis. However, the executor should be careful that his appraisals and valuation methods are supportable. It would be unfortunate if he opted for the default estate tax, only to find his discounts disallowed upon audit. In this case the estate may owe more estate tax than the potential income taxes it would have paid under carryover basis.

6. Unknown Assets

Regardless of which law he chooses, the executor should conduct a thorough search for missing assets. If he is concerned that there are assets that he is not aware of, he should consider electing out of the estate tax and forgo the stepped-up basis under § 1014. Unknown assets can cause significant estate taxes if the executor fails to elect out of the estate tax thinking that the estate was below a certain threshold, and then discovers additional assets after the deadline for the election is past. The 2010 Tax Relief Act did not provide a statutory deadline for electing out of the estate tax. It simply states that the election will be made at the time and manner as the Secretary provides. Presumably it will be made on Form 8939, although there is no place to make the election on the draft form or any other place at this time. The IRS will probably be reluctant to allow executors to make a late election, especially where it is made in hindsight.

Therefore, executors that choose the default estate tax should consider requesting a discharge from personal liability by filing Form 5495 “Request for Discharge From Personal Liability Under IRC Section 2204 or 6905.” The IRS is obligated to notify the executor of any unpaid estate taxes within 9 months of the later of filing the request or filing the estate tax return (6 months in the case of a fiduciary other than the executor). Upon payment of the amount so notified, he is relieved of personal liability for any additional estate tax liability. If the IRS fails to notify the executor within the 9 month period, he is discharged. Neither § 2204 nor the regulations address whether the executor may be discharged from personal liability for estate tax if no estate tax return is required to be filed. To be on the safe side, the executor should consider filing a Form 706, even if the gross estate is under $5 million, and attaching Form 5495. Regardless, discharge of the executor’s personal liability

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129 Frane v. Comm’r, 998 F.2d 567 (8th Cir. 1993); IRC § 453B(f).
130 P.L. 111-132 § 301(c).
applies only to his personal assets and not to estate assets in his possession or to estate assets in the hands of any beneficiary, including the executor.131

7. Unreported Prior Gifts

Estates that do not elect out of the estate tax must file a Form 706 if the decedent was a U.S. citizen or resident and the value of his gross estate plus adjusted taxable gifts exceeds $5 million for 2010.132 “Adjusted taxable gifts” means gifts in excess of the annual gift tax exclusion and amounts paid for medical and educational expenses under § 2503 that are not includible in the decedent’s gross estate.133 Thus it is critical that executors make a diligent search for any unreported gifts. The existence of unreported gifts may affect the requirement to file a Form 706 as well as the executor’s personal liability for unpaid estate and gift taxes.

To the extent unreported gifts were made, the decedent may have used more of his $1 million gift tax exemption than expected, which can increase the estate tax. In that case, the executor may prefer to elect out of the estate tax, especially if he can achieve a full step-up with the basis increases available under § 1022(b) and (c). But if the unreported gifts cause the total gifts to exceed $1 million, the executor may be personally liable for the decedent’s unpaid gift and GST taxes.134 In that case, the executor should file Form 5495 to request a discharge from personal liability for these taxes, but only after the gift tax returns have been filed and the tax paid. The request for personal discharge from the decedent’s gift taxes may be filed even if no estate tax return is required to be filed.135 Within 9 months of filing the application, the executor will be notified of the amount due and upon payment thereof, he will be discharged from any further personal liability.

8. Inadequately Disclosed Prior Gifts

Inadequately disclosed gifts cause many of the same problems as unreported gifts. If the decedent failed to adequately disclose a gift on a Form 709, the IRS may adjust the value of the gift at any time.136 The regulations detail the disclosures required to constitute “adequate disclosure” and start the three year statute of limitations running. They include a description of the property, the method used to value it, any financial and other data used, any restrictions that were considered or discounts applied, and more.137 If the IRS adjusts the value of a gift that was inadequately disclosed on a prior gift tax return, this can cause additional gift taxes as well as additional estate taxes if the adjustment causes the decedent’s total gifts to cross over the $1 million lifetime exemption. In that case, the decedent would have a smaller estate tax exclusion than anticipated, which could affect the executor’s choice between the default estate tax and electing out of it.

Therefore, the executor should carefully review the decedent’s prior gift tax returns.

131 Reg. § 20.2204-1(a).
132 IRC § 6018(a).
133 IRC § 2001(b) (flush language).
135 Reg. § 301.6905-1(a).
136 Reg. § 301.6501(c)-1(f).
137 Reg. § 301.6501(c)-1(f)(2).
to determine whether gifts were adequately disclosed. If inadequate disclosure might give rise to a valuation adjustment that would increase the estate tax because total gifts would use up more of the $1 million lifetime exemption, the executor should factor the potential increased estate tax into the choice between the default estate tax and electing out of it. Regardless of the choice, the executor should consider filing Form 5495 to request a discharge from personal liability for the decedent’s gift taxes. Form 5495 can also be used to discharge the executor from personal liability for the decedent’s estate taxes if a Form 706 is filed.

9. Property Eligible for the Spousal Basis Increase

If electing out of the estate tax causes the entire estate to pass to a non-QTIP trust under the will or trust, none of the decedent’s property will qualify for the $3 million spousal basis increase under § 1022(c), unless the surviving spouse has a one-half interest in the decedent’s community property. If the executor cannot fully use the $3 million spousal basis increase, he should consider applying the default estate tax to achieve a stepped-up basis under § 1014, especially if the assets will be sold shortly or the surviving spouse is not likely to have a taxable estate.

10. State Death and Income Taxes

The executor should determine how his choice of law will affect the state income and estate taxes. States have generally either enacted their own death tax laws independent of the federal law or they define their death tax by reference to the now obsolete federal state death tax credit. Therefore, the executor’s choice of federal law will generally not impact the state death taxes. But the executor should carefully examine the applicable state law to be sure.

Nor will the executor’s choice of law likely affect its state income tax. Most, but not all, states conform to the federal carryover basis rules for decedents dying in 2010. Therefore, electing out of the estate tax means carryover basis for state income tax purposes even where a state death tax applies. However, California does not incorporate § 1022. Instead, it allows a stepped-up basis for assets acquired from a decedent in 2010. Therefore, the executor of a California decedent who chooses to apply 2010 law may pleasantly discover that while the estate has a carryover basis for federal income tax purposes, it has a stepped-up basis for California income tax purposes. While the result is favorable, it will entail extra bookkeeping for two sets of basis. Other states may enact similar legislation.

Nor does California incorporate § 121(d)(11), which excludes up to $250,000 ($500,000 on a joint return) of gain on the sale of a decedent’s principal residence if the recipient and the decedent together meet the 2 out of 5 year ownership and use test under § 121(a). However, because California allows a stepped-up basis, loss of the gain exclusion under § 121(d)(11) is not as detrimental as it might seem.

11. Expenses, Debts, and Claims

The executor should not overlook the decedent’s expenses, debts, and claims in

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choosing between the default estate tax and electing out of it. If the decedent has significant expenses, debts, and claims, he may not owe any estate taxes under the default estate tax and enjoy a full step-up in basis of his assets under § 1014. The ability to apply the default estate tax and stepped-up basis could be very valuable where the decedent has a large estate with very low basis assets and high expenses, debts, and claims deductible under § 2053.

12. Impact on the Second Spouse to Die

In deciding whether to apply or elect out of the estate tax, the executor should consider the estate taxes on both the decedent’s and the surviving spouse’s death. Even if there is no estate tax on the first death, there could be significant estate taxes on the second death if the executor defaults to the estate tax in 2010.

For example, assume a decedent who died in 2010 left property equal to the maximum amount that can pass estate tax-free to a bypass trust and the rest to a QTIP trust for his spouse. There is no estate tax under either a $5 million exemption or a zero estate tax, assuming the executor makes a QTIP election if the estate tax applies. But the QTIP property is included in the surviving spouse’s estate at her death under § 2044. Therefore, the executor should consider electing out of the estate tax to exclude the QTIP property from the surviving spouse’s estate because she does not own it and no QTIP election was made.

13. Impact of Disclaimers

The impact of disclaimers should be carefully considered in choosing between the estate tax and electing out of it. For example, assume a decedent who dies in 2010 leaves property outright to his surviving spouse such as a specific bequest, a joint account with rights of survivorship, or an IRA. There may be no estate tax on the decedent’s death under either choice of law. However, the property will be included in the surviving spouse’s estate at her death to the extent not consumed.

The surviving spouse cannot take advantage of the new portability provisions of the 2010 Tax Relief Act to use the deceased spouse’s unused estate tax exemption because portability does not apply until deaths after 2010.\footnote{IRC § 2010(c)(4), as amended by P.L. 111-132 § 303, effective for estates of decedents dying after December 31, 2010.} To reduce the potential estate tax at the surviving spouse’s death, the surviving spouse might consider disclaiming all or some of a bequest. If the disclaimed property passes to the children, she would need to evaluate whether she can afford to part with it.

But if the disclaimed property passes to a trust for her benefit, a disclaimer can offer two advantages, depending on the size of the couple’s net worth. In smaller estates, the disclaimed assets can help the decedent use more of his $5 million estate tax exclusion. To the extent it is not used, it is lost because portability does not apply to decedents dying in 2010. In larger estates where the executor elects out of the estate tax, the disclaimed property that passes to the trust would be excluded from the surviving spouse’s taxable estate because she does not own it and no QTIP election under § 2044 was made. Therefore, the surviving spouse of both large and small estates should carefully consider the advantages of a disclaimer.
For many decedents who died in 2010, the 9 month period for making disclaimers has passed.\textsuperscript{141} To provide relief from the retroactive effect of the changes, the 2010 Tax Relief Act grants an extension of time to make a qualified disclaimer under § 2518(b) of property passing by reason of the death of a decedent dying after December 31, 2009 and before December 17, 2010. Such disclaimers are due no earlier than nine months after the date of enactment, or September 17, 2011.\textsuperscript{142} Presumably this relief includes transfers in lieu of disclaimers under § 2518(c)(3) that meet the requirements of a qualified disclaimer under § 2518(b). If so, this would alleviate concerns about failing to meet state law disclaimer deadlines, which may be nine months (or even less) after the transfer. However, § 2518(c)(3) is not a “catch-all” to save defective disclaimers.\textsuperscript{143} Where the disclaimant has not met the time requirement under state law, he should make an actual written transfer to the person who would otherwise have received the property had the disclaimer been valid under local law. He cannot simply rely § 2518(c)(3) to save his late disclaimer documents.

14. Potential For § 2036 Inclusion

The potential for estate tax inclusion under § 2036 should be considered in every estate. Section 2036 can rear its ugly head unexpectedly. The IRS can invoke it to include property in the decedent’s taxable estate even though he gave it away during his lifetime if he has enjoyed the use or the income from the property or can designate who will. For example, the decedent may have created a family partnership and gifted interests in it during his life, but continued to use and enjoy the partnership property, borrow from it, or take disproportionate distributions from it. The IRS has invoked § 2036 on many occasions to include partnership assets in the decedent’s taxable estate at their undiscounted value, even though he gave them away during his lifetime.

If the executor is worried that the IRS will include assets in the decedent’s taxable estate under § 2036, he may prefer to elect out of the estate tax, even though the estate assets would have a carryover basis. Eliminating the estate’s exposure to § 2036 might be worth the basis tracking and reporting obligations, especially if the estate can obtain a healthy step-up with the basis increases allowed under § 1022.

15. Assets Ineligible for a Basis Increase

If the decedent has assets that are ineligible for a basis increase under § 1022, such as property acquired by gift within three years of death, property over which the decedent has a power of appointment, certain foreign stock, or an interest in a QTIP trust, QPRT, or GRAT, the executor may want to apply the default estate tax to achieve a stepped-up basis for property that would otherwise be ineligible, even if it means owing a little estate tax. However, if the estate tax resulting from inclusion would exceed the potential income tax cost under a carryover basis regime, the executor may prefer to elect out of the estate tax instead.

\textsuperscript{141} IRC § 2518(b)(2).
\textsuperscript{142} P.L. 111-132 § 301(d)(1)(C).
\textsuperscript{143} Bennett v. Comm’r, 100 T.C. 42 (1993).
III. Form 1099-B Reporting

The Emergency Economic Stabilization Act of 2008 (the Act), (P.L. 110-343), requires every domestic and foreign broker that is required to file a Form 1099 information return reporting the gross proceeds of a “covered security” to now include the customer’s basis in the security and whether any gain or loss is short or long term. It also requires every broker who transfers a security, whether covered or noncovered, to issue a transfer statement to the transferee broker within 15 days after the transfer. The transfer statement is not filed with the IRS. If the security is a covered security in the hands of the transferring broker, the transfer statement must report the basis and holding period information to the transferee broker. In the case of a noncovered security, the broker must still file a transfer statement, but is not required to report any additional information.

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired for cash or through a dividend reinvestment program in the account in which the security is held or (2) was transferred to that account if the transferee broker received a statement under § 6045 with respect to the transfer. Thus, gifted and inherited securities that were covered securities in the account of the donor or decedent remain covered securities when transferred to the recipient’s account and accompanied by a transfer statement from the donor’s broker.

In response to numerous public comments, the IRS issued final regulations in October 2010 to implement these new reporting requirements. The regulations describe how to determine the basis and whether any gain or loss is long or short term. They also address the reporting requirements for brokers transferring stock and for issuers of stock in connection with organizational actions. They do not cover reporting for options, compensatory options, or other equity-based compensation arrangements. These transactions will be addressed in future regulations.

A. New Basis Reporting Rules

Brokers who sell “covered securities” (stocks, bonds, debentures, commodities, derivatives, mutual funds, shares acquired in a dividend reinvestment program (DRP), an interest in a trust or partnership, and noncompensatory options acquired for cash in the broker’s account) after 2010 must now report the cost basis and holding period of the shares on Form 1099-B in addition to the gross sales proceeds. Cost basis reporting for mutual funds, DRP shares, and options is delayed until after 2011.

Brokers must include the name, address, and taxpayer identification number of the customer, the property sold, the CUSIP (Committee on Uniform Security Identification Procedures) number of the security sold (if applicable), or other security identifier number that IRS designates, the adjusted basis of the security, whether any gain or loss is long-term or short-term, the gross proceeds of the sale, and the sale date. The information will be reported on Form 1099-B, “Proceeds from Broker and Barter

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144 IRC § 6045(g).
146 IRC § 6045A.
147 Reg. § 1.6045-1(a)(15).
149 IRC § 6045(g)(3)(B); Reg. § 1.6045-1(a)(3), (15).
Exchange Transactions.” A draft of the 2011 Form 1099-B appears as Exhibit C at the end of this outline and is available at http://www.irs.gov/pub/irs-dft/f1099b.

A broker who transfers a covered security to another broker must also furnish the transferee broker a written statement of the basis and holding period of the security not later than fifteen days after the date of the settlement of the transfer. Transferee brokers are required to take into account information they receive from transferor brokers on a transfer statement, including shares acquired by inheritance and gift. Similar reporting requirements apply to issuers.

The basis of a security is generally its cost when acquired by purchase in the broker’s account. If a customer sells less than his entire holding of a security, the basis is determined using the first-in first-out (FIFO) method, unless the customer notifies the broker in writing and adequately identifies the stock sold or transferred by the settlement date. The basis of mutual funds and DRP shares is generally determined on an averaging method unless the customer notifies the broker that he elects another acceptable method. Wash sales must be reported as such if the purchase and the sale of identical securities occurs in the same account. Section 1091 disallows losses on sales made within 30 days of a purchase of identical securities.

There is a penalty of $50 for each failure to file a Form 1099-B or include all of the required information, subject to a maximum penalty of $250,000. There is also a penalty for failure to timely furnish a correct transfer statement under § 6045A to the receiving broker. However, for transfers of stock in 2011, the Service will not assert penalties under § 6722 for a failure to furnish a transfer statement under § 6045A for any transfer of stock that is not incidental to the stock’s purchase or sale. These penalties are also subject to exception for reasonable cause.

B. Property Acquired by Gift

In the case of a transfer of covered securities by gift, the transfer statement must indicate that the security is a gift and must report the date of the gift (if known when furnishing the statement) and the fair market value of the gift on that date (if known or readily ascertainable at the time the transfer statement is prepared). The transferring broker must also report the basis and original acquisition date of the donor. If the request to transfer ownership between different people is silent as to the reason for the transfer and the broker does not know that it is not a gift, the transfer should generally be treated as a gift. In the case of noncovered securities, the transferring broker is

150 Reg § 1.6045-1(d)(2)(i).
151 Reg. § 1.6045A-1(a)(3).
152 IRC § 6045B.
153 IRC § 6045(g)(2)(B)(i)(I).
154 IRC § 6045(g)(2)(B).
155 IRC § 6045(g)(2)(B)(iii); Reg. § 1.6045-1(d)(6)(iii).
156 Reg. §§ 1.6045-1(j), 301.6721-1.
157 IRC § 6722.
159 Reg. § 1.6045A-1(b)(6)(i).
160 Reg. § 1.6045A-1(b)(6)(i); see also Preamble to Prop. Reg .12/16/2009, Reporting Required in Connection with Transfers of Gifted and Inherited Securities.
not required to include the basis and holding period, but may choose to do so if that information is provided. The rules for reporting gifts appear to apply to all gifts, including those to charity, but not for distributions from trusts to beneficiaries, which are not gifts.

The selling broker must take these basis adjustments into account in reporting adjusted basis upon the subsequent sale or other disposition of these securities. If the transfer statement indicates that the security is acquired as a gift, the broker must apply the relevant basis and holding period rules for property acquired by gift, except that the broker is not required to account for gift taxes paid. If the application of those basis rules prevents both gain and loss from being recognized, or if the initial basis of the security depends upon its fair market value as of the date of the gift but the transfer statement does not report its fair market value as of the date of the gift and this amount is not readily ascertainable by the broker, the broker must treat the initial basis as equal to the gross proceeds from the sale. This takes into account the rules under § 1015(a) that limit losses on sales of gifted shares when the basis exceeds the fair market value of the shares on the date of the gift.

EXAMPLE

X instructs Broker S to give to Y shares of stock in a publicly traded company that X holds in an account with S. On X’s instruction, Broker S transfers custody of the stock to T, Y’s broker. The transfer settles on August 15, 2013. Broker S must indicate on the transfer statement that the transfer is a transfer of gifted securities and report X’s basis and original acquisition date. Broker S must also indicate that the date of the gift was August 15, 2013, if the settlement date was known when S furnished the statement, and the fair market value of the shares on that date.

If a broker transfers a security that was previously gifted to another account of the same customer, the broker must report the security as gifted in the subsequent transfer.

EXAMPLE

Assume the same facts as the example above except that, one year later, Y transfers the stock to an account in his name with U, another broker. T must provide a transfer statement to U that identifies the securities as gifted securities and indicates X’s adjusted basis and original acquisition date of the stock. The transfer statement must also indicate the date of the gift, August 15, 2013, and the fair market value of the stock on that date either by reporting the value that S reported to T or, because T can readily ascertain the fair market value of the stock on August 15, 2013, by determining the fair market value of the stock on that date.

C. Property Acquired by Inheritance

162 Reg. § 1.6045A-1(b)(6)(iii), Ex. 1.
163 Reg. § 1.6045A-1(b)(6)(iii), Ex. 2.
Under the final regulations, when securities are transferred from a decedent or a decedent’s estate, the transfer statement must indicate that the securities are inherited.\(^{164}\) However, transfers to satisfy a cash legacy are not subject to reporting under § 6045. The transfer statement must report the date of death as the acquisition date and must report adjusted basis in accordance with the instructions and valuations provided by an authorized representative of the estate. If the authorized estate representative does not provide instructions or valuations, the broker must report the basis as the fair market value of the security on the date of death. However, if the transferor neither knows nor can readily ascertain the fair market value of the security on the date of death at the time the transfer statement is prepared, the transfer statement must indicate that the transfer consists of an inherited security but may otherwise report the security as if it were a noncovered security. If an inherited security is transferred to another account, the subsequent transfer statement must indicate that the transfer is an inherited security.

The regulations require that the selling broker take these basis adjustments into account in reporting adjusted basis upon the subsequent sale or other disposition of these securities. The final regulations provide no examples of transfers by a decedent’s estate.

IV. **Critical Tax Elections**

The executor has an incredible array of tax elections at his disposal. Some elections involve only timing differences while others involve permanent differences. Not all beneficiaries are affected equally by the elections. Some elections are more important than ever before in a zero estate tax environment and others are temporarily inapplicable. It is critical that the executor be aware of all the possible elections. Although many of them can be made on an extended or amended return, others have no such flexibility. If the executor fails to make an election to the detriment of the beneficiaries, he can be liable for breach of fiduciary duty. The discussion below covers the most common elections. However, it is by no means an exhaustive list.

**A. Elections Affecting the Decedent’s Final Income Tax Return**

If the estate owes estate taxes, the deduction will generally be more valuable on the estate tax return. This is not only because the estate tax rates are higher than the income tax rates, but because the additional income tax owed by the decedent will be deductible under § 2053 for estate tax purposes.

1. **Medical Expenses**

The executor may elect to deduct some or all of the decedent’s medical expenses paid after the date of death either on the decedent’s final income tax return or on the estate tax return.\(^{165}\) To be deducted on the final income tax return, they must be paid within one year after the decedent’s death. Estates that do not file Form 706 or owe any estate taxes should deduct the medical expenses on the final Form 1040. In order to claim them on the Form 1040, the executor must attach a statement that the amount has not been allowed as a deduction on Form 706 and

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164 Reg. § 1.6045A-1(b)(5)(i).

165 IRC § 213(c); Rev. Rul. 77-357, 1977-2 C.B. 328.
waive the right to do so.\textsuperscript{166} Expenses that are lost on the Form 1040 due to the 7.5 percent of AGI floor are not allowed as a deduction on Form 706.

2. **Installment Sales**

If an installment sale occurs in the year of death, the executor may choose to elect out of the installment method. This would result in the gain being taxed on the decedent’s final return, thus creating an estate tax deduction for the income tax liability. In addition, no IRD recognition would occur after death.

3. **Savings Bond Interest**

Any taxpayer may elect to report all previously unreported Series E or EE Bond interest as income in the current year and thereafter report it as accrued under § 454(a). The executor can make this election on a decedent’s final Form 1040.\textsuperscript{167} Even though reporting the income on the decedent’s final income tax return may increase the decedent’s final income tax liability, this debt can reduce the decedent’s federal estate tax.\textsuperscript{168} The election is not binding on the transferee of the bonds.\textsuperscript{169} Therefore, the beneficiaries who receive the bonds may defer tax on the interest accrued after the decedent’s death until redemption even though the executor elected to recognize the income up to the date of the decedent’s death.

4. **Partnership and S Corporation Income Allocations**

Partnership and S corporation income can either be deferred or accelerated into the decedent’s final income tax year simply by an election made at the entity level. Accelerating income can create an income tax liability on the decedent’s final income tax return, which entitles the estate to a deduction under § 2053. Also, bunching income into the decedent’s final income tax return can shelter it from taxes if the decedent has large medical expenses, charitable contributions, capital loss carryovers, or net operating loss carryovers. Otherwise, many of these valuable deductions may expire unused.

Both partnerships and S corporations can choose to allocate income to the decedent under an “interim closing of the books” or a “proration” method.\textsuperscript{170} Under the interim closing of the books method, the books are actually closed on the decedent’s date of death. Income actually earned before his death is allocated to his final income tax return. This method can produce vastly different results than the proration method, which divides the total income for the entire year by 365 days and allocates a portion to the decedent’s final return based on the number of days he was alive. The executor should communicate with the entity to determine the best method. Although the executor does not make the election, he can often influence the manager of the entity.

B. **Elections Affecting the Estate’s Income Tax Return**

\textsuperscript{166} Reg. § 1.213-1(d)(2).
\textsuperscript{167} Rev. Rul. 68-145, 1968-1 C.B. 203; Rev. Rul. 79-409, 1979-2 C.B. 208 (executor may also elect to accrue interest on Series E Bonds held in revocable trust at time of death).
\textsuperscript{168} Ltr. Rul. 9232006.
\textsuperscript{169} Reg. § 1.454-1(a).
\textsuperscript{170} Reg. § 1.706-1(c)(2)(ii); IRC § 1377(a).
1. Taxable Year End

An estate may adopt any tax year it chooses as long as it qualifies as a permissible accounting period.171 Typically, this means a calendar year or fiscal year that ends on the last day of the month.172 Once chosen, the tax year can only be changed by permission from the IRS. Neither the filing of a Form SS-4, *Application for Federal ID Number*, nor an extension determines the year-end.173 A taxable year of a new taxpayer is adopted by filing its first federal income tax return using that taxable year.174 This freedom to choose any tax year offers an estate a great deal of flexibility, especially when it is facing significant and immediate income tax consequences.

Choosing a noncalendar year also offers a deferral advantage. Because most beneficiaries have calendar years, they will report their share of the distributed income in their tax year within which the estate's tax year ends.175 By eliminating the estate's compressed income tax brackets through distributions and deferring the time when beneficiaries must report their share of the income, the executor can achieve significant tax savings.

Estates of decedents who die in 2010 should particularly consider a non-calendar year that extends the estate’s first tax filing as far as possible. For example, the estate of a decedent who died on November 15, 2010 can elect an October 31 tax year, which defers the filing date of its first Form 1041 to February 15, 2012. This allows the executor maximum flexibility on making funding or sale decisions that affect the income tax of the estate or the beneficiaries.

A non-calendar tax year also extends all of the current income tax rates into the next year.176 This may be helpful when rates are expected to go up, such as after 2012. Thus an estate with an October 31, 2012 tax year will be subject to the 2012 income tax rates and provisions until its tax year beginning November 1, 2013. Thus the estate can take longer advantage of the lower income tax rates that apply for tax years beginning before 2013. A fiscal year can also provide extra time to make distributions that will be treated as having been distributed in the prior taxable year under the 65-day election.177

2. Charitable Contributions Made After Year End

An estate or trust is entitled to deduct charitable contributions paid during the year on the prior year’s income tax return.178 Thus the fiduciary has the benefit of hindsight to determine which year is more preferable to claim the deduction.

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171 Reg. § 1.441-1(c).
172 Reg. § 1.441-1(b)(1)(iv).
173 Reg. § 1.441-1(c).
174 Id.
175 Reg. § 1.662(c)-1.
176 P.L. 107-16, § 901, SUNSET OF PROVISIONS OF ACT (“All provisions of, and amendments made by, this Act shall not apply – (1) to taxable, plan, or limitation years beginning after December 31, 2010.”)
177 IRC § 663(b)(1); see also discussion at Section V.B.7. of this outline.
178 IRC § 642(c)(1); Reg. § 1.642(c)-1(b).
However, because income tax rates are scheduled to increase from 35 to 39.6 percent from 2012 to 2013, the fiduciary would generally not make this election, absent other circumstances. But if the estate or trust does not have sufficient income in the current year to absorb the deduction or if the deduction would offset favorably taxed capital gains, it may be wise to make the election to deduct it in the prior year. The fiduciary should make his decision well before the prior year return is filed in order to avoid amended income tax returns for the fiduciary and perhaps the beneficiaries.

3. No Double Deductions

In general, deductions that are allowable on Form 706 under §§ 2053 (expenses and debts) or 2054 (losses) are not also allowed as an income tax deduction on Form 1041.\textsuperscript{179} Thus, most deductions must be claimed on either Form 706, Form 1041, or split between them.\textsuperscript{180} If the estate wishes to deduct expenses on its Form 1041 rather than the Form 706, it must attach an election to Form 1041 that irrevocably waives the right to deduct the expenses on Form 706. The prohibition against double deductions does not apply to deductions in respect of a decedent (DRD) under § 691(b). Examples of such expenses are interest and property taxes accrued prior to the decedent’s death, which can be deducted on both Form 706 and 1041. The chart at Exhibit D summarizes where deductions can be claimed for most commonly encountered deductions.

4. Distributions In-Kind

When an estate or trust distributes property in-kind to a beneficiary, it recognizes no gain or loss on the distribution.\textsuperscript{181} The distribution is valued at the lesser of the property’s basis or its fair market value and the beneficiary takes a carryover basis in the property.\textsuperscript{182} There is an exception to this rule if the property is distributed in satisfaction of a pecuniary bequest.\textsuperscript{183} But if the distribution is not otherwise taxable, the executor may elect to recognize the gain or loss on the distribution as if the property had been sold at its fair market value.\textsuperscript{184} If this election is made, the beneficiaries’ basis in the property will be the estate's adjusted basis plus any gain or loss recognized on the distribution. This generally means that the beneficiary’s basis is the fair market value of the property. The election is made on a year by year basis and once made for a year, is revocable only with the IRS’s consent. Moreover, the election applies to all distributions made during the estate or trust’s taxable year. Thus it cannot be made on an asset by asset basis.

There are good reasons for and against making a § 643(e)(3) election. The election may be beneficial if the fiduciary wants to make sure the income tax is paid on the property’s appreciation. Thus it may be an accommodation to the beneficiaries or intended to avoid surprise on their part when the property is sold. The estate may

\textsuperscript{179} IRC § 642(g).
\textsuperscript{180} Reg. § 1.642(g)-2.
\textsuperscript{181} IRC § 643(e).
\textsuperscript{182} IRC § 643(e)(1).
\textsuperscript{183} IRC § 643(e)(4).
\textsuperscript{184} IRC § 643(e).
also have unused deductions or capital losses that can offset the income.

However, good reasons to avoid the election include a beneficiary who will be taxed in a lower tax bracket on sale of the property. Or the beneficiary may have capital losses that can offset his gain on sale of the property. A big reason to avoid the election is if the beneficiary is not likely to sell the property soon or will hold it until his death, in which case he may obtain a stepped up basis under § 1014.

5. Estimated Tax Payments

Trusts and estates must pay estimated income tax payments in the same manner as individuals. Estates, but not trusts, are exempt from this requirement for the first two taxable years. Qualified revocable trusts that make the § 645 election may take advantage of the two-year exemption from paying estimated taxes that is available to estates. Trusts may also elect to treat any part of an estimated tax payment as having been made by a beneficiary. Estates may also make this election, but only for their final year. The election may be made as to one or more beneficiaries. A beneficiary treated as having made a payment is deemed to have received a distribution on the last day of the trust or estate's taxable year and is deemed to have paid the estimated tax on January 15 of the following year. The election may be made regardless of whether the trust or estate has overpaid its own tax and it only applies to estimated taxes, not withholding.

From a practical standpoint this election is rarely made due to the short time period within which the election must be made. The election must be made by the 65th day after the close of the estate or trust's tax year. There is no extension of time within which to make this election. Thus, by the time the fiduciary considers it, the deadline has usually passed.

6. Trust Treated as an Estate - Section 645

Under § 645(a), if both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) make a proper election, the trust will be treated and taxed for income tax purposes as part of the estate rather than a separate trust. The election applies for two years from the date of the decedent’s death if no estate tax return is filed. If an estate tax return is filed the election period runs from the date of the decedent’s death to 6 months after the date of the final determination of the estate tax liability. The § 645 election once made is irrevocable.

A “qualified revocable trust” means any trust (or portion thereof) that was treated under § 676 as owned by the decedent by reason of a power in the decedent to

185 IRC § 6654(l).
186 Reg. § 1.645-1(e)(4).
187 IRC § 643(g).
188 IRC § 643(g)(1)(B-C).
189 IRC § 643(g)(2).
190 IRC § 645(b)(2); Reg. § 1.645-1(f)(2).
191 Reg. § 1.645-1(e)(1).
revoke, determined without regard to § 672(e). The § 645 election allows a trust to take advantage of the following tax rules that apply to estates:

1. **The charitable set aside deduction under § 642(c), longer period of time to hold subchapter S stock without disqualification under § 1361(b)(1), and the special $25,000 passive loss deduction for rental real estate activities in § 469(i)(4).**

2. **A fiscal year election will be allowed, which is not available to a trust filing its own return. This may be a significant benefit for decedents who die in 2010 with a large part of their property in a revocable trust.**

3. **Recognizing loss upon the satisfaction of a pecuniary bequest with assets that have a fair market value less than basis pursuant to IRC § 267(b)(13).**

4. **The tax items of one entity such as passive activity losses, net operating losses, capital losses or investment interest, which may otherwise be limited, may be offset by the other entity’s passive income, taxable regular income, capital gains and losses, or investment income.**

5. **The two year exception to the obligation to make estimated tax payments.**

### 7. Distributions Within First 65 Days of the Year

Estates and trusts may elect to treat all or part of a distribution made within the first 65 days of the taxable year as paid on the last day of the preceding taxable year. Once made, the election is irrevocable. To make the election, the executor or trustee must check the box on page 2 of Form 1041 filed on or before the extended due date of the return. However, the executor or trustee must also remember to actually make distributions within the first 65 days of the taxable year or else the election does no good.

This election can be invaluable where the will or trust provides for a large pecuniary bequest by a decedent who died in 2012. In some cases, the pecuniary bequest may consist of the entire estate. If there is a significant built-in gain on the assets used to fund the pecuniary bequest, a 65-day election will allow the executor fund the bequest in the first 65 days of 2013 and apply the 2012 tax rates to the gain incurred on funding.

### C. Other Special Elections

1. **QSST or ESBT Election**

   If the decedent owned S corporation stock, it will be very important for the executor or trustee to make sure that the S corporation’s election is not terminated due to the transfer of shares to an ineligible shareholder. The estate is an eligible S corporation shareholder for as long as is reasonably necessary during the administration. However, once the shares are transferred to a beneficiary or trust,

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192 IRC § 645(b)(1).
193 Reg. § 1.645-1(e)(2).
194 IRC § 663(b); Reg. § 1.663(b)-1(a)(1).
195 Reg. § 1.663(b)-2(a)(1).
196 IRC § 1361(b)(1)(B).
the new shareholders must be eligible S corporation shareholders. Only U.S. citizens or residents, certain trusts, organizations exempt under §§ 401(a), 501(a), or 501(c)(3) are eligible to own S corporation stock. If the stock is transferred to an ineligible shareholder, the S election is terminated immediately.

If the executor transfers S corporation stock to a trust, the trust must either be a qualified subchapter S trust (QSST) or an electing small business trust (ESBT). The beneficiary makes the election for a QSST, whereas the trustee makes the election for an ESBT. The election to be a QSST or ESBT must be made no later than 2 years after stock is transferred to a testamentary trust. If the decedent owned his S corporation stock in a revocable living trust, the election must be made no later than 2 years after the death of the shareholder. If the trust makes a valid § 645 election and the estate files a Form 706, the trust can extend the period of time to hold S corporation stock to 6 months after the determination of the final estate tax liability. If the estate does not file a Form 706, a § 645 election does not extend the period of time to hold S corporation stock past two years after the decedent’s death.

The requirements to qualify for QSST or ESBT status are detailed in the statute and regulations. In general, a QSST may have only one current income beneficiary who is a U.S. citizen or resident and the trust must distribute all its income annually. The requirements for an ESBT are more flexible. An ESBT may have multiple beneficiaries and may retain or distribute its income. However, the ESBT pays a flat tax on the earnings of the S corporation at the highest fiduciary income tax rate, which is 39.6 percent beginning in 2013. It also pays the 3.8 percent Medicare tax beginning in 2013.

2. Section 754 Election

Unless the estate elects out of the estate tax, the basis of a partnership interest is adjusted to its fair market value on the date of the partner’s death, or the alternate valuation date, less any amount attributable to income in respect of a decedent. But this adjustment has no effect on the inside basis of the partnership property. So if the partnership sells an asset right after a partner dies, the partner’s successor will report his share of gain or loss just like any other partner as if no basis adjustment occurred. However, if the partnership makes a § 754 election, the inside basis of the partnership property is also adjusted to the outside basis.

An adjustment to the inside basis of the partnership assets generally means that the basis of the partnership assets is adjusted to the fair market value of the partnership interest under § 1014. Thus, the successor partner acquires a basis in his share of

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197 Id.
198 IRC § 1361(c)(2)(A)(iii).
199 IRC § 1361(c)(2)(A)(ii).
200 IRC § 1361(b)(2).
201 IRC § 1361(d)(3).
202 IRC § 1361(e)(1).
203 IRC § 641(c)(2)(A).
204 IRC § 1014(a)(1); Reg. § 1.742-1.
205 IRC § 743(a).
the partnership assets as if he had purchased an undivided interest in them at fair market value on the decedent’s death. Some assets may receive an increased basis and others may receive a decreased basis. The § 754 election does not affect any other partner or the holding period of the partnership assets.\(^\text{206}\) The § 754 election works the same way for deaths in 2010 where the executor elects out of the estate tax and into carryover basis, except that the inside basis of partnership assets is adjusted to the decedent’s carryover basis of the partnership interest plus any basis increases allowed under § 1022(b) and (c) rather than the fair market value of the partnership interest under § 1014.

The election is made by the partnership on the return for the year during which the partner died.\(^\text{207}\) The return must be filed by the extended due date of the partnership return, or within 12 months thereof.\(^\text{208}\) Once made, the election is revocable only with the approval of the Commissioner and must be requested within 30 days after the close of the partnership taxable year for which the revocation is intended to take effect.\(^\text{209}\) Because this revocation deadline occurs before an initial § 754 election could be made, it is not intended to revoke an election made in error. There are no published rulings on revoking a § 754 election, prospectively or retroactively, except for a few dealing with a special one-time transitional revocation that was permitted before 2000.\(^\text{210}\) If an initial election is made in error, it may be possible to amend the return and claim “mistake of fact, particularly if the taxpayer received no benefit from the election.”\(^\text{211}\) An amended return would void the election from inception rather than revoke it.

A partnership interest owned by a QTIP trust is included in the decedent’s gross estate and is treated as passing from the decedent under § 2044. Because there has been a transfer of the partnership interest by death, this enables the partnership to make a § 754 election.\(^\text{212}\) However, if the partner dies in 2010, the QTIP assets are not included in the decedent’s gross estate because § 2044 does not apply. Thus there has been no transfer by death under § 743(a), and the partnership cannot make a § 754 election.

A § 754 election can also be made if there is a transfer by sale or exchange of the partnership interest.\(^\text{213}\) A distribution of a partnership interest is treated as a “sale or exchange” for this purpose.\(^\text{214}\) Accordingly, a distribution of a partnership interest by the estate or trust to a beneficiary should allow the partnership to make a § 754 election. However, some commentators question this result based on the Senate Report to the 1986 Tax Reform Act, which explains that sale or exchange treatment

\(^{206}\) Reg. § 1.743-1(j)(1).
\(^{207}\) Reg. § 1.754-1(b).
\(^{208}\) Id.; Reg. § 301.9100-2(a)(2)(vi).
\(^{209}\) Reg. § 1.754-1(c)(1).
\(^{210}\) Reg. § 1.754-1(c)(2).
\(^{212}\) Ltr. Rul. 200442028.
\(^{213}\) IRC § 743(a).
\(^{214}\) IRC § 761(e).
for distributions of partnership interests is limited, and that the Secretary can provide exceptions, such of the death of a partner.\footnote{S. Rep. 313, 99th Cong., 2nd Sess., 1986-3 C.B. Vol. 3 924.} However, the Senate Report may also indicate Congress’s attempt to avoid a possible adverse treatment on the death of a partner. But there are no rulings or cases on this point.

V. Termination of a Grantor Trust

A common estate planning tool is to transfer property to an intentionally defective grantor trust (IDGT) or a grantor retained annuity trust (GRAT) in order to freeze the value of the property transferred. All future appreciation in the property shifts to the trust, without a gift or estate tax. In addition, the transfers are not recognized for income tax purposes and thus the grantor continues to report income from the property.\footnote{Rev. Rul. 85-13, 1985-1 CB 184.}

However, when the grantor trust status terminates, either by death or by revocation, renunciation, or expiration of the grantor’s power, there may be a taxable transaction. Several authorities address the tax consequences of terminating grantor trust status during the grantor’s lifetime, but not at his death.\footnote{Regs. § 1.1001-2(c), Example 5; Madorin v. Commissioner, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200011005; GCM 37228.} In a nutshell, they hold that at the moment of termination, the grantor and the trust become separate taxpayers for federal income tax purposes. The grantor is deemed to transfer the property to the trust and his basis carries over to the trust. However, if there is consideration from the trust to the grantor, such as debt forgiveness, the grantor recognizes gain equal to the difference between his basis and the consideration received.

A. Sale to an Intentionally Defective Grantor Trust (IDGT)

No single authority addresses the income tax consequences of termination of grantor trust status on death of the grantor. However, Revenue Ruling 77-402, which holds that gain is recognized on lifetime terminations of grantor trust status where there is consideration from the trust, maintains that it doesn’t matter how the grantor trust status terminates:

Furthermore, the result would be the same if the trust ceases to be a grantor trust by reason of the expiration or lapse of the powers. The result would also be the same if the trust were treated as a grantor trust by reason of powers exercisable by a party other than the grantor and ceased to be a grantor trust upon the release or renunciation of those powers by such other party or upon the expiration or lapse of such powers.

Nonetheless, some commentators maintain that death should be an exception to the gain recognition rule because death is not generally a taxable event.\footnote{Jonathan G. Blattmachr and Mitchell M. Gans, “No Gain at Death,” Trusts & Estates (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, “Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death,” J. Tax’n. (Sept. 2002).} While they concede that the IRS and the courts have taxed conversions during the grantor’s lifetime where there is consideration from the trust, they point out that no authority taxes conversions on account of death.\footnote{Id.} But, other commentators argue just as
strongly that termination of grantor trust status on account of the grantor’s death is a taxable event where consideration passes from the trust to the grantor or his estate. Consideration can take many forms, such as debt relief or an installment note payable to the grantor or his estate. To the extent the consideration exceeds the grantor’s basis in the property, gain should be recognized just the same as if the grantor trust status terminated during the grantor’s lifetime.220

1. IRD and Basis of the Note

The unpaid installment note is entitled to a stepped up basis under § 1014(a) because it is required to be included in the decedent’s gross estate.221 However, to the extent there is any deferred gain that constitutes IRD, the note is not entitled to a stepped up basis.222 Whether there is IRD depends on whether the deemed transfer of property to the trust on death of the grantor in return for a note qualifies as an “installment sale” under § 453. If it does not qualify for installment reporting, the gain should be reported on the decedent’s final income tax return because the deemed transfer to trust occurs at the moment of the grantor’s death. All income received on the date of death is taxable on the decedent’s final income tax return.223 If the deemed transfer qualifies for installment sale reporting, then the estate or other successor should report the deferred gain as payments are collected.

An installment sale is defined as a “disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.”224 Installment reporting is mandatory unless the taxpayer affirmatively elects out of the installment method or the method is statutorily precluded, such as a sale of marketable securities.225 The IRS also permits installment reporting in partial nonrecognition transactions, such as bargain sales to charity, tax-free exchanges, and transfers in exchange for stock under § 351.226 Therefore, there is no reason that a transfer to trust for an installment note should not qualify for installment reporting. As such, the deferred gain should constitute IRD and the basis of the note is not stepped up to this extent.227

2. Basis of the Trust Property

The partnership interest owned by the estate or trust is not entitled to an adjusted basis under § 1014 because it was not included in the decedent’s taxable estate.228 Its basis is the greater of the amount paid by the trust (the note balance) or the

221 IRC § 1014(b)(9).
222 IRC § 1014(c).
223 Reg. § 1.451-1.
224 IRC § 453(b)(1).
225 IRC § 453(a), (d); IRC § 453(k), (l).
226 Reg. § 1.453-1(f) (installment sale reporting allowed for nonpermitted property received in partial recognition exchanges such as tax-free exchanges under Section 1031, 351, etc; PLR 7933009 (bargain sale to charity with an installment note qualified for installment sale reporting).
227 IRC § 453(b); IRC § 1014(c).
228 CCA200937028 (Sept. 11, 2009).
grantor’s adjusted basis at the time of the transfer. If the note balance exceeds the grantor’s basis, the trust’s basis in the property is equal to the unpaid note and its holding period starts on the date the grantor trust status ceases. On the other hand, if the unpaid note is less than the grantor’s basis on termination of grantor status, the trust’s basis in the property is equal to the grantor’s basis and therefore it may tack the grantor’s holding period.

**EXAMPLE**

Joe sold a partnership interest on the installment basis to an IDGT for $60,000. The sale is ignored for federal income tax purposes. When Joe died, the note balance was $30,000 and the basis of his partnership interest was $20,000. This, Joe realized a $10,000 gain on the transfer. [$30,000 - $20,000]. If the transfer qualifies for installment reporting, the $10,000 is IRD, which his estate or legatees report as they collect the note payments. If the transaction does not qualify for installment reporting, Joe reports the $10,000 gain on his final Form 1040. The trust’s basis in the partnership is $30,000, the amount paid.

Perhaps the IRS will someday clarify the income tax treatment of installment sales to a grantor trust when the grantor dies before the note is paid. But the Service is unlikely to hold that the unpaid note balance has no income tax consequences to the grantor or his estate. Nonetheless, there is comfort in the fact that any gain would likely be eligible for installment sale reporting and should also increase the trust’s basis in the property.

**B. Grantor Retained Annuity Trust (GRAT)**

If an individual transfers property to a GRAT, but dies before the end of the GRAT term, there is included in his taxable estate the lesser of the value of the GRAT property or the value necessary to pay the annuity for the rest of the GRAT period without reducing or invading principal.

**EXAMPLE**

D transferred $100,000 to a GRAT when the § 7520 rate was 3.2 percent. The GRAT pays a qualified annuity of $12,000 a year for 10 years. D died before the end of the GRAT term when the § 7520 rate was 6 percent and the GRAT property was worth $300,000. The amount includible in the grantor’s estate is $200,000, which is the lesser of the value of the GRAT property or the value necessary to pay the annuity for the rest of the GRAT period without reducing or invading principal.

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229 Reg. § 1.1015-4(a).
230 Ltr. Rul. 7752001; Reg. § 1.1015-4.
231 Id.
232 Reg. § 1.1001-1(e).
property ($300,000) or the principal necessary to pay a $12,000 annuity at 6
percent. [$12,000/.06=$200,000]^{234}

Thus, if interest rates rise and the GRAT property appreciates, the value includible in
the grantor’s estate with a 10-year GRAT could be less than what would have been
included if no GRAT had been created.

There should be no income tax consequences to the grantor or his estate when the
grantor dies during the term of the GRAT, even if the annuity payments continue to be
paid to the estate. The IRS and the courts have consistently held that the moment a
trust ceases to be a grantor trust, it becomes a separate nongrantor trust.^{235} In the
conversion, the grantor is deemed to have transferred his property to the trust. If there
is any consideration in the exchange (cash, debt relief, an annuity, etc.) paid to the
grantor, the transfer is taxable to the grantor to the extent that the consideration
exceeds the grantor’s basis in the property.^{236} However, because GRAT property is
included in the grantor’s estate when he dies during the term of the GRAT, the
property receives a stepped-up basis. Thus it is unlikely that the value of the remaining
annuity payments payable to the estate (if any) will exceed the basis of the property.

VI. Flow-Through Entities Owned by Fiduciaries

A. 3.8 Percent Surtax on Unearned Income of Estates and Trusts

Section 1411 imposes a surtax of 3.8 percent on the unearned income of individuals,
estates, and trusts for taxable years beginning after December 31, 2012. The surtax is
in addition to all other taxes imposed by Subtitle A (Income Taxes), including the
alternative minimum tax.^{237} In the case of an estate or trust, the surtax applies to the
lesser of a) adjusted gross income under § 67(e) in excess of the highest income tax
bracket threshold ($11,200 in 2010) or b) undistributed net investment income.^{238} The
threshold for the highest bracket is indexed for inflation each year, unlike the threshold
for individuals, which is fixed at $250,000 for married individuals, $125,000 for those
married individuals filing separately, and $200,000 for other individuals.^{239} It is
unlikely that a trust can divide into multiple smaller trusts to take advantage of
multiple thresholds. Multiple trusts are aggregated and treated as one and the same
trust if they have substantially the same trustees and beneficiaries.^{240}

*Adjusted Gross Income*

Adjusted gross income (AGI) of an estate or trust is determined under § 67(e). It is
computed in the same manner as for an individual, except that deductions are allowed
for charitable contributions, the personal exemption, distributions to beneficiaries, and

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^{234} Example based on Reg. § 20.2036-1(c)(2)(iii), Ex. 2.
^{235} Regs. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-
402, 1977-2 C.B. 222; TAM 200011005; GCM 37228.
^{236} *Id.*
^{237} IRC § 1411(a)(1).
^{238} IRC § 1411(a)(2).
^{239} IRC § 1(f); IRC § 1411(b).
^{240} IRC § 643(f).
costs “which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” This last category has been interpreted by the Supreme Court to mean costs that hypothetical individuals would not commonly or customarily incur if they owned the same property.241 Unfortunately, there is a great deal of confusion over what costs this covers.

Undistributed Net Investment Income

“Undistributed net investment income” is not defined in the Code. Presumably it means net investment income minus distributions, excluding distributions of income not included in net investment income. Distributions reduce both AGI and net investment income. Therefore, the trustee may want to make distributions to beneficiaries if they will not be subject to the surtax because their AGI does not exceed the $250,000/$125,000 threshold that applies to individuals.

Net investment income includes gross income from interest, dividends, rents, royalties, annuities, gains from the disposition of property, passive activities, and trading activities less “properly allocable” expenses.242 Several types of income are excluded from net investment income. The statute expressly excludes distributions from IRAs and qualified plans.243 It also excludes nonpassive trade or business income.244

Net investment income also excludes tax exempt income and annuities (because it is not included in gross income) and guaranteed payments from partnerships. Guaranteed payments that are subject to self-employment tax are excluded because § 1411(c)(6) specifically excludes any item subject to self-employment tax. Guaranteed payments that are not subject to self-employment tax, such as those from investment partnerships, are excluded from investment income simply because they are not on the list of items that constitute investment income under § 1411(c)(1)(A).

Allocating Expenses

The trustee’s classification of expenses will impact the amount of the surtax in two ways. First, expenses classified as miscellaneous itemized deductions subject to the 2 percent floor will not likely reduce the surtax. This is because they are not deductible in computing AGI, which will generally be the lesser of AGI in excess of the threshold or undistributed net investment income. Therefore, the trustee may want to consider allocating as many expenses as it can to “above the line” deductions not subject to the 2 percent floor to minimize the surtax.

Second, in determining the character of income distributed to beneficiaries, the regulations require that expenses deducted in determining DNI be allocated to various classes of income included in DNI, including tax exempt income.245 Direct expenses must be allocated to the class of income to which they relate. Indirect expenses may be

242 IRC § 1411(c)(1).
243 IRC § 1411(c)(5).
244 IRC § 1411(c)(1)(A)(ii).
245 IRC § 652(b); Reg. § 1.652(b)-3.
allocated to any category as long as a portion is allocated to tax exempt income.\textsuperscript{246} The regulations list trustee fees, safe deposit box rental, and state income and personal property taxes as examples of indirect expenses.\textsuperscript{247} Thus to the extent that expenses are allocated to income excluded from the surtax base, such as tax-exempt income, these deductions are wasted for purposes of the surtax. Therefore, the trustee may want to allocate as few expenses as reasonably possible to tax exempt and other classes of income that are not subject to the surtax.

\textit{Capital Gains}

Net capital gains are part of both AGI and undistributed net investment income in computing the surtax. Net capital losses do not reduce either. But the capital gains of most trusts are usually retained as corpus and not able to be distributed. Hence they become trapped in the trust and subject to the surtax, unless they can be included in DNI and distributed to the beneficiaries.

The IRS regulations describe the circumstances under which capital gains can be included in DNI.\textsuperscript{248} These circumstances include a) where the trust instrument provides that capital gains are included in trust income (rare), b) the distributions are in full or partial liquidation of the trust, c) the trustee has the power to adjust and consistently designates principal distributions as capital gains, or d) the gains are included in a unitrust distribution. In addition to these specified circumstances, capital gains flowing from a partnership K-1 are included in DNI. Therefore, the trustee may want to consider investing through a partnership so that capital gains can be distributed and escape the surtax.

\textit{IRA Distributions}

IRA distributions are included in AGI, but not net investment income.\textsuperscript{249} Therefore, if a trust is receiving IRA distributions, its undistributed net investment income will likely be lower than its AGI in excess of the threshold. Therefore, because IRA distributions will likely escape the surtax, it may be good planning to name a trust as an IRA beneficiary. To the extent that the trust distributes the IRA distribution to the beneficiary, the distribution retains the same character in the hands of the beneficiary as it had in the hands of the trust.\textsuperscript{250} Thus, IRA distributions from an estate or trust should be exempt from the net investment income of the individual.

\textit{Passive Income}

Passive income is included in both AGI and net investment income. Passive income is trade or business income in which the taxpayer does not materially participate.\textsuperscript{251} In the case of an estate or trust, the IRS has ruled that the trustee himself needs to meet the material participation test.\textsuperscript{252} Rental income is, however, per se passive.\textsuperscript{253}

\textsuperscript{246} Id.
\textsuperscript{247} Reg. § 1.652(b)-3(c).
\textsuperscript{248} Reg. § 1.643(a)-3.
\textsuperscript{249} IRC § 1411(c)(5).
\textsuperscript{250} IRC § 652(b).
\textsuperscript{251} IRC § 469(c).
\textsuperscript{252} TAM 200733023.
Nonetheless, it can be offset by favorable depreciation deductions. A trust with passive income might consider investing in passive loss activities to shelter its passive income.

B. Passive Activities

Fiduciaries frequently own an interest in a trade or business such as a ranch, rental property, or other business enterprise. These activities can be owned directly or indirectly through passthrough entities. They are either acquired for investment purposes or simply inherited by virtue of the partner’s death. In order to deduct their share of losses incurred by these activities, however, the trustee must materially participate in the activity.\(^{254}\) The Treasury Department has issued regulations explaining how individuals can meet the material participation requirements, but it has not yet issued regulations addressing material participation by trusts and estates.\(^{255}\)

Individuals (natural persons) can meet one of seven safe harbor tests in Reg. § 1.469-5T(a)(1)-(7) in order to materially participate in an activity for purposes of deducting passive losses.\(^{256}\) Limited partners, however, may only avail themselves of three of these seven tests in order to materially participate in the activity. Members of limited liability companies (LLCs) are considered general rather than limited partners and may therefore rely on one of the seven tests for material participation.\(^{257}\)

The critical question for estates and trusts is whose participation counts for purposes of the material participation test - the trustee, the beneficiaries, or agents. Until regulations are issued for estates and trusts, § 469(h)(1) remains the sole standard for determining whether a trust or estate satisfies the material participation test. Section 469(h)(1) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. But who is the taxpayer?

The District Court for the Northern District of Texas addressed this issue for a trust for the first time in *Carter v. United States*.\(^{258}\) The Carter Trust was a testamentary trust that owned a 15,000 acre working cattle ranch with mineral interests. The trustee had extensive business, managerial and financial experience and maintained regular office hours pertaining to trust business. However, he delegated certain aspects of the operations to a full-time ranch manager and several employees who performed all of the ranch activities. The trust claimed losses of $856,518 and $796,687 in 1994 and 1995 in connection with the ranch operations, which the IRS disallowed as passive activity losses under § 469. The IRS maintained that the “material participation” of a trust is determined by reference to only the activities of the trustee in his capacity as such. Because he delegated so much of his responsibility, the IRS argued that he himself did not materially participate. The Carter Trust, however, argued that because the trust (not the trustee) is the taxpayer, “material participation” should be determined

\(^{253}\) IRC § 469(b)(2).

\(^{254}\) IRC § 469(h)(1).

\(^{255}\) Reg. § 1.469-8 [Reserved], T.D. 8417 (May 12, 1992).


by assessing the activities of Carter Trust, through all its fiduciaries, employees, and agents.

Agreeing with the Carter Trust, the district court held that the material participation in the ranch operations should be determined by reference to all the persons who conducted the business of the ranch on Carter Trust’s behalf, including the trustee. The evidence was clear that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation.

Notwithstanding the Carter decision, the IRS issued Private Letter Ruling 201029014 which maintains that the sole means for a trust to materially participate in a trade or business activity is for the fiduciary to be involved in the operations of the activity on a regular, continuous, and substantial basis.259 The ruling involved a complex trust with A as both the trustee and beneficiary. The trust held various assets including a partnership interest in B. B wholly owned C, which wholly owned D. The trust requested a ruling as to whether the trust can materially participate in the activities of D. The IRS concluded that it may materially participate in D’s activities if A is involved in the operations of D’s activities on a regular, continuous, and substantial basis. It expressed no opinion about whether A in fact materially participated in D’s activities. Nor did it mention whether D’s activities constituted an “appropriate economic unit” with another wholly owned business in which A materially participated.260 If so, A may have been able to meet the material participation test.

In TAM 200733023 the IRS held that losses incurred by a trust flowing from an LLC were passive because the trustee himself was not involved in the LLC’s operations on a regular, continuous, and substantial basis as required by § 469(h)(1). The TAM justified its position on the basis that individual business owners cannot rely on the activities of their employees to satisfy the material participation requirement.261 Trades or businesses generally involve employees or agents and therefore a contrary approach would allow an owner to be treated as materially participating in any trade or business activity, which guts the test altogether.

However, TAM 200733023 may provide a roadmap for trustees wishing to establish material participation. The trust in the TAM employed “Special Trustees” who ran the business, but could not legally bind or commit the trust to any course of action and had no discretionary powers. Therefore, they were not fiduciaries for purposes of the material participation test. But even if they were, their duties of negotiating tax matters, handling the entry of new partners, and reviewing operating budgets had a questionable nexus to the conduct of the business. Therefore trusts wishing to meet the material participation test should make sure that their trustees participate on a regular, continuous, and substantial basis in the operations of the business activity and that any special trustees have discretionary powers and the power to bind the trust.

260 Reg. § 1.469-4(c).
C. Determining “Trust Income” From a Partnership

In addition to the prudent investor and tax issues, the trustee must also determine whether distributions from a partnership are income or principal. Most wills and trust agreements default to the state law rules for determining income and principal. The Uniform Principal and Income Act treats money distributions from “entities” as income and property distributions as principal.\(^{262}\) Entities include corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds, and any other organization in which a trustee has an interest (except a trust or estate, a business activity, or an asset-backed security to which other sections of the Act apply.)

However, any money distributed in complete or partial liquidation of the entity is principal. A partial liquidation is one that the entity “indicates” as a partial liquidating distribution regardless of the size of the distribution.\(^{263}\) A trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity’s board of directors or other person or group vested with powers similar to a board of directors.\(^{264}\)

If the entity is silent about whether the distribution is a partial liquidating distribution, the trustee can rely on the 20-percent rule. A distribution or a series of related distributions that exceeds 20 percent of the entity’s gross assets is considered a partial liquidation.\(^{265}\) However, the portion of the distribution that equals the income tax due on the entity’s taxable income is ignored in calculating the 20 percent.\(^{266}\) Although the Act resolved some of the issues regarding income from entities, it leaves several more unanswered questions.

1. QTIP Trusts

Trustees of marital trusts should be especially careful that the surviving spouse is entitled to all the “income” from the entity so that the trust qualifies for the estate tax marital deduction under § 2056(b)(7). The IRS has shown willingness to accept reasonable allocations between income and principal where a marital trust owns a partnership interest.\(^{267}\)

Most recently, Revenue Ruling 2006-26 held that a QTIP trust qualifies for the marital deduction where its income is determined under a state law unitrust of 3 to 5 percent or based on traditional income, with or without an exercise of the power to adjust by the trustee.\(^{268}\) In addition, the spouse must be able to compel the trustee to

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\(^{262}\) UNIF. PRINCIPAL & INCOME ACT §§ 401(b), (c).

\(^{263}\) Id. at § 401(d)(1).

\(^{264}\) Id. at § 401(f).

\(^{265}\) Id. at § (d)(2).

\(^{266}\) Id. at § (e).

\(^{267}\) FSA 199920016 (contribution of assets of a QTIP trust to a family limited partnership didn't result in a gift because the beneficiary still received the same amount of income that she received from the QTIP trust before); (P.L.R. 9739017 (IRS allows a will formula allocating a portion of partnership liquidation payments to marital trust income to meet the marital deduction requirements).

make the property productive. Although this Revenue Ruling deals strictly with income from IRAs paid to a QTIP trust, its reasoning can apply to income from a partnership interest.

Where a QTIP trust owns a partnership interest that does not distribute either 3 to 5 percent of its assets or its “traditional” income, the IRS could find that the trust does not qualify as a QTIP under § 2056(b)(7). Thus, QTIP trusts owning partnerships should be especially careful that the partnership is distributing sufficient income to avoid potential disqualification of the marital trust status.

2. The 20-Percent Rule

In determining whether a distribution, or series of distributions, is in partial liquidation because it exceeds 20 percent of the entity’s gross assets, the trustee needs the entity’s financial statements for the year ended immediately before the distribution (or first distribution of a series). The entity may prepare its financial statements on GAAP, fair market value, or any other method it deems appropriate. For example, in 2004 when Microsoft declared a dividend that exceeded 30 percent of its book value, trustees could use Microsoft’s December 31, 2003 audited financial statements included in its Form 10-K filing with the SEC.

If the entity prepares its financial statements using historical cost and its assets have appreciated substantially, the 20-percent rule favors the principal beneficiary because distributions are more likely to exceed 20 percent of gross assets and be treated as principal. Note also the control that the entity has over the trust’s income or principal. The entity can specify that a distribution is either a partial liquidating distribution or not by merely stating so. In addition, the entity can simply pay more than 20 percent of its gross assets if it wants to create a principal distribution for the trust beneficiaries.

The trustee can also manipulate income and principal under the 20-percent rule. For example, if the trustee transfers trust assets to an entity that makes no distributions or that distributes more than 20 percent of its gross assets, the trust has no income from that entity. Alternatively, if the entity distributes less than 20 percent of its gross assets, the trust can have a steady stream of income even if the entity is selling off corpus to support the distributions. Of course these maneuvers are tempered by the fiduciary’s duty of loyalty to all the beneficiaries under the Uniform Prudent Investor Act.

Another criticism of the 20-percent rule is its rigidity. If a distribution exceeds 20 percent of the entity’s gross assets, it is per se principal. Although UPIA 401(d)(1) allows a payment of less that 20 percent of an entity’s gross assets to be classified as principal if the entity indicates it is principal at or near the time of a distribution, there is no corresponding rule that allows payments in excess of 20 percent to be classified as income. This is so despite that the distribution may actually represent many years of accumulated income that is no longer needed by the entity in its operations. This was probably the case with Microsoft. Some trustees treated the 2004 extraordinary distribution as income and some treated it as principal.

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269 Reg. §§ 20.2056(b)-5(f)(4) and (5).
In addition, a recent California Court of Appeal found the 20 percent rule susceptible of two different interpretations. In *Thomas v. Elder*, the beneficiary interpreted the statute as classifying distributions to income when a *single owner* receives less than 20 percent of the entity’s gross assets, regardless of the owner’s percentage interest. The Court of Appeal agreed that the statute was capable of that interpretation and held in favor of the beneficiary. In reaction to *Thomas*, the California state legislature enacted as an emergency measure an amendment to their UPIA statute to clarify that distributions are income only when the total amount distributions to *all* shareholders collectively exceeds 20 percent of the entity’s gross assets.

But the problems didn’t stop there. In a more recent California Court of Appeal, *Hasso v. Hasso*, the trustee claimed that distributions from an S corporation to a trust were principal because they exceeded 20 percent of the S corporation’s $133 million of “special purpose” assets. The company had prepared its financial statements on the “equity” method of accounting at the special request of a lender rather than on a GAAP basis. But a footnote to the financial statements disclosed that the company actually had $630 million of assets under a GAAP basis consolidated method of reporting. This was confirmed by the company’s chief financial officer in deposition testimony. Both the court and the parties struggled to interpret the company’s complex financial statements. But in the end the court found that the company’s true assets were $630 million rather than $133 million and classified the distributions as income.

Similarly in *Manson v. Shepherd*, a California Appeal Court determined that a $3 million distribution to a Trust from its primary asset, Wave Crest development corporation, was a distribution in partial liquidation and therefore principal. The court found that Wave Crest’s board had indicated that the $3 million distribution was the result of selling its High Street property in order to achieve a better cash position. Consequently, the distribution met the definition of a partial liquidation under § 16350(d)(1)(A) of the Cal. Uniform Principal and Income Act and the $3 million was properly applied to principal. Most significant were the corporate minutes in which the Wave Crest board made known its intention to use the cash proceeds of the High Street sale to, in part, provide cash to the Trust so that the Trust would in turn pay its debt to Wave Crest. This intention was consistent with the strategic plan for Wave Crest, which was to generate additional cash flow for Wave Crest. From those minutes, the court inferred that Wave Crest made it known, or “indicated,” at the time of the board meeting that the $3 million distribution was a liquidating distribution properly allocated to principal.

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D. Taxes on Undistributed Partnership Taxable Income

When a trust owns an interest in a partnership or S corporation, it must report its share of the entity’s taxable income, regardless of how much the entity distributes to the trust. The entity may distribute nothing. Or it may distribute an amount less than the trust’s tax on the entity’s taxable income. Or it may distribute more than enough for the trustee to pay its tax on the entity’s taxable income, but less than all of the entity’s taxable income. In each case, the trustee must allocate the taxes on its share of the entity’s taxable income between income and principal.

UPIA § 505(c) and (d) require a trust to pay taxes on its share of an entity’s taxable income from income to the extent that receipts from the entity are income and from principal to the extent that receipts from the entity are principal. In determining the trust’s taxes and how much is owed to the beneficiary, UPIA § 505(d) requires the trustee to take into account the fact that distributions to the beneficiary may be tax deductible to the trust. Prior to amendment in October 2008, Act sections 505(c) and (d) were unclear as to how they were intended to apply. To remove the ambiguity, NCCUSL amended § 505 to read as follows:

**UPIA § 505 INCOME TAXES**

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(c) A tax required to be paid by a trustee on the trust’s share of an entity’s taxable income must be paid:

(1) from income to the extent that receipts from the entity are allocated only to income;

(2) from principal to the extent that receipts from the entity are allocated only to principal;

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust’s taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Many states have already adopted the 2008 amendments to UPIA § 505. Those states that are operating under the pre-amendment version of UPIA § 505, potentially face at least two different interpretations of their state statute, which produce vastly

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273 Generally amounts paid by a trust to a beneficiary are tax deductible. However, in the case of an Electing Small Business Trust (ESBT), the trust is not entitled to deduct payments to beneficiaries. The comments to UPIA § 505 explain that 505(d) was intended to address both situations.

different results. However, it is likely that such dispute will be resolved on the basis of NCCUSL’s intended meaning of the statute as clarified in the 2008 amendment.

The goal of Section 505 is to require the trustee to first calculate the trust’s tax on an entity’s taxable income and then reduce income or principal receipts before making a payment to the beneficiary. If necessary, the trustee must use the entire distribution from an entity to pay its taxes on the entity’s taxable income. If the distribution from the entity exceeds the trust’s taxes on its share of the entity’s taxable income, the trustee allocates the rest to income or principal depending on whether the receipt was income or principal. Because the trust’s taxes and the amount paid or payable to the beneficiary are interdependent, it requires an algebraic formula to determine the proper amount due the beneficiary from the entity.

**Entity Distributes Less Than Enough to Pay the Trust’s Taxes**

Many times the entity distributes little or nothing to its owners. Regardless, the trustee must report its full share of the entity’s taxable income and pay the tax thereon. This can create cash flow problems for the trustee if the entity does not distribute enough to pay the trust’s share of taxes on the entity’s income. Consider the following example:

**EXAMPLE 1**

ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $100,000 to the trust which is allocated to income. The trust is in the 35 percent tax bracket. The trust’s tax liability on $1,000,000 is $350,000. But the trust only received $100,000 from the entity, which is not enough to pay its tax obligation. The trustee must use the $100,000 to satisfy its tax obligation and the income beneficiary receives nothing.

Under a pre-amendment interpretation, however, no taxes would be allocated to the $100,000 of income receipts because they are fully deductible by the trust when distributed to the beneficiary. That is, they do not contribute to the trust’s tax. Although the income beneficiary will pay tax on the $100,000 received from the trust, the trust, on the other hand, has a $315,000 tax obligation to satisfy [35% X ($1,000,000 – 100,000)], regardless of its ability to pay the tax.

**Entity Distributes More Than Enough to Pay the Trust’s Taxes**

Assume, however, that the entity distributes more than enough to pay taxes on its K-1 income. The trustee has income receipts left over to pay the beneficiary. But how much? Under the 2008 amendments, the trustee must first determine its tax on the K-1 taxable income before paying the beneficiary. But the trust’s tax depends on the amount paid to a beneficiary. Thus, the calculation is circular, either solved by trial and error, or by the algebraic equation D = (C-R*K)/(1-R) where:

- **D** = Distribution to income beneficiary
- **C** = Cash paid by the entity to the trust

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275 UPIA § 505, cmt. Example 1.
276 UPIA § 505(d) and comments.
R = tax rate on income
K = entity’s K-1 taxable income

This equation is needed only when the entity distributes more than enough to pay the tax on its taxable income, but less than its total taxable income. When the entity distributes more than its taxable income, the trust’s tax attributable to that entity’s taxable income is zero, because payments to the income beneficiary theoretically reduce the trust’s taxable income to zero.

EXAMPLE 2

ABC Trust receives a K-1 from Partnership reflecting taxable income of $1 million. Partnership distributes $500,000 to the trust, which it represents to be income. The trust is in the 35 percent tax bracket.

In the example above, the partnership distribution exceeds the trust’s $350,000 tax on the K-1 income by $150,000. But because the trust can deduct the $150,000 payment to the beneficiary, it must apply the algebraic formula to derive the amount owed the beneficiary so that after deducting the payment, the trust has exactly enough to pay its tax on the remaining taxable income from the entity.

Taxable Income per K-1 1,000,000
Payment to beneficiary 230,769\(^2\)
Trust Taxable Income $ 769,231
35 percent tax 269,231
Partnership Distribution $ 500,000
Fiduciary’s Tax Liability (269,231)
Payable to the Beneficiary $ 230,769

The trustee allocates $269,231 of the entity’s income receipts to pay the trustee’s taxes. The income beneficiary also pays $80,769 [35% X $230,769] of personal income taxes when he reports the $230,769 on his individual income tax return, assuming he is in the 35 percent tax bracket. Thus the income beneficiary bore total taxes of $350,000 [$269,231 + $80,769], or the entire tax liability on the entity’s $1,000,000 of Schedule K-1 income.\(^2\)

Critics fault this result as being unfair to the income beneficiary. Drafting attorneys should anticipate that a trust might own a significant interest in a partnership that fails to distribute all its taxable income and draft the trust instrument to clarify how the taxes should be allocated.

E. When Can Partnership Capital Gains Be Included in DNI

As a general rule capital gains from the sale or exchange of capital assets are excluded from

\(^{2}D = (C-R*K)/(1-R) = (500,000 - 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity’s K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

\(^{2\text{a}}\)UPIA § 505, cmt. Example 2.
the trust’s state law income. As a consequence, they are also excluded from the trust’s
distributable net income (DNI). IRC § 643(a) defines DNI as:]

“the taxable income of the estate or trust computed with the following
modifications –

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Gains from the sale or exchange of capital assets shall be excluded to the
extent that such gains are allocated to corpus and are not (A) paid, credited,
or required to be distributed to any beneficiary during the taxable year or
(B) paid, permanently set aside, or to be used for the purposes specified in
IRC § 642(c).”

1. What the Regulations Say

Recently issued regulations expand on that definition and provide that a trustee
may include capital gains in DNI and carry it out to the beneficiaries only when the
trustee:

a) has either the power to adjust or the discretion to distribute principal, and
   has discretion under local law or the governing instrument to deem all or
   part of such items as capital gains;

b) is operating under a state unitrust statute that either provides an ordering
   rule or leaves it to the trustee’s discretion whether to distribute capital
   gains;

c) distributes trust property or sale proceeds thereof in full or partial
   termination of a beneficiary’s interest; or

d) uses the sales proceeds of specific assets to determine the amount
   required to be distributed to a beneficiary.

Thus, the regulations make it clear that a trustee may include capital gains in DNI
only if either the state law or the governing instrument expressly authorizes the
trustee to do so. Texas is the only state with this express authority in its power to
adjust statute. Other states have provided the authority to distribute capital gains
in a unitrust distribution, but not under a power to adjust. Most state unitrust
statutes provide an ordering rule under which ordinary and tax-exempt income
flow out first, then short term capital gains, then long term capital gains, and then
principal. This ordering statute follows the examples in the regulations.

Query: Can a trust that has capital gains flowing from a pass-through entity
include the entity’s capital gains in DNI? The AICPA asked this very question in

279 IRC § 643(a)(3).
280 Reg. § 1.643(a)-3.
281 TEX. PROP. CODE § 116.005.
282 Reg. § 1.643(a)-3(e), Examples 11 and 13.
comments issued to the IRS in May 2001. In response, the Preamble to the final regulations under IRC § 643(a) states:

“One commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.”

The IRS probably avoided this issue because it knew that IRC § 643(a)(3) includes partnership capital gains in DNI by defining DNI as taxable income minus “gains from the sale or exchange of capital assets…allocated to corpus” that are not paid to a beneficiary or permanently set aside for charity. Because partnership capital gains are not “gains from the sale or exchange of capital assets…allocated to corpus” they cannot be excluded from DNI.

Keep in mind that partnership capital gains arise from the sale of assets belonging to a separate legal entity. The trustee has no authority to allocate them to corpus. The trustee can only allocate receipts from the entity to corpus if they meet the definition of principal under the trust agreement or the state property or trust code. The United States Court of Federal Claims addressed this very issue in Crisp v. United States.

2. Crisp Holds That Partnership Capital Gains are Included in DNI

In Crisp, the Hunt Trust invested $5 million for a 2/3 limited partnership interest in ZH Associates, a Texas limited partnership. ZH generated a large amount of capital gains from sophisticated trading activities such as arbitrage and hedging. The trustee, Don Crisp, included the trust’s share of the partnership capital gains in DNI and carried them out to the income beneficiary, Caroline Hunt. The IRS challenged the inclusion of the partnership’s capital gains in the trust’s DNI as contrary to the Texas Trust Code, the trust instrument, and IRC § 643(a).

First the IRS argued that partnerships are not separate taxpayers under §§ 701 and 702, but mere conduits through which tax items flow through to their partners. As a conduit, the partnership capital gains are corpus and should not be included in DNI. However, the Court noted that the Internal Revenue Code does not control the allocation between income and principal. Second, the IRS analogized partnership profits to capital gains from regulated investment companies (RICs) and mutual funds, which the Texas Trust Code allocates to corpus even though the trust does not hold title to the underlying securities. However, the Court was not persuaded by this argument either because ZH was neither a RIC nor a mutual fund.

Third, the IRS pointed out that the partnership capital gains fit squarely the definition of capital gains in the tax code and therefore they should be excluded.

283 Tax Notes Today, 2001 TNT 97-26 (May 17, 2001) (Comments by the AICPA to Treasury regarding the proposed regulations to revise the definition of trust income under Section 643(b)).

284 T.D. 9102.

285 See also E. James Gamble, Trust Accounting and Income Taxes, AICPA Conference (June 2005).

from DNI under § 643(a)(3). However, the Court reminded the IRS again that although the Internal Revenue Code affects the rate of tax on capital gains, it does not control whether they are income or principal. Finally, the IRS argued that allowing the trustee to treat partnership capital gains as income permitted him to use the partnership form to convert corpus into income. However, the Court pointed out that trustees can do this anyway simply by choosing whether to invest in income or growth assets. Further, the trustee was merely exercising the discretion granted him in the trust instrument to choose among various business structures.

In sum, the Court held that the partnership profits are not corpus under either the trust agreement or state law because the trust did not acquire the securities. Rather, the partnership, a distinct legal entity acquired the securities. It also gave weight to the fact that the trustee hired a national accounting firm to audit the trust and they determined that its partnership profits were allocating its profits to income did not jeopardize the interests of the remaindermen. But even if the trustee’s allocation favored the income beneficiary, the facts indicate that the settlors intended that result. Therefore, the capital gains from the partnership constituted trust income.

Even though Crisp was decided before the final § 643 regulations and the adoption of the Uniform Principal and Income Act (1997), its holding is still sound because partnership capital gains are not “gains from the sale or exchange of capital assets…allocated to corpus” under either state law, the trust instrument, or Section 643(a).

3. Carrying Out Capital Gains from a Unitrust

Capital gains can also be carried out with a unitrust payment. Most state unitrust statutes provide an ordering rule under which ordinary and tax-exempt income flow out first, then short term capital gains, then long term capital gains, and then principal. This order follows the examples in the regulations, which are safe harbors. As such, they do not preclude other means of distributing capital gains, especially if the trust instrument requires a particular method. The regulations do, however, require that if the trustee has discretion, he exercise that discretion consistently in allocating capital gains to income. Presumably this means that once the trustee picks an allocation method, he stick with it.

However, the trustee may wish to allocate taxable income under a different ordering rule than the regulations illustrate. For example, he may wish to allocate capital gains in the same proportion as the trust’s capital gains bears to its total taxable income for the year. So if 80 percent of a unitrust’s taxable income consists of capital gains, the trustee might allocate 80 percent of the unitrust payment to capital gains. It is not clear whether the IRS will recognize this as a valid means of determining DNI under § 643. But regardless of whether the IRS recognizes the allocation as valid, it should not adversely affect the trust’s qualification as a

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287 Crisp v. United States, 34 Fed. Cl. 112 at 118-120.
288 Reg. § 1.643(a)-3(e), Examples 11 and 13.
289 Reg. § 1.643(a)-3(b)(1).
marital trust. The regulations under § 2056 require only that the trustee’s power to adjust between principal and income meet the requirements of Reg. § 1.642(b)-1, which addresses the amount and not the character of the income distributed.290

F. Investment Advisor Fees and the 2-Percent Rule

Trusts frequently incur a variety of administrative costs each year in carrying out their fiduciary duties. Some of these costs are incurred directly and some are incurred indirectly through passthrough entities such as partnerships and S corporations. Most of the expenses incurred by estates and trusts, whether directly or indirectly, are classified as miscellaneous itemized deductions under § 67(b). Individuals who incur such costs must reduce them by 2 percent of their adjusted gross income under § 67(a). The 2-percent reduction also applies to costs incurred indirectly through an individual’s ownership in a passthrough entity.291 This 2-percent reduction is popularly referred to as the “floor.”

The application of the 2-percent floor to individuals is relatively straightforward. But there is a great deal of uncertainty about how it applies to estates and trusts. Section 67(e) provides an exception from the floor for estates and trusts for administrative costs “which would not have been incurred if the property were not held in such trust or estate…” The Supreme Court’s attempt to clarify this ambiguous phrase in Knight v. Commissioner only created more confusion.

1. The Supreme Court’s Holding in Knight

On January 16, 2008 in Knight v. Commissioner, the U.S. Supreme Court held that § 67(e)(1) allows estates and trusts a full deduction only for costs that hypothetical individuals do not “commonly” incur.292 Because Michael Knight had the burden of proof and did not show how his trust’s investment fees differed from those that a hypothetical individual would commonly incur, the Court held in favor of the government. The problem with the Court’s interpretation is determining what hypothetical individuals commonly do. No one knows. The nature of investment advice differs from individual to individual depending on a variety of factors, including their age, goals, tolerance for risk, and other resources.

While the Knight opinion narrowly dealt with the investment advisory fees paid by the Rudkin Trust, its interpretation of the statute applies broadly to every type of fiduciary administrative cost, except those expressly exempted from the floor by § 67(b) (i.e. taxes, interest, casualty losses, and a few others). Such administrative costs may include:

- Trustee fees
- Accounting fees
- Legal fees
- Bank charges

290 Reg. § 1.2056(b)-7(d)(1).
291 IRC § 67(c).
- Safe deposit box
- Insurance
- Appraisal fees
- Family office expenses (rent, salaries, supplies, telephones, etc.)
- Tax advice and preparation
- Property maintenance
- Costs from passthrough entities

In order to determine whether the above costs are subject to the floor, the Supreme Court requires the trustee to predict whether a hypothetical individual with the same property would commonly incur the same cost. Unfortunately, the Court’s decision to interpret § 67(e) as requiring not only a determination of what expenses are “commonly incurred by individuals,” but also a bifurcation of expenses, has developed a complex standard that involves extensive recordkeeping and creates difficulty in administration. Such complexity contradicts the goal of Section 67.

Until regulations further clarify the Court’s interpretation or Congress changes the law, lawyers and accountants should provide their trust clients detailed statements, itemizing which costs are “commonly incurred” by individuals and which are not. Engagement letters can also describe the estate and trusts services in such a way as to distinguish them from services provided to individuals. Special billing codes can be used to capture time that is unique to estates and trusts. However, it can be a challenge to determine this for many types of services. In short, the Knight decision created an administrative nightmare for both the IRS and the taxpayer, who must now determine whether each expenses incurred by the trust would have been “commonly” incurred by an individual holding the same property as the trust.

2. Proposed Regulation § 1.67-4

Before the Knight opinion was issued, the IRS had published proposed regulations under § 67(e) requiring that costs be “unique” to an estate or trust in order to be exempt from the 2-percent floor. Unique means that “an individual could not have incurred that cost in connection with property not held in an estate or trust.” They also required the trustee to unbundle his or her trustee fee, allocating their fee among the various services they performed for the trust during the year, and deducting only those costs that are unique. But because the Supreme Court rejected this interpretation of § 67(e), these proposed regulations have effectively been rendered obsolete.

3. Extensions on Unbundling

Since the Knight decision, the Service has issued three notices that waive the unbundling requirement for trustee fees for 2007, 2008, and 2009 returns.

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293 Lindsay Roshkind, “Interpreting IRC § 67(e): The Supreme Court’s Attempt to Nail Investment Advisory Fees to the ‘Floor’”, 60 Fla. L. Rev. 961, 970-972 (2008).
2008-32 also stated that final regulations might include safe harbors for unbundling trustee fees. It requested comments on whether safe harbors would be helpful, how they may be formulated, and what might be reasonable percentage(s) of administrative costs subject to the 2-percent floor. It also requested input on whether safe harbors should reflect the nature or value of the trust assets and/or the number of beneficiaries. This indicates that the IRS may be considering a safe harbor to exempt small trusts or those with multiple beneficiaries. The Notice did not, however, ask for comments on which expenses are “commonly” incurred by individuals. This indicates that the Service may either draw some bright lines or leave that open as a facts and circumstances test.

The AICPA and dozens of other individuals and groups wrote comments in response to Notice 2008-32 and the proposed regulations. Not surprisingly, nearly all of the comments opposed unbundling of trustee fees because of the difficulty and because there is no basis for it in the statute’s legislative or judicial history. Many commentators, including the AICPA, offered alternative safe harbors if the Service insists on unbundling. These include an exemption for small trusts (i.e. those under the applicable exclusion amount for estate tax purposes), noncorporate trustees, executors, legal, accounting, tax preparation, and appraisal fees, and de minimis fees below a certain dollar amount. Many commentators also asked the IRS to reissue the regulations in proposed form and allow another round of comments. However, Treasury has taken no action thus far.

4. Administrative Expenses From Passthrough Entities

Neither the court decisions nor the IRS guidance discuss whether investment advisor fees and other miscellaneous itemized deductions from passthrough entities owned by the trust are subject to the 2-percent floor. But presumably, based on Knight, deductions from passthrough entities are subject to the 2-percent floor if they would have been commonly incurred by individuals holding the trust property for themselves. This requires the trustee to apply the commonly test to each miscellaneous itemized deduction on the K-1 from the passthrough entity. Temporary Regulation § 1.67-2T requires a passthrough entity to provide information to its owners, including estates and trusts, about deductions that might be subject to the 2-percent floor. But the entity may not provide enough detail for the trustee to determine whether individuals would have commonly incurred the same cost.

5. Legislative Change

Regardless of how carefully the regulations are drafted or what kind of safe harbors are adopted, they are bound to be controversial. Any partitioning of a trustee’s fee based on time spent will be entirely arbitrary because trustee fees are based on the value of assets under management, not time spent. And if the final regulations provide a different rule for fees paid to trustees than those paid to outside advisers, they will be arbitrary and unfair. Unskilled trustees will lose deductions merely because they properly delegate the investment function to comply with their fiduciary duties. Thus, all signs point to a legislative fix.
The AICPA has made § 67(e) reform a top legislative priority. It wrote letters to Congress in September 2008 and July 2009 urging it to allow estates and trusts a full deduction for all ordinary and necessary administrative costs. It has also commented at numerous public hearings before the IRS and the administration urging the same. The AICPA is currently exploring various alternatives to bring about needed reform in this area.

VII. Conclusion

It would be dangerous to ignore the significant planning opportunities and traps that exist during the administration of an estate or trust. Many of these situations have a limited time period in which to act. The fiduciary has an awesome responsibility to make decisions that have significant and long-lasting impact. Therefore, it is imperative that the fiduciary document the basis for his decisions and seek the best advice possible.