

**Michigan Society of Enrolled Agents
MiSEA**

presents

**Federal Income Tax Concepts
Needed to Prepare Fiduciary
Form 1041 and the
Final Form 1040 of the Decedent**

at the

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Frankenmuth, Michigan**

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TABLE OF CONTENTS

	<u>PAGE #</u>
I. Fiduciary Issues: IRS Form 1041	1
A. Estate Filing Issues	1
B. Estate Administration Expenses on IRS Form 1041 : Expenses Incurred at Death	2
C. §642(g) Election Statement	4
D. Checklist of Deductible Administrative Expenses	5
E. Purpose of the Governing Instrument	6
F. Estate Basics	6
G. Estate Income	7
H. Trust Basics	8
I. Review of Simple vs. Complex Trust	10
J. Introduction to the Taxation of Estates and Trusts	11
K. Allocating Estimated Tax Payments to Beneficiaries	12
L. Income Distribution Deduction and Distributable Net Income (DNI) ...	13
M. Distributable Net Income and Entity Losses	14
N. §652 and §662 Allocations of Net Income to Beneficiaries	15
O. Class of Net Income	15
P. Capital Transactions and DNI	16
Q. §663(b) Provision for Estates and Trusts: 65-Day Rule Election	17

	<u>Page</u>
R. Termination of an Estate and Trust	19
S. Terminology: For Estates and Trusts	20
T. Basic Checklist of Personal Representative Duties	22
U. Summary of Will Provisions and Codicils	25
V. Federal Forms that May Need to Be Filed for the Decedent and the Fiduciary	27
W. Summary: Types of Trusts, Purpose and Tax Treatment for Income, Estate and Gift Taxes	29
X. Glossary for Estates and Trusts	31
Y. Income and Expense Chart for the Final Form 1040 of the Decedent or Beneficiary and the 1041 of the Estate	38
Z. Estates and Trusts Subjected to Medicare Tax on Net Investment Income	44
Self Study Questions and Answer Sheet	48
II. Decedent's Final 1040: Filing Requirements, Includible Income and Allowable Deductions	57
A. Filing Requirements	57
B. Mandatory Filing Requirements	58
C. Form 1310: Claiming a Refund for a Decedent	59
D. Joint Return Issues	60
E. Where to File a Decedent's Form 1040	61
F. Payment of Taxes and Estimated Tax Payments of the Decedent	61

	<u>Page</u>
G. Name, Address and Signature Issues	61
H. Actual or Constructive Receipt and Disbursement	62
I. Income in Respect of a Decedent (IRD)	62
J. Character of Income	63
K. Deductions in Respect of a Decedent (DRD)	64
L. Wage Issues	64
M. Farm Income from Corps, Crop Shares and Livestock	65
N. Interest and Dividends	66
O. Forms 1099 - Interest and Dividend Income	66
P. Practical Issues of Form 1099 Reporting: How to Report Discrepancies	66
Q. U.S. Savings Bond Series E and EE Interest Reporting Issues: Use of §454 Election After Death	67
R. Capital Gains and Losses of the Decedent: Form 1040	68
S. Capital Losses Generated by the Estate of the Decedent: Form 1041	69
T. Income Tax Treatment of the Sale of the Decedent's Former Residence	69
U. Passive Losses of the Decedent and Unused PALS: Form 1040	70
V. The Estate's Suspended PAL in Real Estate Activities: Form 1041	71
III. Income and Expenses	72
A. Cash Basis Taxpayer vs. Accrual Basis Taxpayer	72
B. Self-Employment Income Issues of a Decedent	72
C. Income and Expenses After Death	73

	<u>Page</u>
D. Net Operating Losses (NOL) of Decedent: Form 1040	73
E. Net Operating Losses (NOL) of the Estate: Form 1041	73
F. Rental Income, Expenses and Depreciation	73
G. Subchapter S Corporation Income (Loss): Pro-rata Share Allocation Method (General Rule) vs. §1377(a)(2) Election to Close S-Corp Books	74
H. Partnership Income (Loss): Partnership Closes Books on Date of Death	74
I. IRA and Pension Distributions: Decedent's Distributions Prior to Death	75
J. Post Death Required Minimum Distribution (RMD) Rules	76
K. Roth IRA Issues	77
L. Coverdell Education Savings Account (ESA) Issues	78
M. Income Tax Issues of an Installment Sale Contract	78
N. Medical Expenses of the Decedent	79
O. HSA, Archer MSA and Medicare Advantage MSA	81
P. Accelerated Death Benefits	81
Q. Funeral Expenses	82
R. Interest Expenses	82
S. Charitable Contributions	83
T. Real Estate and State and Local Income Taxes	83
U. Unrecovered Investment in an Annuity Contract	83
V. Tax Forgiveness for Members of the Armed Forces and Victims of Terrorism	84
W. Income Tax Benefits of Survivors of the Decedent	88

Supplements: 90

Form 1041 Simple Trust S-1 to ST-3

Form 1041 Complex Trust Final Year With Capital Losses C-1 to C-5

Form 1041 Decedent's Estate E-1 to E-5

I. **Fiduciary Issues - IRS Form 1041**

A. **Estate Filing Issues**

1. **IRS Form 1041** is required to be filed for the transactions carried on by a Fiduciary who is responsible for the conservation of assets and earnings placed in their care and protection. The net results of the transactions carried out by the Fiduciary will require reporting first at the entity level and then by following the dictates of the controlling document (last will and testament or trust agreement) specific items of net income, loss, deductions and credits will be reported to a specific beneficiary or beneficiaries on **Schedule K-1**.
2. The other income tax issue that the Fiduciary will have to be aware of is the federal income tax implications of distributions of assets vs. income to a specified beneficiary or beneficiaries.
3. An estate comes into existence on the date of the decedent's death and continues until all of the decedent's property is distributed to the heirs and/or the estate is terminated under operation of law in the specific jurisdiction.
4. A Trust is a legal entity created to hold a donor's property and income created from that property according to the dictates of a trust agreement.
5. It is possible that the income is included and taxed only in the entity's **Form 1041** or only in the designated beneficiary's or beneficiaries **Form 1040** or some of it could be reported at the entity level and some at the beneficiary level.
6. In an Estate situation there could be items of income which the decedent had the right to receive at the time of death but was not actually received until *after* the death. This generally will be the result because most income is required to be included when there is an actual receipt or constructive receipt for a cash basis taxpayer. The income received by the Fiduciary *after* the date of death under these circumstances is called "income in respect of a decedent" (**IRD**).
7. **IRD** includes items such as:
 - a. income for which decedent had a right
 - b. U.S. Savings Bond interest accrued
 - c. dividends declared *before* the decedent's death, but payable *after* death

- d. interest on savings accounts from the last payment date up to the date of death
 - e. rent, etc.
8. In addition to the possibility of having **IRD** the entity could also have to account for expenses incurred by the decedents that are deductible for federal income tax purposes (DRD). If the estate pays these types of expenses, then they are deductible in the taxable year paid by the entity.
 9. The duration of an estate is the period of time actually required by the Fiduciary to carry out the ordinary duties and responsibilities of administration.
 10. An estate that has gross income of **\$600** or more during a tax year must file a return. **§6012(a)** provides that if one of the beneficiaries is a nonresident alien then the **Form 1041** is required to be filed even if the gross income is *below* **\$600**.
 11. The Fiduciary can *elect* to have either a calendar year or a fiscal year for the estate and the first year will generally cover a period of less than 12 months. Once the estate's tax year is selected it must be the same year-end *unless* permission is received from the IRS to change the tax year.
 12. **§642(b)** provides that an estate is allowed a personal exemption of **\$600** *except for* the final income tax return when no personal exemption is allowed.
 13. An estate is unique in that the Fiduciary is allowed to *elect* an accounting method which can be cash or accrual. All subsequent returns must retain the elected method *unless* permission is received from the IRS to make a change.
 14. Under the general rule an estate is not required to make estimated income tax payments in its first two taxable years. Therefore, any tax is due with the timely filed return. The Estate is required to pay estimated tax in the third taxable year.

B. Estate Administration Expenses on the Form 1041: Expenses Incurred At Death

1. The law provides that those expenses incurred as the result of the decedent's death are "administrative expenses."

2. The general rule provides that administrative expenses are deducted on the Estate's Form **706**.
3. There is an **election** provision available under **§642(g)** of the Internal Revenue Code provides that the executor can *elect* to deduct these expenses on a timely filed **Form 1041** (including extensions).
4. The executor must also attach a "**waiver**" **statement** that these expenses will **not** be deducted on the Estate Tax Return **Form 706**.
5. If these expenses are deducted on **Form 1041** then any allocable expenses must be allocated between exempt and non-exempt income.
6. The amounts allocated to the tax-exempt income are **not** deductible.
7. The law provides that "excess administrative" expenses may only be passed through to beneficiaries in the "final tax year" **of the estate's Form 1041**.
8. The passed through "excess administrative" expenses are deducted by the beneficiaries on Schedule A as Miscellaneous Itemized Deductions **subject to** the 2% of AGI Limitation.

C. §642(g) Election Statement

**ESTATE ELECTION TO CLAIM ADMINISTRATIVE
EXPENSES AS FIDUCIARY INCOME TAX DEDUCTION - §642(g)**

Estate Of:

P. R. Name:

Y/E:

Address:

EI #:

I, as Personal Representative for the above-referenced Estate, do hereby **elect** under **§1.642(g)-1** of the Regulations to claim the administrative expenses detailed below as deductions for fiduciary income tax purposes for the Estate for the year ended _____ in the amount of \$_____.

I certify that these items have not been allowed as deductions from the gross estate of the decedent under the applicable Federal estate tax laws and **I waive** all rights to have such items as deductions under the applicable Federal estate laws. The items claimed as income tax deductions are as follows:

Probate fees	\$
Attorney fees	
Accountant fees	
Executor fees	
Other:	

TOTAL	<u><u>\$</u></u>

_____ By: _____
Date Personal Representative

D. Checklist of Deductible Administrative Expenses

Accountant fees
Appraiser fees
Attorney fees
Bonding expense
Borrowing costs
Brokerage fees (for qualifying sales of estate property)
Business expenses
Clerk hire
Collection costs
Costs of discovering and collecting estate assets
Court costs
Death notice advertising
Documentary stamps
Estate tax liability, cost of determining
Executors commissions and fees
Farm expenses
Interest (accrued after death)
Investment advice fees
Legal expenses
"Loss" from sale of estate property to dealer at less than fair value
Notary fees
Office-type expenses
Probate costs and fees
Property maintenance, cost of
Rental property rental commissions
Selling expense (on qualifying sales of estate property)
Special guardian's fee
Storage costs
Surrogate's fees
Telephone and telegraph
Transportation
Will construction suit, cost of defending

E. Purpose of Governing Instrument

1. The governing instrument, along **with** the appropriate **state laws**, will give guidance on the following matters:
 - a. **identification** of beneficiaries.
 - b. **distributions** to be made to the beneficiaries.
 - c. **special allocations** of income or expenses.
 - d. **fiduciary accounting income.**

Tax Professional Note: The tax consultant should carefully read and analyze the governing instrument and have the representative seek legal interpretation when necessary.

2. One of the main duties of the fiduciary is to properly allocate receipts and expenditures in regard to the respective interests of the beneficiaries.
3. This allocation is determined by the terms of the governing instrument.
4. If the governing instrument is silent, then the receipts and expenditures are to be allocated in accordance with state law.

F. Estate Basics

1. At the moment of the decedent's death an estate begins its existence as a separate and independent taxpayer.
2. For income tax purposes, the estate begins with the probate estate. The probate estate includes all property that comes under the control of the personal representative by operation of either the will or state law.
3. The term probate refers to the formal court proceedings to administer the property subject to probate.
4. A person who dies with a will is said to die testate.
5. A person who dies without a valid will is said to die intestate. In this event, the heirs are determined under the state laws of intestacy.

G. Estate Income

1. An estate's taxable income includes all income from assets coming under the control of the personal representative during the period of probate administration (**Rev. Rul. 57-133; Rev. Rul. 59-375; Rev. Rul. 62-116**), subject to the rules of community property.
2. The estate would also report income from items passing to the estate as a named beneficiary (or under state law - such as the case where a named beneficiary predeceased the decedent and no contingent beneficiary was named).

Example: Decedent owned an Individual Retirement Account for which the predeceased spouse was the beneficiary. No contingent beneficiary was named. Under state law, the estate would then be the beneficiary. The IRA would be income to the estate when it is received from the payor.

3. Personal property owned solely in the name of the decedent produces taxable income to the estate. This results because title to such property passed to the estate at the moment of death.
4. Ownership of the assets will not pass to the beneficiaries until the property is distributed by the personal representative as part of the probate process. Once the personal representative has distributed an asset, the income from that asset must be reported by the beneficiaries.
5. If the decedent's will transfers solely owned personal property to a testamentary trust, then the estate will report the income from that personal property from the date of death until the time it is actually transferred to the trust. This transfer would normally occur at conclusion of the probate process.
6. If the decedent operated a business or a farm up to his date of death, then the estate (through the personal representative) is not considered by law to operate the business or farm unless there is specific language in the will directing the operation of this activity to continue.

H. Trust Basics

1. A trust is a legal entity created by a donor to hold property for a stated purpose determined under the dictates of the trust agreement.
2. While an estate is created automatically by the death of the decedent, a Trust is specifically created by a transfer of property under the dictates of the trust agreement.
3. There are different types of trusts which could be created while the donor is alive (inter vivos) or created at the donor's death (testamentary). The trust could also be a simple trust or a complex trust.
4. **§651(a)(1)** provides that a simple trust is required to:
 - a. distribute all of its income currently
 - b. have no charitable beneficiary, and
 - c. make no distributions from corpus (principal).
5. A complex trust is one that does not satisfy the requirements of **§651(a)(1)**. Therefore, it would include a trust which:
 - a. does not distribute all of its income currently
 - b. has a charitable beneficiary, or
 - c. distributes corpus.
6. A trust that has gross income of **\$600** or more during a taxable year must file a federal income tax return **Form 1041**. If there is a beneficiary who is a nonresident alien, then a trust return must be filed.
7. **§6012(a)** also provides that if a trust has *any* taxable income, then an income tax return must be filed even if the gross income was *below* **\$600**.
8. Unlike an estate which can elect a fiscal year, a trust must have a calendar year.
9. The personal exemption for a Simple Trust is **\$300** and the personal exemption for a Complex Trust is **\$100**. A full personal exemption is allowed for the first year even if it is a short year. No personal exemption is allowed for the final return of a trust.

10. The trustee of a trust can *elect* an accounting method which is cash or accrual on the first income tax return, but all subsequent income tax returns must use the same accounting method *unless* permission is granted by the IRS to make a change.
11. Unlike an estate, a trust is required to submit estimated income tax payments in its first tax year.
12. A trust may be:
 - a. revocable (grantor or living trust) - this type of trust may be changed by the grantor at any point during his/her lifetime; or
 - b. irrevocable - this may be established either by will (testamentary trust) or by the grantor during his/her lifetime (inter-vivos).
13. A revocable trust is not recognized as a separate entity for federal income tax purposes.
14. A trust must meet both state law and federal tax law requirements to be so recognized.
15. A trust is a legal arrangement where property, real and/or personal, is held by a trustee for the benefit of beneficiaries.
16. The Internal Revenue Code does not provide a definition of a trust.
17. The grantor is the person who transfers property to the trustee.
18. Beneficiaries of the trust fall into two categories:
 - a. lifetime beneficiary: entitled to receive income (and possibly principal) from the trust property; and
 - b. remainder beneficiary: entitled to receive a portion of the principal at termination of the life interest.

I. Review of Simple vs. Complex Trust

1. An irrevocable trust may be either simple or complex. The terms simple and complex are not found in the Internal Revenue Code. They are, however, to be found in the regulations and on the **Form 1041** tax return and instructions.
2. For a trust to qualify as a simple trust in any year, **§651** and **§652** state that it must meet **all three** of the following criteria:
 - a. The trust requires that **all** *fiduciary accounting income* must be distributed currently to the beneficiaries; and
 - b. The trust does not make charitable contributions; and
 - c. The trust does not distribute principal.
3. The phrase "all accounting income be distributed currently" means that **all** *fiduciary accounting income* is required by the terms of the trust instrument to be distributed in the year that it is received.
4. The trustee must be under a duty to distribute the income currently. The fact that the actual distribution is not made until after the close of the taxable year does not eliminate status as a simple trust.
5. If the trust requires **all** income to be distributed currently, then it is *deemed* to have been distributed (**Reg. §1.651(a)-2**).
6. If the trust does not qualify as a simple trust, then, by definition under **§§661-663** it is a complex trust.

Tax Professional Note: All trusts will be treated as complex trusts in its final year because it must distribute principal at that time.

A trust that requires **all** *fiduciary accounting income* to be distributed currently can be a simple trust even though the instrument permits principal to be distributed. As long as the *principal* is not actually distributed, the trust is a simple trust for that year. Such a trust can be a simple trust in one year and a complex trust in the next year (when it actually distributes principal).

SIMPLE VS. COMPLEX TRUST DETERMINATION

For a trust to qualify as a **SIMPLE TRUST**, **ALL ANSWERS** to the following questions **MUST BE YES** (IRC §§651-652):

- | | <u>Yes</u> | <u>No</u> |
|--|------------|-----------|
| 1. The trust requires that all fiduciary accounting income must be distributed currently | ----- | ----- |
| 2. The trust does not allow amounts to be paid, permanently set aside or used in the tax year for charitable purposes. | ----- | ----- |
| 3. The trust does not distribute amounts from the principal of the trust. | ----- | ----- |

If you answered **NO** to **ANY** of the above **QUESTIONS**, the trust does not qualify as a simple trust. It is a **COMPLEX TRUST** (IRC §661 - 663) for the current year.

J. Introduction to the Taxation of Estates and Trusts

1. Subchapter J of the Internal Revenue Code provides the laws for taxing the income of estates and trusts. It is important to note that **estates** are separate entities from non-grantor **trusts** for federal income tax purposes.
2. The entity computes taxable income in much the same manner as an individual. Many of the deductions and credits allowed to individuals are also allowed to estates and trusts.
3. Estates and trusts are allowed a unique deduction called an “*income distribution deduction.*” It is a deduction for *distributing income* to beneficiaries. Estates and trusts are generally “pass through” entities. The entity:
 - a. may *distribute* part or all of its income to the beneficiaries,
and
 - b. may then take a deduction for the amount distributed (the income distribution deduction).

4. The amount of the “income distribution deduction” at the entity level on **Form 1041** determines the amount of income to be taxed directly to the beneficiaries on their **Form 1040**.
5. The income distributed to the beneficiaries retains the same character as it had in the estate or trust.
6. The *undistributed* part of the income represents taxable income retained by the entity and taxed on **Form 1041**. The trust or estate then pays income tax on this taxable income. Therefore:
 - a. total taxable income of an estate or trust will always be taxed to someone; and
 - b. total taxable income must equal:
 - I. income taxable to the beneficiaries on **Form 1040**; plus
 - ii. income taxable to the trust or estate on **Form 1041**.

K. Allocating Estimated Tax Payments to Beneficiaries

1. **§643(g)(3)** provides that the fiduciary may *elect* to treat any portion or all of an estimated tax payment made by the entity as having been made by beneficiaries. A **trust** may make the *election* for *any* tax year.
2. An **estate** can only make the *election* in the entity’s **final** tax year.
3. **§643(g)(1)** provides that any such amount so allocated to a beneficiary is treated as a distribution that carries out distributable net income (**DNI**) to the beneficiaries **on the last day of the tax year** of the estate or trust. It is treated as a payment of the estimated tax made by the beneficiary on the following **January 15th**.
4. The *election* is made by completing and filing **Form 1041-T**, “Allocation Of Estimated Tax Payments To Beneficiaries,” *on or before* the 65th day *after the close* of the tax year for which the election is made (**§Reg. 5h.6(a)(1)**).
5. **Form 1041-T** may be filed separately with the Service Center where **Form 1041** is to be filed. **Form 1041-T** must be signed if it is filed separately. **Form 1041-T** may be filed as an attachment to **Form 1041** if the income tax return is filed by the **65th** day *after the close* of the tax year. In that event, **Form 1041-T** does not have to be signed.

6. The amount of estimated tax allocated to an individual beneficiary is reported on **Schedule K-1, line 14a**.

Tax Professional Note: The preparer should **attach a copy of 1041-T** to the **Form 1040** of any **beneficiary** claiming income tax payments allocated from an estate or trust. Be sure to use the name, address and TIN of the trust or estate exactly as reported on **Form 1041-T**. This should minimize computer-generated notices from the Service Center.

L. Income Distribution Deduction and Distributable Net Income (DNI)

1. Taxable income of estates and trusts is taxed at *either*:
 - a. the *entity* level;
 - b. the *beneficiary* level; or,
 - c. a *combination* of the two levels.
2. The entity receives a tax deduction for the taxable income distributed to its beneficiaries. The income distribution deduction is computed on **Schedule B** on **page 2** of **Form 1041**.
3. The beneficiaries, must report the distributed income on their own income tax returns in the tax year within which the estate or trust tax year ends. The income is reported to the beneficiaries on **Form K-1**.
4. The total income to be reported by beneficiaries cannot exceed the amount of the income distribution deduction.

Tax Professional Note: Losses are not distributed to beneficiaries *until* the termination of the estate or trust.

5. **DNI** and paid, credited or required distributions are the keys to establishing how much income must be reported by the entity and how much by the beneficiaries.
6. **DNI** also establishes the character of the income to the beneficiaries.
7. Although distributions and distributable net income may contain tax-exempt income, the income distribution deduction will never include these tax-exempt income components.

8. A basic fiduciary income tax concept is that cash distributions (and payments made on behalf of a beneficiary) first distribute income to the beneficiaries, *before* corpus regardless of the source of funds for the distribution.

Example #1: Mary died on **June 1, 20X0**. Her beneficiaries are her two sons, Rob and Rod. An estate income tax return was filed *electing* a fiscal year ending **May 31, 20X1**. During that fiscal year, the estate earned **\$6,000** of interest income; it had no deductible expenses. The personal representative made cash distributions of **\$2,000** each to Rob and Rod on **December 1, 20X0**, which were not payments of any specific bequests under the will. The estate income tax return will report **\$6,000** of gross income and will have an income distribution deduction of **\$4,000**, as follows:

Estate Gross Income	\$ 6,000
Less: Income Distribution Deduction	(4,000)
Less: Estate Exemption	(600)
Estate Taxable Income on Form 1041	<u>\$1,400</u>

Rob and Rod will each have interest income of \$2,000 to report on their 20X1 income tax returns; these amounts will be reported to them on **Schedules K-1**. The estate will pay income tax on the taxable income of **\$1,400**. Rob and Rod will not file the returns until April 15, 20X2 and pay the tax then.

Example #2: An irrevocable trust established for a six year old minor pays medical expenses in the amount of **\$6,000** directly to the providers of such services. The trust had interest income of **\$10,000**. The **Schedule K-1** will reflect a **\$6,000** of income distribution to the beneficiary (for whom income tax returns must be filed!)

Tax Professional Note: Such medical expenses would also be an itemized deduction on the minor beneficiary's individual income tax return. This should be noted on **Schedule K-1, line 14c**.

M. Distributable Net Income and Entity Losses

1. Losses of an estate or trust are not distributed to beneficiaries *until* the termination of the entity. The losses that are retained within the entity until termination include:

- a. net operating losses
- b. capital losses
- c. passive losses
- d. current year excess deductions expense (lines 10 - 15b exceed total income on line 9) (does not carry forward to future tax years of entity - USE IT OR LOSE IT!)

N. §652 and §662 Allocations of Net Income to Beneficiaries

1. **§652** for simple trusts and **§662** for complex trusts and estates provide that unless the **governing instrument has a provision** which:
 - a. *either* allows the fiduciary to make tax-motivated allocations or
 - b. *specifically* allocates different classes of income to different beneficiaries,

then classes of net income (after expenses allocation) are to be allocated among the beneficiaries in proportion with their shares of **DNI**.

O. Class of Net Income

1. The *amounts* of each class of net income to be *included in* a beneficiary's income are proportional to the *ratio* each class of items entering into **DNI** bears to the whole.
2. This *pro rata allocation* of net income items to beneficiaries is to avoid manipulation of distributions for tax effect (i.e., distribution of all tax-exempt income to a beneficiary in a high tax bracket while retaining taxable income in a lower tax bracket entity).
3. The character of the income is retained from entity to the beneficiary.
4. If an estate or trust makes distributions in excess of **DNI** for the year, then the beneficiaries report in income those amounts equal to their individual shares of the **DNI**.

Example: Don's Will requires annual payments of **\$30,000** to his widow and **\$15,000** to his daughter out of the estate's income **during each year** of the period of administration of the estate. The estate's distributable net income (**DNI**) for the current year is **\$36,000**. Since the distributable net income is less than the actual distributions (\$30,000 and \$15,000), the beneficiaries report only their proportionate shares of the **DNI** as follows:

Widow: $\$36,000 \times (\$30,000/\$45,000) = \underline{\underline{\$24,000}}$

Daughter: $\$36,000 \times (\$15,000/\$45,000) = \underline{\underline{\$12,000}}$

P. Capital Transactions and DNI

1. Capital gains are normally *excluded* from **DNI** because capital gains are allocated to principal if they are not paid, credited, or required to be distributed to any beneficiary during the taxable year (**Reg. §1.643(a)-3**).
2. If the instrument is silent with regard to capital gains, then the basic principles of fiduciary accounting allocate capital gains to corpus and it is not available for distribution to beneficiaries and, therefore is not a part of the distributable net income.
3. Capital gains will only be included in **DNI** if they are:
 - a. Realized in the termination year of the estate or trust (**Reg. §1.643(a)-3(b)**, example 4; and also **Rev. Ruling 83-121**); or
 - b. Allocated to income per the governing instrument or local law or by the fiduciary entity on its books or by notice to the beneficiary (**Reg. §1.643(a)-3(a)(1)**) (Note that local law usually allocates capital gains to principal); or
 - c. Actually paid, credited, or required to be distributed to beneficiaries even though allocated to principal (**Reg. §1.643(a)-3(a)(2)**). **Rev. Rul. 68-392**, 1968-2 CB 284 is a trust ruling which the IRS very restrictively interprets when such a distribution occurs; or
 - d. Used per the governing instrument or the regular practice of the fiduciary to determine the amount required or actually distributed (**Reg. §1.643(a)-3(a)(3)**); or

- e. Paid, permanently set aside, or to be used for charitable contributions generating a deduction (**§643(a)(3)**).

Tax Professional Note: The IRS position is generally that capital gains are to be reported by the entity unless one of the exceptions discussed above applies.

- 4. Capital losses are excluded from **DNI** (except as used to offset gains that are included in **DNI** (**Reg. §1.643(a)-3**)).
- 5. A net capital loss does not reduce **DNI** even in a termination year. Capital losses do not pass through to the beneficiaries *until* the final estate or trust income tax return.

Q. §663(b) Provision for Estates and Trusts: 65-Day Rule Election

- 1. **§663(b)** provides that the trustee of a complex trust and the executor of an estate may *elect* to treat an amount paid or credited to a beneficiary *within* the first **65** days of a trust taxable year as having been distributed on the last day of the *prior* tax year (**Regs. 1.663(b)-1**).
- 2. The *election* is made annually by checking the block on **line 6** (page 2, **Form 1041**) and attaching a statement to the return for the year in which the distributions are deemed to have been made.
- 3. It applies only to those amounts designated by the trustee.
- 4. The *election* is *irrevocable* after the due date of the return, including extensions.
- 5. The *election* applies to distributions to the extent of the *greater of*:
 - a. The trust's fiduciary accounting income in the year for which the distribution is considered to have been made; or
 - b. The **DNI** for that year.
- 6. The annual amount eligible for the election is reduced by amounts distributed earlier during the same year (excluding amounts for which an election was made for the previous year).

7. This *election* is not available to simple trusts since all fiduciary income is required to be distributed annually.

Example: A trustee of a complex trust estimates taxable income for the year at **\$30,000**. On **December 31st**, the trustee distributes **\$30,000** to its sole beneficiary. On **January 20th**, it is **determined** that **taxable income** for the prior year was **\$35,000**. The trustee may **elect to** distribute(or credit) the additional **\$5,000** on or before March 6th and make the **65-day** election under **§663(b)**. The **\$5,000** is deemed to be distributed on **December 31st**.

Tax Professional Note: The **65-day** rule *election* is a very powerful tool for complex trusts and estates with the discretion to distribute income if the entity has undistributed income on the last day of its tax year. Given the compressed tax brackets and the much higher tax rates on income retained within the entity, it would be possible in many situations to minimize the total income tax by distributing income to the beneficiary. In addition to the income tax at a possible maximum rate of **39.6%**, the tax professional and fiduciary must now plan for the minimization of the new **3.8%** net investment tax imposed beginning January 1, 2013 on the *undistributed* income of the estate and trust.

Election Statement

ELECTION UNDER IRC §663(b) TO TREAT TRUST DISTRIBUTIONS UNDER "65-DAY RULE"

Trust Name: _____ EI#: _____
 Trustee Name: _____ Year Ended: _____
 Address: _____

Trustee *elects* pursuant to Internal Revenue Code **§663(b)** to treat the distribution(s) listed below as having been made on the last day of the trust's current tax year.

<u>Item Distributed</u>	<u>Date of Distribution</u>	<u>Recipient</u>	<u>Beneficiary</u>
-------------------------	-----------------------------	------------------	--------------------

X _____
 Date

X _____
 Trustee Signature

R. Termination of an Estate and Trust

1. A trust will terminate when all of the corpus (principal) has been distributed and the administration completed.
2. Instructions for distribution of corpus are usually provided in the trust instrument.
3. If no instructions are provided then state law must be consulted.
4. An estate is considered terminated for probate purposes at the end of the period of administration when distribution of the assets to the beneficiaries has been completed.
5. The IRS concludes that the period of administration for income tax purposes is the time actually required by the personal representative to assemble all of the decedent's assets, pay all of the expenses and obligations and distribute the assets to the beneficiaries.
6. This may be different than the time allowed (or required) by state law for administration of estates (**Reg. §1.641(b)-3(a)**). Although the determination of when the estate administration ends for income tax purposes is a question of facts and circumstances, the IRS position is that administration cannot be unduly prolonged.
7. The IRS takes the position that the income tax estate ends if all assets have been distributed except for a reasonable amount set aside in good faith for the payment of unascertainable or contingent liabilities or expenses. From that point on, the income, deductions, and credits by the estate are to be reported by the beneficiaries.
8. Therefore, even though tasks remain to complete the estate probate administration, the IRS may seek to treat the estate as terminated for federal income tax purposes where it appears that the delay is unreasonable.
9. Generally, an estate can be kept open to settle litigation or tax controversies. It is reasonable to expect that the time necessary to receive state inheritance/estate tax and/or federal estate tax clearances would be a reasonable time to keep an estate open. This would include the time necessary to settle any audit examinations of the returns.
10. The executor actually has a great deal of latitude as to when the actions necessary to terminate an estate for tax purposes can be completed. In most estates, the question of excess length of administration would not arise. Hence the executor can select the time for termination with a view to the tax advantages and disadvantages of termination at a given time.

11. There will be no tax to the estate or trust in the final year. All of the income will pass through to the beneficiaries. Also passing to the beneficiaries are any unused tax carryovers:
 - a. Capital loss carryovers
 - b. Excess deductions on termination
 - c. Net operating loss carryovers

S. **Terminology: For Estates and Trusts**

The following is a partial list of terms which are either unique in the field of taxation for estates and trusts or are of specific importance to understanding the transactions of the entity and/or the beneficiary.

Administrator: Fiduciary of an estate named by a court to settle the decedent's affairs.

Beneficiary: A person for whom trust property is held and administered.

Complex Trust: A complex trust is a trust that is not a simple trust. The term includes trusts with a charitable beneficiary and trusts that distribute corpus or accumulated income.

Corpus: The principal or property transferred to a trust or accumulated in a trust.

Estate: A separate taxable entity that comes into existence automatically at the death of an individual.

Executor: Fiduciary of an estate named in the decedent's will to manage and settle the decedent's affairs according to the will.

Fiduciary: A person such as an administrator, trustee, or executor who has been given a special trust, confidence or responsibility to manage property in a trust or estate according to a controlling document (trust agreement or will) in the best interests of the beneficiaries of the estate or trust.

Grantor Trust: A separate legal entity that is not a properly constituted trust for federal income tax purposes.

Heir: A person who inherits property from a decedent.

Income Beneficiary: Designated beneficiary who has an interest in the income of the trust.

Income for the Benefit of Grantor: If at the discretion of the Grantor, trust income can be distributed to the Grantor or held for future distribution to the Grantor then the trust income is taxable to the Grantor.

Inheritance: A transfer of property transferred by a decedent's estate.

Inter Vivos Trust: An inter-vivos trust is a trust created during the lifetime of the grantor.

Intestate: A person who dies without a will.

Last Will and Testament: The document that directs the transfer of ownership of the decedent's assets to specified heirs.

Period of Administration: The time which spans the life of an estate or trust from its creation to its termination.

Personal Representative: A person who assumes fiduciary responsibilities of the decedent's estate not named as an executor in the will or appointed by the court as an administrator.

Remainder Beneficiary: Designated beneficiary who has an interest in the trust property (corpus) after an income beneficiary interest expires.

Revocable Trust: The grantor or creator of a trust retains the right to revoke the trust thereby requiring the trust income to be includible in the gross income of the grantor (§676(a)).

Simple Trust: Pursuant to the terms of its governing instrument, a simple trust must: (1) distribute all of its income currently, (2) have no charitable beneficiary, and (3) make no distribution from corpus. §651(a)(1) and (2) Reg. §1.651(a)-1.

Testamentary Transfers: These are transfers of property or rights that take place upon the death of the donor.

Trust: A legal entity created to hold property.

Trustee: The administrator of property according to the dictates of the trust agreement.

T. BASIC CHECKLIST OF PERSONAL REPRESENTATIVE'S DUTIES

Decedent Name: _____ Date of

Death: _____

P e r s o n a l R e p r e s e n t a t i v e

N a m e : _____

Title: _____

Phone Number(s): Home _____ Business

Address: _____

GENERAL DUTIES

Yes No N/A

1. Probate **will** (or notify of intestate death) within ten days of death and publish death notice. **Obtain letters of administration or testamentary.**

2. Prepare a schedule of the contents of the safe deposit box.

3. **Apply for employer identification number** (U.S. Form SS-4); may obtain by telephone or online at IRS Website.

4. **Open** estate checking and/or savings account(s); **close** decedent's solely _____ owned bank accounts and CD's into the estate account(s). **Deposit** all funds received and pay all bills using these account(s). **Identify** all deposits in detail.
5. **Schedule cash needs of estate:** determine which assets must be sold. If insufficient assets are available to meet obligations, review state laws regarding abatement and claims priority.
6. Be sure all **assets** are properly safeguarded and adequately insured. **Verify** _____ that all bank holdings are within FDIC limits and that deposits are insured.
7. **Pay debts** of decedent, costs of administering estate and funeral expenses; save invoices and canceled checks.
8. **Notify** Social Security Administration and Veterans' Administration of death; apply for lump sum death benefits.
9. **File** claim(s) for life insurance benefits - **obtain** Form 712 from insurance company for **each** policy.
10. **File** claim(s) for pension and profit-sharing benefits; **consider** income tax implications of mode of payment.
11. **Obtain** three prior years of decedent's federal and state

individual income
tax returns and one year of canceled checks and bank
statements.

Yes No

N/A

12. **Obtain** five prior years of financial statements or income
tax returns on any business interests owned by decedent plus any buy/sell
agreements.

13. **Obtain copies of all federal and state gift tax returns
filed by decedent.**

14. **Obtain appraisals of real property and of personal
property at fair market values as of date of death (consider income tax basis
issues).**

Consider obtaining a lien and assessments search in the county
of domicile
of the decedent.

15. **Obtain** from banks written statements as to date of death
values of all bank accounts, including principal balance and interest accrued
to date of death. For certificates of deposit, request principal balance,
interest accrued to date of death, issuance and maturity dates, interest
rate and

frequency of interest payment (monthly, quarterly, at maturity, etc.).

16. **Value stocks at average** of high and low prices on date of death (or get ___ ___ ___ broker's statement if values are not published).
17. **Obtain** broker's statement as to date of death value on commercial ___ ___ ___ and tax-exempt bonds (if values are not published).
18. If stocks and/or bonds are not to be liquidated, consider fiduciary's duty to ___ ___ ___ notify heirs to request indemnification for market value fluctuation during period of administration.
19. Prepare a schedule of U.S. Savings Bonds by type (E/EE/H/HH), ___ ___ ___ face amount, issue date, and value as of date of death.
20. **Prepare** a statement regarding distribution of assets. ___ ___
21. Consider obtaining releases from beneficiaries. ___ ___
22. **Review income tax issues and elections before selling or distributing any** ___ ___ ___ specific assets.
23. **Review post-mortem tax planning opportunities**

available on: — — —

- decedent's final federal and state income tax returns.**
- estate/trust income tax returns.**
- federal estate tax return.**
- state inheritance tax return.**
- federal and state gift tax returns.**

FORMS AND RETURNS TO BE FILED FOR A DECEDENT AND THE ESTATE:

Probate Office:

Yes No

N/A

- Inventory: three months after letters issued; may be extended. ___
___ ___
- Accounting(s): within twelve months of date of death (or annually if estate is ___ ___ ___ open more than twelve months). At same time, file other required probate information forms.

Internal Revenue Service:

- **Form SS-4: Application for Employer Identification Number;** at ___ ___ ___ beginning of estate.
- **Form 56: Notice of Fiduciary Relationship;** at beginning of ___ ___ ___ estate.
- **Form 1040: Final U.S. Individual Income Tax Return for** ___ ___ ___ **decedent;** by April 15 of following year.
- **Form(s) 1041: Fiduciary Income Tax Return(s)** (mandatory if ___ ___ ___ gross income exceeds \$600; elective otherwise); three and one-half months after end of estate fiscal

year.

- **Form 706:** **United States Estate (and Generation-Skipping) Tax** ___ ___ ___
Return (if gross estate exceeds \$600,000); nine months after date if death.
- **Form 709:** **United States Gift (and Generation-Skipping Transfer)** ___ ___ ___
Tax Return; by April 15 of following year.
- **Form 4810:** **Request for Prompt Assessment Under IRC** ___ ___ ___
Section 6501(d); with Forms 1040 and/or 1041.
- **Form 8855** **Election to Treat a Qualified Revocable Trust As Part of an Estate (§645 Election)** ___

State of Domicile:

- **Form** ___ : **Final Individual Income Tax Return of decedent;**
by ___ ___ ___
_____ of following year.
- **Form** ___ : **Fiduciary Income Tax Return(s);** ___ months
after end ___ ___ ___
of estate fiscal year.
- **Form** ___ : **Inheritance Tax Return;** ___ months after date
of death. ___ ___ ___
- **Form** ___ : **Estate Tax Return;** ___ months after date of

death.
- Form ____: **Gift Tax Return**; by _____ of following year.

U. SUMMARY OF WILL PROVISIONS AND CODICILS

1 . D e c e d e n t

Name: _____

2 . D a t e o f

Death: _____

3. Decedent Domicile: State: _____ County:

_____ Country: _____

4. Social Security Number: _____

5. Personal Representative(s): Name/Address/Title

6. **Specific and General Monetary Bequests:**

Name/Address/Relationship/Description

7. Charitable Bequests: Charity/Address/Amount/Timing

8. Residual Heirs: Name/Address/Relationship/Social Security Number

9. Classification of Income and Principal in Will:

	<u>Income</u>	<u>Principal</u>	<u>Will is Silent</u>
Rent	_____	_____	_____
Interest	_____	_____	_____
Cash dividends	_____	_____	_____
Stock dividends	_____	_____	_____
Return of corporate capital	_____	_____	_____
Accrued increment on bonds	_____	_____	_____
Income from business and farming operations	_____	_____	_____
Oil and gas royalties	_____	_____	_____
Capital gains	_____	_____	_____
Section 1231 gains	_____	_____	_____
Other gains and losses (list):			
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
Administration expenses (list):			
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

Identify any special accounting treatment required by the will:

10. Attach schedule of probate assets.

V. FEDERAL FORMS THAT MAY BE NEED TO BE FILED FOR A DECEDENT AND THE FIDUCIARY

IRS FORM NO.	TITLE	DUE DATE
General		
SS-4	Application for Employer Identification No. (EI # may be requested via telephone)	As soon as possible. The identification # must be included in returns, statements or other documents
56	Notice Concerning Fiduciary Relationship.	As soon as all necessary information is available.
4571	Explanation for Filing Return Late or Paying Tax Late	File with any tax return (1040, 1041, 706, etc.) that is not timely filed and/or tax paid timely.
8822	Change of Address	As soon as the address is changed.
Income Tax		
1040	U. S. Individual Tax Return (To report income of decedent from January through date of death).	April 15th of the year after death for calendar year filer.
1040NR	U. S. Nonresident Alien Income Tax Return	15th day of 6th month after end of tax year.
1041	U. S. Fiduciary Income Tax Return (To report income from day after death until close of estate.)	15th day of 4th month after end of estate's tax year; fiscal years elective by estate.
1041-A	U. S. Information Return-Trust Accumulation of Charitable Amounts	15th day of 4th month after end of tax year.
1041-T	Allocation of Estimated Tax Payments to Beneficiaries	By 65th day after close of tax year.
1041-ES	Estimated Tax for Fiduciaries	Generally, April 15, June 15, Sept. 15 & Jan. 15 for calendar year filers; modify for fiscal year filers.
1310	Statement of Person Claiming Refund Due a Deceased Taxpayer.	To be filed with Form 1040 or Form 1040NR if refund is due. If the person claiming the refund is a surviving spouse filing a joint return with the decedent or a personal representative, this form is not required.
4810	Request for Prompt Assessment Under Internal Revenue Code Section 6501(d).	As soon as possible after filing Form 1040 or Form 1041.
4868	Application for Automatic Extension of Time to File U. S. Individual Income Tax Return.	By April 15th (for calendar year filer).
8800	Application for Additional Extension of Time To File Return for a U. S. Partnership, REMIC, or for Certain Trusts	File in adequate time to permit the Internal Revenue Service to consider the application and apply before the return's regular or extended due date.
8855	Election to Treat a Qualified Revocable Trust as Part of an Estate	By the 15 th day of the 4 th month of the Tax Year: April 15 (including extensions)
706	United States Estate (and Generation-Skipping Transfer) Tax Return	9 months after date of decedent's death.
706A	United States Additional Estate Tax Return.	6 months after cessation or disposition of special-use valuation property.
706CE	Certification of Payment of Foreign Death Tax	9 months after decedent's death. To be filed with Form 706.
706GS(D)	Generation-Skipping Transfer Tax Return for Distributions	See form instructions.
706NA	United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of Nonresident Not a Citizen of the United States	9 months after date of decedent's death.
712	Life Insurance Statement	Part I to be filed with federal estate tax return.

Other		
1042	Annual Withholding Tax Return for U. S. Source Income of Foreign Persons	April 15th
1042S	Foreign Person's U. S. Source Income Subject to Withholding	April 15th
8300	Report of Cash Payments over \$10,000 Received in trade or Business.	15th day after the date of the transaction.
Gift Tax		
709	United States Gift (and Generation-Skipping Transfer) Tax Return	Form 709 is an annual return. Calendar-year filers should file Form 709 on or after January 1 but not later than April 15 of the year following the calendar year when the gifts were made, unless extended. If the donor of the gifts died during the year in which the gifts were made, the executor must file the donor's Form 709 not later than the earlier of: (1) the due date (with extensions) for filing the donor's estate tax return; or (2) April 15 of the year following the calendar year when the gifts were made. If no estate tax return is required to be filed, the due date for Form 709 (without extensions) is April 15. Any extension of time granted to file the calendar year income tax return will also extend the time to file Form 709. Income tax extensions are made using Forms 4868, 2688, or 2530. If an extension was received, attach a copy of it to Form 709.

W. SUMMARY: TYPES OF TRUSTS PURPOSE AND TAX TREATMENT FOR INCOME, ESTATE AND GIFT TAXES

<u>Type of Trust</u>	<u>Purpose</u>	<u>I n c o m e T a x Treatment</u>	<u>Estate and Gift Tax</u>
Revocable Trust	Asset protection and planning. Assets are transferred to an inter-vivos trust and may revert to the grantor at a specified time or event or at the direction of the grantor.	Income is taxable to grantor.	Fully subject to estate tax (IRC Sections 2036 and 2038) if in existence at death.
Irrevocable Trust	Asset protection and tax planning. Assets are transferred to an inter-vivos trust and do not revert to the grantor.	Distributed income is taxed to beneficiary. Accumulated income is taxed to trust if grantor trust rules are not violated.	Subject to gift tax for value of interests given to non-charitable third parties. Estate tax on retained interest.
Marital Deduction Estate Trust or "A" Trust or Power of Appointment Trust	Testamentary trust for benefit of surviving spouse with income for life of surviving spouse plus a general power of appointment.	All distributed income taxed to spouse. Any retained income taxed to trust.	Not taxed on first estate because qualifies for marital deduction. Subject to estate tax at surviving spouse's death on full value of assets because of general power of appointment.
Nonmarital Trust or Bypass Trust or Credit Shelter Trust or "B" Trust	Testamentary trust that shelters assets from federal estate taxes in estates of both spouses. Funded with the current year's Lifetime Exclusion Amount at death of first	Distributed income is taxed to beneficiary. Accumulated income is taxed to trust.	Protected from estate tax on first death by unified credit. Excluded from second estate (even though assets may have grown far above

spouse. Surviving spouse may hold an income interest.

the Lifetime Exclusion) as surviving spouse does not hold general power of appointment.

SUMMARY: TYPES OF TRUSTS

<u>Type of Trust</u>	<u>Purpose</u>	<u>I n c o m e T a x Treatment</u>	<u>Estate and Gift Tax</u>
Qualified Terminable Interest Property (QTIP) Trust	Estate tax planning inter-vivos or testamentary trust that provides surviving spouse with an income interest for life. Enables creator to control the disposition of remainder interest in the trust after the surviving spouse's death.	During the lifetime of the estate owner, ordinary income is taxable to the grantor. After death of grantor, accounting income is taxable to the surviving spouse. Undistributed capital gains are taxable to the trust.	Not taxable in first estate because qualifies for marital deduction elected by executor. No gift taxes if inter vivos trust qualifies for marital deduction elected by donor. Taxable in surviving spouse's estate.
Irrevocable Life Insurance Trust	Estate planning inter-vivos trust owning insurance policies. Grantor is the insured, but retains no interest as beneficiary or trustee. At grantor's death, remainder passes to named beneficiaries of trust.	Trust income available for payment of insurance premiums is taxed to the grantor.	Not includible in estate if three year rule met (IRC §2035). Can be drafted to avoid estate tax in estates of both spouses. Gift tax on cash value of existing policies funded into trust.

X. GLOSSARY FOR ESTATES AND TRUSTS

Account of proceedings. A detailed statement of the fiduciary's actions in connection with the estate given by him/her under oath to the probate court and to the persons interested in the estate.

Administration. The management of a decedent's estate, including the gathering and safeguarding of assets, the payment of expenses, debts, and charges, the payment or delivery of bequests, and the rendition of an account.

Administration Expenses. Includes any expenses incurred to reasonably administer the estate or trust, such as fiduciary commissions, attorneys' and accountants' fees and other expenses.

Administrator/Administratrix. A fiduciary appointed by the probate court to administer the estate of an intestate decedent.

Alternate Executor. A person named to serve as executor in the event the person first named is unable or unwilling to serve.

Alternate Trustee. A person named to serve as trustee in the event the person first named is unable or unwilling to serve.

Alternate Value. For federal estate tax purposes, the value of the gross estate six months after the date of death, unless distributed, sold, exchanged or otherwise disposed of within six months, when the value is determined as of the date of such disposition.

Ancillary. Subordinate; auxiliary; as "ancillary administration," meaning an auxiliary administration required in other states than

the one in which a decedent had his residence. Used where decedent owned real estate in state(s) other than the state of domicile.

Appraise. To establish value by systematic procedures that include physical examination, pricing, and often engineering estimates.

Appraiser. One who appraises property, such as the property in a decedent's estate.

Beneficial Interest. An interest in property held in trust, as distinguished from legal ownership.

Beneficiary. One who inherits a share or part of a decedent's estate; or one who takes the beneficial interest under a trust.

Bequest. A gift of personal property by will; it means the same as "legacy".

Codicil. A document, testamentary in character, which serves as a written supplement to an existing will. It may explain, modify, add to, subtract from, qualify, alter, restrain or revoke provisions in the will.

Commission. The compensation provided by law for a fiduciary.

Community Property. Property owned in common by a husband and wife as a kind of marital partnership. Defined by statute in eight states, where the community system of property is recognized.

Corpus. The property comprising the gross estate of a decedent; the property comprising the fund which has been set aside in trust, or from which income is expected to accrue; principal.

Creator. The person who establishes a trust, either while alive or through will on death; grantor; settlor.

Decedent. The deceased person whose estate is being administered.

Decree. An official court order of the probate court.

Deduction for Distributions to Beneficiaries. The deduction allowed on a fiduciary income tax return for income currently paid, credited or required to be distributed to beneficiaries of estates and trusts.

Devise. A disposition of real property under a will.

Devisee. One who receives real estate by will.

Descent. The disposition of the real property of an intestate person.

Distribution, Law of. The apportionment and disposition, by authority of a court, of the balance of an intestate's personal property after payment of debts and costs.

Distributable Net Income (DNI). For fiduciary income tax purposes, the taxable income of the estate or trust for any taxable year, computed with certain modifications. IRC Section 643(a).

DNI - Modified. DNI computed without the deduction for charitable contributions - for use only when income is required to

be distributed currently by a complex trust. IRC Section 662(a)(1).

Domicile. That place which is an individual's permanent home and to which, whenever absent, the individual has the intention of returning.

Donee. The recipient of a gift.

Donor. The person who makes a gift.

Estate Tax. The federal tax levied on the transfer of property as the result of death (now part of the unified transfer tax).

Executor (Executrix). A person named in a will as the fiduciary who is to take charge of the deceased's estate to administer and dispose of it as directed in the will.

Fiduciary. Any person responsible for the custody or administration, or both, of property belonging to another, as, a trustee, executor, or administrator.

Fiduciary Income Tax Return. The income tax return (Form 1041) filed by the fiduciary of an estate or trust.

Gift. Property or property rights of interests transferred without adequate consideration to another, whether the transfer is in trust or otherwise, direct or indirect.

Gift Tax. The federal tax levied on the transfer of property by inter-vivos gift (now part of the unified transfer tax).

Grantor. The person who establishes a trust, either while alive (inter-vivos trust) or through will on death (testamentary trust).

Grantor Trust. A trust which fails to meet certain income tax rules and the property of which is, therefore, considered to be still owned (and reported) by the grantor for income tax purposes.

Gross Estate. The value of the decedent's assets and rights for federal estate tax purposes.

Guardian. An individual or trust company appointed by a court to manage the financial affairs of a minor or other incompetent individual.

Heir. One who on the death of another becomes entitled by operation of law to succeed to the deceased person's estate; anyone inheriting from a deceased person.

Income Beneficiary. The person entitled to the income from property in trust, as contrasted with a principal beneficiary, who will receive the property itself.

Inheritance. The property received from a deceased person, by succession or by will; strictly, property received by descent rather than by devise.

Intestate. A person who dies without leaving a valid will.

Inter-Vivos Trust. A trust created between living persons, as contrasted with a testamentary trust.

Irrevocable Trust. A trust that cannot be set aside or changed by its creator.

Joint Tenant. Any one of two or more persons who together own an item of real or personal property, whereby upon the death of any one of them his/her interest passes to the other(s) without becoming a part of his probate estate.

Judicial Settlement. The court's adjudication in respect of any accounting. It is finally and conclusively binding on all parties over whom the court had or obtained jurisdiction. The decree releases and discharges the petitioner (personal representative) from all further liability.

Legacy. A bequest of personal property under a will.

Legacy - General. A monetary legacy payable out of the general assets of the estate.

Legacy - Residuary. A bequest of all of the property of the testator not otherwise disposed of by will.

Legacy - Specific. A testamentary gift of a specific item in the decedent's estate which can be specifically identified.

Legatee. The person to whom a legacy is given.

Letters of Administration. A court order appointing and giving authority to the person selected to be the administrator/administratrix of an intestate's estate.

Letters Testamentary. A document granted by the probate court office to an executor/executrix named in a will, authorizing him/her to act as such.

Life Estate. The title of the interest owned by the life tenant (income beneficiary).

Life Tenant. The person who receives the income from a legal life estate or from a trust fund during his own life or that of another person (income beneficiary).

Living Trust. A trust created by a living person, to take effect before his/her death; an inter-vivos trust.

Marital Deduction. The deduction allowed for federal gift tax and federal estate tax purposes for qualifying property transferred to the spouse.

Marital Deduction Trust. A testamentary trust which meets certain tax requirements so that its property may qualify for the marital estate tax deduction.

Personal Property. Property of a temporary and movable character, as contrasted with real property; any property that is not real property.

Powers of Appointment. Powers given to the possessor (donee of the power) by another person (the donor), which authorize him/her to control, with certain limitations, the ultimate disposition of the property subject to the power. Basically, for tax purposes,

a general power of appointment is one which the donee can exercise in favor of himself/herself, his/her estate or the creditors of himself/herself or his/her estate. More limited powers are called "special powers" (also known as "non-general" or "limited powers"). The beneficiary of a power of appointment is called the "appointee". The person who receives the property if the power is not exercised is called the "taker in default".

Principal. The property comprising the estate or fund which has been set aside in trust, or from which income is expected to accrue (corpus).

Principal Beneficiary. The person to whom the property constituting the principal of a trust will go upon termination of the trust.

Probate. The formal, legal proving of a will and its acceptance by the court having jurisdiction over the administration of estates.

Probate Court. The court which administers justice in all matters relating to decedent's estates, etc.

Real Property. Land and land improvements, including buildings and attachments.

Remainderman. The person who is entitled to receive the principal (corpus) of an estate upon the termination of the intervening life estate or estates.

Residuary Estate (Residue). The estate of a decedent remaining after the payment of all administration and funeral expenses, debts,

charges and legacies.

Residuary Legatee. One entitled to receive the balance of an estate after specific bequests, taxes, and other liabilities have been satisfied.

Revocable Trust. A trust changeable or terminable at the pleasure of or under certain conditions by its creator.

Settlor. The person who makes a transfer to an inter-vivos trust; grantor; creator.

Successor Trustee. One named to assume the duties of trustee upon the death or disqualification of the original trustee.

Taxable Estate. For federal estate tax purposes, the excess of a decedent's gross estate over the deductions allowed.

Taxable Gifts. The excess of the total gifts made by a donor during the calendar year for federal gift tax purposes (adjusted for gift-splitting, incident to gifts of both donor and spouse), less unused annual exclusions and other deductions.

Taxable Income. For income tax purposes, the excess of the total income of an estate or a trust over the distribution deduction and all other deductions, including the exemption.

Tenancy In Common. Ownership of property by two or more persons with possession only, when the tenants may have acquired their titles at different times, through separate conveyances, with each having a different degree of interest. When one of the tenants

dies, his interest passes to his/her estate, not to his/her fellow tenants.

Tenancy, Joint - With Right of Survivorship. Ownership by two or more persons of the same property, at the same time, by the same title, through the same conveyance, with each having the same degree of interest and the same right of undivided possession as the others. It is distinguished by the automatic passage of one tenant's interest to the other(s) by survivorship.

Tenancy By The Entirety. Similar to a joint tenancy, except that it applies only to real property, ownership must be by husband and wife; neither can terminate the tenancy without the consent of the other while he or she is alive. Upon the death of one tenant, entire ownership of the property automatically passes to the other.

Testament. A will.

Testate (Adj.) Deceased, leaving a valid will.

Testamentary Trust. A trust created by a person's will, to go into effect after his/her death.

Testamentary. Pertaining to a testator or his estate.

Testator (Testatrix). The maker of a will.

Trust. A right, enforceable in courts of equity, to the beneficial

enjoyment of property, the legal title to which is in another. The person creating the trust is the creator, settlor, grantor, or donor; the holder of the legal title is the trustee; and the holder of the beneficial interest is the beneficiary.

Trust - Complex. For income tax purposes, all trusts other than "simple" trusts.

Trust - Estate. A testamentary trust for the benefit of a surviving spouse. The trustee is given discretion to distribute or accumulate income for the survivor's benefit. Any accumulated income and corpus must be distributed to the surviving spouse's estate upon death. Such a trust qualifies for the marital deduction.

Trust - Grantor. For income tax purposes, a trust under which the settlor (grantor) retains substantial ownership. The income from such a trust is includible in the owner's annual income for tax purposes.

Trust - Inter-Vivos. A gift of property by a living settlor to a trustee for the uses and purposes set forth in the trust instrument.

Trust - QTIP, Qualified Terminable Interest Property. A type of marital deduction trust in which the donee spouse has no control over the principal, but is entitled to the income of the property for life, paid at least annually. The value of the property is includible in the estate of the donee-spouse. It qualifies for the marital deduction when the executor so elects.

Trust - Simple. For income tax purposes, a trust which requires that income, as defined by the governing instrument or by local

law, be distributed currently to beneficiaries other than charities.

Trust - Testamentary. A legacy or devise of property to a trustee for the uses and purposes set forth in the will.

Trustee. The fiduciary nominated by the testator or settlor or appointed by the court to administer the trust property.

Trust Fund. A fund held by one person, the trustee, for the benefit of another, pursuant to the provisions of a formal trust instrument.

Trustor. A person who established a trust; creator; grantor.

Trust Instrument. A written document reciting the terms and conditions under which property placed in trust shall be administered.

Undivided Right (or Interest). The right owned by one of two or more tenants in common or joint tenancies to an undivided portion in an estate, before partition. Their rights may be either equal or unequal in value or quantity.

Unified Transfer Tax. The tax imposed on all taxable transfers; paid as a gift tax on lifetime transfers and as an estate tax on transfers at death.

Will. A document prepared by a natural person, containing instructions for the disposition of his/her property, to take effect upon his death.

Y. Income and Expense Chart for the Final Form 1040 of A Decedent or Beneficiary and Form 1041 of the Estate

INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR BENEFICIARY AND 1041 OF THE ESTATE (Assume Cash Method Of Accounting)		
Category	Where to Report	Explanation
Income & Expenses	Final Form 1040	Income actually or constructively received and expenses actually paid before death.
	Form 1041 (or beneficiary's return)	Income and expenses received or paid after death including "income and expense in respect of the decedent."
Income in Respect of a Decedent	Form 1041 (or beneficiary's return)	All gross income that the decedent had a right to receive, but is not includible on the final Form 1040 .
Estate Tax Deduction	Form 1041 (or beneficiary's Form 1040, Schedule A)	Any estate tax paid on Form 706 due to income in respect of the decedent can be taken as a deduction at the time such income is reported; taken on Form 1041 (line 19) or on beneficiary's Form 1040 as a miscellaneous itemized deduction <u>not</u> subject to the 2% of AGI limitation.
Expenses in Respect of a Decedent	Form 1041 (or beneficiary's return)	Items such as business expenses, income-producing expenses, interest and taxes for which the decedent was liable, but which are not deductible on the final Form 1040.
Standard Deduction	Final Form 1040	Full amount allowed; no proration is required.
Exemptions	Final Form 1040	Full amount allowed for decedent; no proration is required. For the decedent to claim the exemption of a dependent, the decedent must have furnished over one-half of the support for the entire year.
Due Date	Final Form 1040	April 15
Filing Status	Final Form 1040	Maybe single, head of household, joint w/ surviving spouse, qualifying widow(er) or married filing separately.
Place to File	Final Form 1040	IRS Service Center of person filing returns.
Estimated Taxes of Decedent	Form 1040-ES	None required after death (Reg. 1.6015(b) - 1(c)(2).7 and Private Letter Ruling 9102010)
Self-Employment Income	Form 1040 Schedule SE	Include SE income actually or constructively received through midnight of day of death. Partnership: include distributive share of SE income/loss through last day of month of death .
Wages	Final Form 1040	Wages actually received before death.
	Form 1041 (or beneficiary's return)	Wages earned before death but not received until after death (income in respect of the decedent).
Interest Earned	Final Form 1040, Schedule B	Interest paid prior to death.
	Form 1041 (or beneficiary's return)	Interest earned from the date of the last interest compounding prior to death up to the date of death (income in respect of the decedent).
	Form 1041 (or beneficiary's return)	Interest earned after death.

**INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR
BENEFICIARY AND FORM 1041 OF THE ESTATE
(Assume Cash Method Of Accounting)**

Category	Where To Report	Explanation
Series E or EE U.S. Savings Bond Interest (Decedent did not elect to report interest annually.)	Final Form 1040 OR Form 1041	Rev. Rul. 68-145 - Options 1 and 2 1) All interest accrued before death can be included on final Form 1040 . Interest accrued after death is reported on Form 1041 (or beneficiary's return); or 2) No accrued interest is reported on the final Form 1040 . All interest earned before and after death may be reported on any Form 1041 (or any beneficiary's return). The transferee (estate or beneficiary) will then report accrued interest each year. 3) If no elections are made, interest is reported when the bonds mature or are cashed, whichever is earlier (Rev. Rul. 64-104),
Series E or EE U.S. Savings Bond Interest (Decedent elected to report interest annually.)	Final Form 1040	Interest accrued up to date of death.
	Form 1041 (or beneficiary's return)	Interest accrued after death.
Dividends	Final Form 1040, Schedule B	Dividend checks received before death.
	Form 1041 (or beneficiary's return)	Dividends declared to stockholders of record before date of death, but not available or received by stockholder until after date of death.
	Form 1041 (or beneficiary's return)	Dividends declared and received after death.
Capital Gains and Losses	Final Form 1040, Schedule D	Gains or losses on capital asset transactions when payment is received before death. Any unused excess capital losses are lost and cannot be carried over to Form 1041 (or beneficiary's return).
	Form 1041 (or beneficiary's return)	Capital asset transactions before death when payment is received after death (income in respect of the decedent).
	Form 1041, Schedule D (or beneficiary's return)	Gains or losses on capital asset transactions that occur after death. Any unused capital loss carryovers when estate is terminated can be passed through to the beneficiaries on Schedule K-1 (Form 1041).
Decedent's Passive Losses	Final Form 1040	The decedent's passive income or loss in the year of death is reported under the normal rules. Suspended passive activity losses of prior years will be recognized on the decedent's final return (IRC §469(g)(2)) but only to the extent the suspended losses exceed the amount of the step-up in basis of the related property interest under §1014(a) . Remaining unused passive losses cannot be transferred to the estate or beneficiaries.

**INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR
BENEFICIARY AND FORM 1041 OF THE ESTATE
(Assume Cash Method Of Accounting)**

Category	Where To Report	Explanation
Business Income and Expenses	Final Form 1040, Schedule C and F	1) Cash Basis Business - Income and expenses actually received or paid up until the date of death. 2) Accrual Basis Business - Income and expense accrued to the date of death. A net operating loss cannot be carried from the decedent's final Form 1040 to Form 1041 or to beneficiary's returns.
	Form 1041 (or beneficiary's return)	Under the cash method of accounting, income and expenses accrued before death but not actually received or paid until after death (income in respect of the decedent)
	Form 1041 Schedules C and F, (Form 1040)	If the estate continues to operate the business, income and expenses accrue after death. However, the net income is NOT subject to self-employment tax. NOL's incurred by the estate are computed the same way as for individuals. Any unused NOL on the final estate return can be passed through to the beneficiaries on Schedule K-1 (Form 1041).
Rental Income	Final Form 1040, Schedule E	Income and expenses received or paid before death.
	Form 1041 (or beneficiary's return)	Income and expense accrued before death but not actually received or paid until after death (income and expense in respect of the decedent).
	Form 1041 (Schedule E, Form 1040)	Income and expenses received or paid after death.
Depreciation	Final Form 1040	Depreciation prorated for period ending on date of death.
	Form 1041 (Form 4562)	If the estate continues to operate the decedent's business or rental property, depreciation must be allocated between the estate and the income beneficiaries (if the estate is claiming an income distribution deduction) on the basis of the income allocated to each. The estate is not allowed to take the §179 deduction. The basis of property acquired from the decedent generally is its fair market value on the date of death. The "Short Tax Year" rules for depreciation apply for any tax year of the estate that is less than twelve full months.
Partnership Income (Loss)	Final Form 1040, Schedule E	Only include income (or loss) from a partnership tax year that ended before or on the date of death.
	Final Form 1040, Schedule SE	For self-employment tax purposes, include the deceased partner's distributive share of income (or loss) from the partnership through the end of the month in which death occurred.
	Form 1041 (or beneficiary's return)	All income (or loss) from a partnership year that ends after the date of death.

**INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR
BENEFICIARY AND FORM 1041 OF THE ESTATE
(Assume Cash Method Of Accounting)**

Category	Where To Report	Explanation
S-Corporation Income (Loss)	Final Form 1040, Schedule E	Pro-rata share of income (or loss) up to the date of death. The amount of income or loss is computed by the following formula: S-corp income (or loss) divided by number of days in S-corp year times the number of days the shareholder was alive. An election (§1377(A)(2)) can be made to close the S-corp books on the day of death, thereby using the actual profit or loss through the date of death. (Assumes Dec 31 fiscal year)
	Form 1041 (or beneficiary's return)	Income or (loss) after date of death that is not included on the final Form 1040 .
Decedent's Income From Estate or Trust	Form 1040 Schedule E	Simple Trust: include pro-rata share of income if actually distributed prior to death. Complex Trust and Estate: include pro-rata share of income actually paid, credited or required to be distributed.
IRA Distributions, Pensions and Annuities	Final Form 1040	Amounts actually received before death.
	Form 1041	Payments distributed by payer before death, but not yet received by decedent at the time of death (income in respect of the decedent).
	Form 1041 (or beneficiary's return)	Distributions made after death. These distributions are not subject to the 10% early withdrawal penalty (IRD).
Installment Sales Contracts	Final Form 1040, Form 6252	Payments received through the date of death.
	Form 1041 (or beneficiary's return) Form 6252	Payments received after death. The estate or beneficiary uses the same gross profit percentage the decedent used. If the installment contract is cancelled due to the death of the decedent, gain must be recognized by the estate .
Personal Residence	Final Form 1040	Exclusion permissible if home sold when decedent was a resident in nursing home for at least one year and if owned and used the property as a principal residence for 1 year in last 5 years.
	Form 1040 of Surviving Spouse	Surviving spouse receives only a \$250,000 exclusion if the sale is <i>more than 2 years after</i> the death of the decedent spouse.
	Form 1041	The exclusion of gain of a personal residence by a fiduciary does not qualify for exclusion. The FORMER personal residence becomes a capital asset to the estate, trust or the beneficiaries.

**INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR
BENEFICIARY AND FORM 1041 OF THE ESTATE
(Assume Cash Method Of Accounting)**

Category	Where To Report	Explanation
Medical Expenses	Form 1040, Schedule A	Medical expenses paid before death. An election can be made to include medical expenses of the decedent incurred before death but paid by the estate within one year after death. (Reg. §1.213-1(d)). To make the election, attach a statement to Form 1040 that states the estate has waived the right to claim the medical expense as a deduction on the estate tax return (Form 706).
	Form 1041	Medical expenses are never deductible on the estate income tax return. Report as income any insurance reimbursements received after death that were previously deducted on Form 1040 .
Funeral Expenses		The decedent's funeral expenses are never deductible on either Form 1041 or the final Form 1040 .
Interest Expense	Final Form 1040	Interest paid before death.
	Form 1041 (or beneficiary's return)	Interest expense accrued before death but paid after death (expenses in respect of the decedent).
	Form 1041 (or beneficiary's return)	Interest paid after death.
Charitable Contributions	Final Form 1040	Amounts contributed before death.
	Form 1041, Schedule A	Deductible only if the decedent's will provides for the contribution and it is payable out of income.
Casualty and Theft Losses	Final Form 1040	Casualties and thefts incurred before death.
	Form 1041	Casualties and thefts incurred during the administration of the estate can be reported on Form 1041 ; attach a statement that states the loss was not claimed on Form 706 .
Estate Administration Expenses	Form 1041	Expenses which would not have been incurred except for the fact that the decedent's property was held in the estate are not subject to the 2% AGI limitation; attach a statement that they were not claimed on Form 706 . These expenses must be allocated between taxable income and tax-exempt income; amounts allocated to tax-exempt income are not deductible.
Miscellaneous Itemized Deductions of Estate	Form 1041	These expense are subject to the 2% AGI limitation; attach a statement that they were not claimed on Form 706 . These expenses must be allocated between taxable income and tax-exempt income; amount allocated to tax-exempt income are not deductible.

**INCOME AND EXPENSE CHART FOR THE FINAL FORM 1040 OF A DECEDENT OR
BENEFICIARY AND FORM 1041 OF THE ESTATE
(Assume Cash Method Of Accounting)**

Category	Where To Report	Explanation
Real Estate and State and Local Income Taxes	Final Form 1040, Schedule A	Taxes paid before death.
	Form 1041 (or beneficiary's return)	State and local income taxes and real estate taxes accrued before death, but paid after death (expenses in respect of a decedent).
	Form 1041 (or beneficiary's return)	Taxes accrued and paid after death. This deduction must be allocated between taxable income and tax-exempt income; amount allocated to tax-exempt income are not deductible.
Unrecovered Investment in Annuity Contract	Final Form 1040, Schedule A	Unrecovered contributions fully deductible (for annuities begun after July 1, 1986) as an itemized deduction <u>not</u> subject to 2% of AGI limitation (§72(b)(3)(A)).
Unamortized Loan Cost (Points)	Final Form 1040, Schedules A, C, E and /or F	Unrecovered costs fully deductible on appropriate schedule(s).
Court Ordered Spousal Allowance	Form 1041	Any support allowance for a widow(er) or a dependent of the decedent that is paid from estate funds under a court order or decree or under local law is deducted only as a distribution deduction (never as alimony).
Earned Income Credit	Final Form 1040, Schedule EIC	Computed as if decedent was alive for the full year.
Credit for the Elderly or Disabled	Final Form 1040, Schedule R	Computed as if the decedent was alive for the full year.
Business Tax Credits	Final Form 1040, Form 3800	Credits and carryforward credits must be used up on the final Form 1040 ; unused amounts cannot be carried to Form 1041 or a beneficiary's return.

Z. Estates and Trusts Subjected to Medicare Tax on Net Investment Income

1. Effective January 1, 2013 **§1411(a)(2)** imposes an additional tax on **estates and trusts**. It provides that there is a tax imposed for each taxable year. It is a tax of **3.8%** of the *lesser of*:
 - a. the *undistributed* net investment income for such taxable year, or
 - b. the *excess* (if any) of:
 - (i) the adjusted gross income (as defined in **§67(e)**) for such taxable year, *over*
 - (ii) the *dollar amount* at which the highest tax bracket in **§1(e)** begins for such taxable year.

Tax Professional Education Fact: Since **2013** the highest estate and trust income tax rate is **39.6%**. It begins at **\$12,400** for 2016 and **\$12,500** for 2017. The bracket is indexed for inflation. The importance of reviewing any *undistributed* income from the estate and trust becomes more important than ever.

2. For purposes of calculating the **2%** floor on miscellaneous itemized deductions, **§67(e)** provides that the **AGI** of an estate or trust shall be computed in the same manner as in the case of an individual. There are exceptions for:
 - a. the deductions for 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, and
 - b. the deductions allowable under:
 - (i) **§642(b)** personal exemption
 - (ii) **§651** income **distribution** for current year income (**Simple Trust**)
 - (iii) **§661** income **distribution** for other amounts properly paid or credited required to be distributed (**Complex Trust**).

EXAMPLE: In 2016 Don's trust earns **\$10,000** of interest and dividends and **\$15,000** of long-term capital gains. The trust states that the income beneficiary is to receive all the fiduciary accounting income which for this purpose is all income *except* the long-term capital gains. Therefore the trust will distribute the \$10,000 of interest and dividends to the beneficiary and report it on **Form 1041 Schedule K-1** to the beneficiary. The trust is a Simple Trust and therefore receives a personal exemption of **\$300** resulting in taxable income of **\$14,700** as follows:

Interest and Dividends	\$10,000
Long-term Capital Gain	<u>15,000</u>
Total Income	25,000
Less: §651 income distribution to the beneficiary	(10,000)
<u>§642(b)</u> personal exemption	<u>(300)</u>
<hr/> Taxable Income on Form 1041	<u>\$14,700</u>

The trust's income tax will be **\$1,938** which is calculated as follows:

	<u>Taxable Income</u>	<u>Income Tax</u>
Total Taxable Income	\$14,700	
Less: Amount taxed at 15% bracket subject to preferential LTCG rate of 0%	(2,550)	\$ -0-
Less: Amount taxed at 25% -33% brackets subject to preferential LTCG rate of 15%	<u>(9,850)</u>	1,478
Equals: Amount taxed at 39.6% bracket subject to preferential LTCG rate of 20%	<u>\$ 2,300</u>	<u>460</u>
Total Income Tax on Form 1041		<u>\$1,938</u>

_____ ● The **3.8%** Net Investment Income Tax is **\$87** and is calculated on **Form 8960** as follows:

Lesser of:

1. Undistributed Net Investment Income \$15,000

or

2. The excess of Adjusted Gross Income:

Total Income	\$25,000
Less: §642(b) personal exemption	(300)
§651 income distribution deduction	<u>(10,000)</u>
Balance	14,700

Over: §1(e) highest tax bracket threshold (12,400)

Balance subject to Net Investment Tax \$ 2,300

===== As a result, the *lesser* is \$2,300 and the Net Investment Income Tax is **3.8%** of \$2,300 equal to **\$87** reported on **Form 8960**.

The total tax paid by the Trust is **\$2,025**.

FEDERAL INCOME TAX RATES FOR ESTATE AND TRUST

2016

Taxable Income					
Over	But Not Over	Pay	+	Excess	over -
\$ 0	\$ 2,550	\$ 0		15%	\$ 0
\$ 2,550 -	\$ 5,950	\$ 382.50		25%	\$ 2,550
\$ 5,950 -	\$ 9,050	\$ 1,232.50		28%	\$ 5,950
\$ 9,050 -	\$ 12,400	\$ 2,100.50		33%	\$ 9,050
\$12,400 -		\$ 3,206.00		39.6%	\$ 12,400

2017

Taxable Income					
Over	But Not Over	Pay	+	Excess	over -
\$ 0	\$ 2,550	\$ 0		15%	\$ 0
\$ 2,550 -	\$ 6,000	\$ 382.50		25%	\$ 2,550
\$ 6,000 -	\$ 9,150	\$1,245.00		28%	\$ 6,000
\$ 9,150 -	\$12,500	\$2,127.00		33%	\$ 9,150
\$12,500 -		\$3,232.50		39.6%	\$ 12,500

* Note there is no 10% or 35% bracket as there is for individual taxpayers. There is a 15%/20% long term capital gain rate available for qualified dividends and for capital assets held longer than one year.

Self Study Questions and Answer Sheets

Answer each questions with the **capital letter A-E** marked clearly. Select the answer that best provides the correct solution to the question.

1. IRS **Form 1041** includes filing transactions which could affect which taxpayer(s)?
 - a. Decedent of an estate
 - b. Creator of a trust
 - c. Beneficiary(ies) of an estate or trust
 - d. All of the above
 - e. a and b only

2. For purposes of filing an estate income tax return **Form 1041**, which statement is correct?
 - a. the entity comes into existence when the probate court accepts the final will
 - b. the entity comes into existence when the decedent signs the final will
 - c. the entity comes into existence on the date of the decedent's death
 - d. the entity comes into existence on the date the Fiduciary first submits the final will and testament to the probate court
 - e. none of the above

3. For purposes of filing an estate income tax return **Form 1041**, which statement is incorrect?
 - a. the entity ceases to exist when the probate court accepts the final will
 - b. the entity ceases to exist when the decedent dies
 - c. the entity ceases to exist on the date that the Fiduciary submits the initial accounting to the probate court
 - d. the entity ceases to exist when all the beneficiaries are identified
 - e. all of the above are incorrect

4. In an estate situation for federal income tax purposes there could be items of income which:
 - a. a decedent received during his/her lifetime that the Fiduciary can *elect* to include on the **Form 1041** of the estate
 - b. a decedent had the right to receive during his/her lifetime that the Fiduciary can *elect* to include on the **Form 1041** of the estate
 - c. a decedent had a right to receive during his/her lifetime but not actually received until after the death
 - d. a decedent received after death that the Fiduciary can *elect* to include on the decedent's final **Form 1040**
 - e. none of the above

5. Income in Respect of a Decedent (IRD) could include which type of income items?
 - a. interest in a savings account earned by the decedent at death but interest was credited to the account after the date of death
 - b. dividends declared during the taxpayer's lifetime as a shareholder of record but paid after the date of death
 - c. U.S. Savings Bond interest on earnings during the decedent's lifetime
 - d. payments on an installment note paid after the date of death
 - e. all of the above

6. Which of the following statements concerning the filing requirements of a **Form 1041** are true for an estate:
 - a. if there is a foreign beneficiary no return is required to be filed
 - b. a tax period can never be less than 12 months
 - c. there is a \$600 personal exemption in every tax year of an estate
 - d. the Fiduciary can not elect a specific accounting method
 - e. none of the above

7. Administrative expenses of an estate:
 - a. are incurred because of the decedent's death
 - b. cannot be deducted on **Form 1041**
 - c. are deducted only on **Form 706**
 - d. can cause a deduction of excess administrative deductions allowing a loss in any tax year of the estate
 - e. are allowed to be deducted against tax exempt income

8. The Governing Instrument will provide guidance to the Fiduciary of an Estate or Trust in the following matters:
 - a. identify the beneficiary(ies)
 - b. proper distribution of corpus and income
 - c. fiduciary accounting income
 - d. need for any special allocations of income and expenses
 - e. all of the above

9. If the trust document or will is silent as to the treatment of certain transactions, then the Fiduciary will:
 - a. do what is easiest for all parties concerned in order to avoid any contestment by the beneficiary(ies) and IRS
 - b. consult state law
 - c. allocate income and expense items equally among the remainder beneficiaries, if any
 - d. include the items as transactions at the entity level in all cases
 - e. all of the above are allowable for federal income tax purposes

10. For federal income tax purposes a Simple Trust:

- a. does not have to issue Schedule K-1s to beneficiaries
- b. has a charitable beneficiary
- c. is not required to distribute all of its income currently
- d. makes no distributions from corpus
- e. all of the above

11. For purposes of filing **Form 1041** for a trust, which of the following is incorrect?

- a. a calendar year is required
- b. if there is any taxable income, then a return is required to be filed
- c. the fiduciary can *elect* a fiscal year for income tax reporting purposes
- d. the fiduciary cannot *elect* an accrual accounting method
- e. the personal exemption is either \$100 or \$300 in all years of the trust

12. Subchapter J of the Internal Revenue Code provides for which of the following:

- a. the entity computes taxable income in the same manner as an individual
- b. many deductions and credits allowed to individuals are also allowed to estates and trusts
- c. estates and trusts have a unique deduction called an income distribution deduction
- d. estates and trusts are generally pass-through entities
- e. all of the above

13. Which statement is correct?
- a. the income distributed to beneficiaries retains the same character that it had at the entity level
 - b. the fiduciary can *elect* to reallocate the character of income distributed to beneficiaries differently than transacted at the entity level
 - c. the income can be distributed to the beneficiaries but still be included in the income of the entity
 - d. the income distributed by the entity is deducted by the beneficiary
 - e. the income distributed by the entity is included in income by both the entity and the beneficiary
14. Which statement about estimated tax payments made by the entity is incorrect?
- a. a fiduciary can *elect* to treat any portion of entity payments as if made by a beneficiary
 - b. both an estate and trust can make the *election* in each and every tax year of the entity
 - c. the payments are deemed to have been made on following January 15 after the tax year for the beneficiary
 - d. the *election* is made using IRS **Form 1041-T**
 - e. the *election* is required by the 65th day after the year end of the entity
15. When discussing the issue of the income distribution deduction and the distributable net income of an estate and trust which of the following is incorrect?
- a. taxable income is taxed at the entity level, the beneficiary level or a combination of the two levels
 - b. the computation for determining the maximum income distribution deduction is calculated on **Schedule B of Form 1041**
 - c. the result of the maximum deduction is reported to the beneficiary(ies) on Schedule K-1
 - d. the total income reported to the beneficiary(ies) can exceed the amount of the income distribution deduction at the entity level
 - e. the income distribution deduction will never include tax exempt income

16. Which of the following statements concerning the income distribution deduction is incorrect?
- a. Distributable net income establishes the character of income to the beneficiaries
 - b. losses are deducted by beneficiaries in all tax years of the entity
 - c. cash distributions to a beneficiary or on behalf of a beneficiary first distribute income before principal
 - d. the total amount of income reported on the Schedule K-1 cannot exceed the amount of income distribution deduction at the entity level
 - e. the income distribution deduction will never include tax exempt income items
17. Which statement concerning losses of an estate or trust is incorrect?
- a. losses of an estate or trust are retained by the entity until the termination of the entity
 - b. losses retained by the entity include passive losses
 - c. net operating losses are distributed annually to the beneficiary who will eventually own the operation generating the NOL
 - d. excess deductions of the current year for administrative costs do not get carried forward by the entity to the next tax year
 - e. capital losses are retained until the termination year
18. Which of the following statements concerning the **§663(b)** election is correct?
- a. it is allowed only in the termination year of the entity
 - b. it is required to be made by the end of the tax year
 - c. the election is irrevocable
 - d. it causes both the entity and beneficiary to pay tax
 - e. it is available for a Simple Trust

19. Which of the following statements about capital transactions for an estate and trust is correct?
- a. capital gains are normally excluded from the distributable net income
 - b. if the controlling document is silent with regard to capital gains then they are allocated to the corpus of the entity
 - c. capital gains are not part of distributable net income
 - d. capital gains are allowed in the termination year
 - e. all of the above
20. In issues addressing the termination year of an estate or trust which of the following statements is incorrect for purposes of Federal income tax?
- a. if the entity is an estate, then the termination takes place when the distribution of the assets to the beneficiaries is completed
 - b. if the entity is a trust, then the termination takes place when all of the corpus has been distributed and the administration is complete
 - c. reasonable amounts of cash can be kept aside for unascertainable or contingent liabilities or expenses
 - d. the fiduciary can hold the estate open for an unduly prolonged period
 - e. an estate can be kept open to settle litigation or tax controversies

ANSWER SHEET FOR SELF STUDY COURSE

**Form 1041: Introduction and Review of the Fiduciary Income Tax Return
for Estates and Trusts**

Instructions:

Fill in the answers on this answer sheet.

- | | | | |
|----------|-----------|-----------|-----------|
| 1. _____ | 6. _____ | 11. _____ | 16. _____ |
| 2. _____ | 7. _____ | 12. _____ | 17. _____ |
| 3. _____ | 8. _____ | 13. _____ | 18. _____ |
| 4. _____ | 9. _____ | 14. _____ | 19. _____ |
| 5. _____ | 10. _____ | 15. _____ | 20. _____ |

II. Decedent's Final 1040: Filing Requirements, Includible Income and Allowable Deductions

A. Filing Requirements

1. At the time of a person's death the individual **ceases** to exist as a "taxable entity."
2. As a result of death a newly created "taxable entity" comes into existence.
3. If an income tax return is required to be filed for the decedent, then it is due by the April 15th *following* the year of the decedent's death.
4. If the individual died *after* the close of the tax year, but before the return for that year was filed, then the return for the year just closed will not be the final return of the decedent.
5. The return for that year will be a regular return and the personal representative must file it by the normal due date plus extensions.

EXAMPLE: Samantha died on March 21, of the current year, before filing her prior year income tax return. Her personal representative should file her prior year return by April 15 of the current year. Her final tax return is due April 15, after the year of death with an **automatic extension** to October 15, after the year of death.
6. The gross income, age, and filing status of a decedent generally determine the filing requirements of a final **Form 1040**. In general, filing status depends on whether the decedent was considered single or married at the time of death.
7. Gross income usually means money, goods and property received or constructively received on which a decedent must pay tax.
8. A final return must be filed in order to obtain a refund if income tax was withheld from any source, or if estimated income tax was paid.
9. The time period covered by the final **Form 1040** of the decedent is January 1st through midnight of the date of death.
10. The decedent's year of death is **not** treated as a short tax year.
11. The income does **not** have to be annualized.

12. The **full** personal exemption is available.
13. The **full** standard deduction and the **full** additional standard deductions for age and blindness are also available.
14. Any dependents of the decedent will still qualify as a dependency exemption in the year of death as if the taxpayer had lived for the full year.
15. **Child Tax credit:** If the decedent had a qualifying child, then you may be able to claim the child tax credit on the decedent's final return even though the return covers less than 12 months. If the decedent had enough earned income, then you may be able to claim the additional child tax credit and get a refund if the credit is more than the decedent's liability.
16. **Adoption credit:** Depending upon when the adoption was finalized, the adoption credit may be taken on a decedent's final income tax return if the decedent:
 - a. Adopted an eligible child and paid qualified adoption expenses, or
 - b. Has a carryforward of an adoption credit from a prior year.

Also if the decedent is survived by a spouse who meets the filing status of qualifying widow(er), then the unused adoption credit may be carried forward and used following the death of the decedent.
17. **Earned Income Credit:** If the decedent was eligible for the Earned Income Credit, then the earned income credit can be claimed on the decedent's final return even though the return covers less than 12 months. If the allowable credit is more than the tax liability for the year, then the excess is still fully refundable.

B. Mandatory Filing Requirements

1. A final **Form 1040** is mandatory if:
 - a. Gross income is *greater than* minimum filing requirements based on filing status,
 - b. Self-employment net income is **\$400 or more**,

- c. Decedent may owe **FICA** and **Medicare** taxes on **tips** not reported by an employer, or
- d. It is necessary to correct **information returns**.
- e. Early withdraw penalty issues under §72(t) on **Form 5329**.

Tax Professional Note: A decedent may also be required to file **Schedule H** “*Household Employment Taxes*.”

C. Form 1310: Claiming a Refund For a Decedent

1. Generally, a person who is filing a return for a decedent and claiming a refund must file a **Form 1310**, *Statement of Person Claiming Refund Due A Deceased Taxpayer*, with the return.
2. However, **Form 1310** does not have to be filed if the:
 - a. surviving spouse is filing a joint return with the decedent, whether original or amended or
 - b. there is a court-appointed or certified personal representative filing an original return for the decedent, and a copy of a court certificate showing the appointment is attached to the return.

Tax Professional Note: The personal representative must attach a copy of the court certificate to the return showing that he or she was appointed the personal representative. If such certificate is not attached, then the IRS will rule the return non-processable and send the return back to the personal representative.

EXAMPLE. Assume that Joe died on March 25 of the current year, before filing his tax return for the prior year. On April 3, of the current year, Don was appointed the personal representative for Joe's estate. Don filed Joe's **Form 1040** showing a refund due. Don does **not** need **Form 1310** to claim the refund if he **attaches a copy** of the court certificate showing that Don was appointed the personal representative.

Tax Professional Note: As a practical matter it is highly recommended that a **Form 1310** always be filed in a request for refund situation. The **Form 1310** includes the personal representative's name, address and social security number as well as decedent information. It also must be signed.

3. If the surviving spouse is filing the return and receives a tax refund check in both names, then the surviving spouse can have the check reissued in the surviving spouse's name alone. Return the joint-name check marked "VOID" to the local IRS office or the service center where the return was mailed along with a written request for reissuance of the refund check. A new check will be issued in the surviving spouse's name alone.
4. **Death certificate:** When filing the decedent's final income tax return, do not attach the death certificate or other proof of death to the final return. Instead, the personal representative or surviving spouse should keep it for their records and provide it if requested.
5. **Nonresident Alien:** If the decedent was a nonresident alien who would have had to file **Form 1040NR**, U.S. Nonresident Alien Income Tax Return, then you must file a **Form 1040NR** for the decedent's final tax year. See the instructions for **Form 1040NR** for the filing requirements, due date and where to file.

D. Joint Return Issues

1. Generally, the personal representative and the surviving spouse can file a joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if no personal representative has been appointed before the due date for filing the final joint return for the year of death. This also applies to the return for the preceding year if the decedent died *after* the close of the preceding tax year and *before* filing the return for that year.
2. The income of the decedent that was includible on his or her return for the year up to the date of death and the income of the surviving spouse for the entire year must be included in the final joint return.
3. A final joint return with the decedent cannot be filed if the surviving spouse remarried *before the end* of the year of the decedent's death. The filing status of the decedent in this instance *is married filing separate*.
4. A court-appointed personal representative may revoke an election to file a joint return previously made by the surviving spouse alone. This is done by filing a separate return for the decedent *within one year* from the due date of the return (including any extensions). The joint return made by the surviving spouse will then be regarded as the separate return of that spouse by excluding the decedent's items and recalculating the tax liability.

5. **Relief from joint liability:** In some cases, one spouse may be relieved of joint liability of tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. If the decedent qualified for this relief while alive, then the personal representative can pursue an existing request, or file a request for relief from joint liability.

E. Where to File a Decedent's Form 1040

1. A decedent's **Form 1040** is filed at the IRS Service Center of the person filing returns for the decedent. The tax return must be prepared on a form for the year of death regardless of the date the taxpayer died.

EXAMPLE: Taxpayer dies on March 31, of the current year, the form to prepare is the current year's **Form 1040**, not the prior year's Form 1040.

Tax Profession Reminder: The decedent has a full tax year in the year of death.

F. Payment of Taxes and Estimated Tax Payments of the Decedent

1. The income tax withheld from the decedent's salary, wages, pensions, or annuities, and the amounts paid as estimated taxes are credits that must be claimed on the final **Form 1040**.
2. Estimated income tax payments are **not** required *after* the date of death per **IRS Reg. §1.6015(b)-1(c)(2)** and **Private Letter Ruling 9102010**.

G. Name, Address, and Signature Issues

1. The word "DECEASED," the decedent's name, and the date of death should be written across the top of the tax return.
2. If the decedent is filing a joint return then in the name and address space write the name and address of the decedent and the surviving spouse.
3. If a joint return is not being filed, then the decedent's name should be written in the name space and the personal representative's name and address should be written in the remaining space.

4. If a personal representative has been appointed, then that person must sign the return.
- _____ 5. If it is a joint return, then the surviving spouse must also sign it.
6. If no personal representative has been appointed, then the surviving spouse (on a joint return) should sign the return and write in the signature area "*Filing as Surviving Spouse.*"
7. If no personal representative has been appointed and if there is no surviving spouse, then the person in charge of the decedent's property must file and sign the return as "*Personal Representative.*"

H. Actual or Constructive Receipt and Disbursement

1. All income actually or constructively received *before* death is included on the final **Form 1040**.
2. All expenses actually or constructively paid *before* death are deducted on the final **Form 1040** for a cash basis taxpayer.

I. Income In Respect of a Decedent (IRD).

1. All gross income to which the decedent had *a right* to receive at death but was not actually or constructively received is not included in the final **Form 1040** because these items are "income in respect of a decedent" (**IRD**).
2. If there is no designated beneficiary then these **IRD** items are reported on the **Estate's Form 1041** as income.
3. If there is a named beneficiary or the property is transferred by operation of law then the income (**IRD**) is reported by that beneficiary on their **Form 1040**.

EXAMPLE 1. Frank owned and operated an apple orchard. He used the **cash method** of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for \$2000, but did not receive payment before his death.

When the estate was settled, payment had not been made and the estate transferred the *right to* the payment to his sister. When Frank's sister collects the \$2,000, she must include that amount in her return. It is neither reported on the final **Form 1040** of the decedent nor on the **Form 1041** of the estate.

EXAMPLE 2. Assume Frank used the **accrual method** of accounting in Example 1. The amount accrued from the sale of the apples would be included on **Frank's** final return. Neither the estate nor the sister will realize income in respect of the decedent when the money is later paid.

EXAMPLE 3. On February 1, George, a **cash method taxpayer**, sold his tractor for **\$3,000**, payable **March 1** of the same year. His adjusted basis in the tractor was **\$2,000**. He died on **February 15**, before receiving payment. The gain to be reported as **income in respect of the decedent** is the \$1,000 which is the difference between the decedent's basis in the property and the sale proceeds. Therefore, **the income in respect of the decedent** is the gain the decedent would have realized had he lived. It is not reported on George's Final **Form 1040**. However, it is reported either on the **Form 1041** of his estate or the **Form 1040** of his designated beneficiary.

EXAMPLE 4. Bill was entitled to a large salary payment at the date of his death. The amount was to be paid in five annual installments. The **estate**, collected two installments, and then distributed the right to the remaining installments to the beneficiary.

None of the payments would be **included** in Bill's final return. The **estate** must include the two installments it received in gross income, and the **beneficiary** must include each of the three installments in gross income in the tax year received.

EXAMPLE 5. Joe inherited the right to receive renewal commissions on life insurance sold by his father before his death. Joe inherited the right from his mother, who acquired it as a bequest from the father.

The mother died before she received all the commissions she had the right to receive, so Joe received the rest. **None** of these commissions were included **in the father's final return**, but the commissions received by the mother were included in her gross income. The commissions Joe received are not includible in his mother's gross income on her final return. Joe must include them in his income.

J. Character of Income.

1. The **character** of the income received in respect of a decedent is the same as it would have been to the decedent if he or she were alive.
2. If the income would have been a capital gain to the decedent, then it will be a capital gain to the beneficiary.

K. Deductions In Respect of a Decedent (DRD)

1. If the decedent had obligations before death that were not paid at the time of death then these items are "deductions in respect of a decedent."
2. Items such as business expenses, interest, taxes and income producing expenses for which the decedent was liable at death, but were not paid before death are deducted by either the Estate on **Form 1041** or the beneficiary on **Form 1040** as the case may be.

L. Wage Issues

1. Wages actually or constructively received **prior** to death are included on the final **Form 1040**.
2. Any wage received **after** death is IRD and reported by either the Estate on **Form 1041** or the beneficiary on their own **Form 1040**.
3. The **decedent's Form W-2 Box 1** Income Subject to Federal Tax on the final **Form 1040** includes only the **actual** gross wages received. The Social Security and Medicare Wages Boxes **3** and **5** include **100%** of the actual amount and accrued amounts.
4. The **IRD** is to be reported by the employer on **Form 1099 MISC** as non-employee compensation in **Box 3** and is **not** subject to self-employment tax.

EXAMPLE: Smith received **\$10,000** of gross wages in 2010 *prior to* death. Smith's estate received **\$6,000** for wages, vacation and accrued sick time not received by Smith.

Smith's employer should report Federal wages **Box 1** as \$10,000 and Social Security **Box 3** and Medicare wages **Box 5** as \$16,000 each.

Smith's estate will receive a **1099 MISC** for \$6,000. The executor should be careful to note that the Social Security and Medicare taxes will be subtracted from the actual gross amount on the **Form W-2**. No withholding will be taken from the **1099 MISC** recipient.

5. **§3121(a)(14)** provides that wages **paid** as income in respect of a decedent **after the year of death** are not subject to withholding for any federal taxes.

M. Farm Income from Crops, Crop Shares and Livestock

1. A farmer's **growing** crops and livestock at the date of death would **not** normally give rise to income in respect of a decedent nor would it be income to be included in the final return.
2. However, when a **cash method** farmer receives rent in the form of crop shares or livestock and owns the crop shares or livestock at the time of death, the rent is income in respect of a decedent. It is reported in the year in which the crop shares or livestock are sold or otherwise disposed of by the estate or beneficiary.
3. The same treatment applies to crop shares or livestock the decedent had a **right to receive** as rent at the time of death for economic activities that occurred before death.
4. If the individual died during a rent period, then only the *portion* of the proceeds from the portion of the rent period ending with death is income in respect of a decedent.
5. The proceeds from the portion of the rent period from the day *after* death to the end of the rent period are income to the estate or beneficiary.
6. Cash rent or crop shares and livestock **received** as rent and reduced to cash by the **decedent** are includible in the **final return** even though the rent period did not end until after death.

EXAMPLE. Joe who used the **cash method of accounting**, leased part of his farm for a 1-year period beginning **March 1**. The rental was one-third of the crop, **payable** in cash **when** the crop share is **sold** at the direction of Joe.

Joe died on **June 30** and was alive during **122 days** of the rental period. Seven months later, Joe's personal representative ordered the crop to be sold and was paid **\$1,500**. Of the \$1,500, **122/365, or \$501, is income in respect of a decedent** reported by the estate. The balance of the **\$1,500** received by the estate, **\$999**, is income to the estate. **Nothing is includible on Joe's final Form 1040.**

N. Interest and Dividends

1. Amounts **received** *prior to death* are included on the decedent's final **Form 1040**.
2. An amount *earned* from the date of the last interest compounding date prior to death *up to* the date of death is **IRD**.
3. All dividends received *prior to death* are included on the final **Form 1040**.
4. Interest and dividends earned *after death* is reported by the estate on **Form 1041** or the **Form 1040** of the named beneficiary.
5. Any dividend declared *before* death but not received is **IRD** and included on the Estate's **Form 1041** or the beneficiary's **Form 1040**.

O. Forms 1099 Interest and Dividend Income

1. A **Form 1099** should be received for the **decedent** reporting interest and dividends that were includible on his or her return *before* death.
2. A *separate* **Form 1099** should be received showing the interest and dividends includible on the returns of the estate or other recipient *after* the date of death and payable to the estate or other recipient.
3. The representative should request a “**corrected**” **Form 1099**, if the form does properly reflect the correct recipient or amounts.

P. Practical Issues of Form 1099 Reporting: How to Report Discrepancies

1. The amount reported on **Form 1099-INT** or **Form 1099-DIV**, Dividends and Distributions, may not necessarily be the correct amount that should be properly reported on each income tax return.
2. A **Form 1099-INT** reporting interest payable to a decedent may include income that should be reported on the final income tax return of the decedent, as well as income that the estate or other recipient should report, either as income earned after death or as income in respect of the decedent.

3. For income *earned after death*, the representative should ask the payer for a **Form 1099** that properly identifies the recipient (by name and identification number) and the proper amount.
4. If that is not possible, or if the form includes an amount that represents income in respect of the decedent, then include an explanation, describing the amounts that are properly reported on the decedent's final return.
5. When preparing the decedent's final return and there are **Forms 1099-INT** or **Forms 1099-DIV** for the decedent that include amounts belonging to the decedent and to another recipient (the decedent's estate or another beneficiary), report the total amount shown on **Form 1099-INT** or **Form 1099-DIV** on **Schedule B (Form 1040)**.
6. Next, enter a "subtotal" of the interest or dividend shown on **Forms 1099**, and the interest or dividend reportable from other sources for which you did not receive **Forms 1099**.
7. Report any interest or dividend (including any interest or dividend received as a nominee) belonging to another recipient separately and subtract it from the subtotal. Identify the amount of this adjustment as "Nominee Distribution" or other appropriate designation.

Q. U.S. Savings Bond Series E and EE Interest Reporting Issues: Use of §454 Election After Death of Decedent

1. The law allows the executor of the decedent's estate to make an **election** to include all accrued interest from U.S. Savings Bonds includible in the gross income of the decedent on the **final 1040**.
2. If the election is **not** made on the **final 1040** then the executor may **elect** to include the accrued interest **on the Estate's Form 1041**.
3. If the election is **not** made on the **Form 1041** then the **election** may be made **by the beneficiaries** of the bonds and reported **on their Form 1040**.

Note: If the decedent elected to use the provisions of **§454** *prior to death* then the **final 1040** must include the accrued interest earned up to the date of death.

- The incremental interest earned **after death** must be reported on the **Form 1041** of the estate or the **Form 1040** of the beneficiary returns as long as bonds are held.

Election Statement			
<u>Election to Recognize Current Income on Noninterest-bearing Discount Bonds Under §454</u>			
Taxpayer or Entity Name			
Social Security or Taxpayer ID#			
For 1040, or Form 1041 Tax Year Ending 12/31/20XX			
Taxpayer hereby elects , under Reg. §1.454-1(a)(3) , to include in current income the annual increase in the redemption price of all noninterest-bearing discount obligations he now owns or may hereafter own.			
Face Value	Serial#	Issue Date	Maturity Date
<u>Amount</u>			

R. Capital Gains and Losses of the Decedent: Form 1040

1. Capital gains and losses *before death* are netted against each other.
2. The decedent's *annual limitation* on net capital losses is still only \$3,000 on the final **Form 1040**. (\$1,500 if married filing separate from surviving spouse.)
3. If the decedent has any **unused** capital losses at death then they **cannot** be transferred and as a result they are lost if they were generated from **separately owned property** of the decedent.

Tax Professional Note: Both the law and regulations are silent as to the availability of the capital losses when the property which generated the losses was **owned jointly by spouses who filed joint returns**. It is presumed that the losses are available to the surviving spouse.

S. Capital Losses Generated By the Estate of the Decedent: Form 1041

1. If the **estate** of the decedent incurs **net capital losses** then those losses have an annual limitation of \$3,000 just like an individual taxpayer.
2. Any **excess losses** are carried forward to the next tax year and are used against future capital gains generated by the estate just like an individual taxpayer.
3. The capital loss **carryforwards** remain in the estate until the *termination* of the estate.
4. When the estate is terminated the unused capital loss carryovers are **passed through to the beneficiaries** retaining their short-term and long-term character.
5. If the decedent had an installment note receivable then the estate or beneficiaries step into the shoes of the decedent and have the same gross profit percentage on the amounts received. The note is **IRD**.

T. Income Tax Treatment of the Sale of the Decedent's Former Residence

1. **§121(b)(4)** provides that in the case of a sale or exchange of a principal residence of an unmarried individual whose spouse is deceased on the date of such sale, the normal \$250,000 exclusion will be \$500,000 instead if such sale occurs *not later than 2 years after* the date of death of such spouse, and the exclusion rules for the 2 out of 5 year holding period was met immediately before the date of the decedent spouse's death.

EXAMPLE: Mary died on **June 21, 20XX** and she and John, her surviving spouse, both satisfied the ownership and occupancy tests for the 2 out of 5 year rule of **§121**. If John sells the property *not later than 2 years after* **June 21, 20XX**, then he may exclude up to **\$500,000** on the sale. If John sells the property *after* the 2 year grace period is up, then his maximum exclusion will be *only* **\$250,000**.

2. **§1221** provides that an asset of the decedent becomes a capital asset in the hands of the estate or beneficiaries.

3. Since a property receives a fair market value (FMV) at the date of the decedent's death, it is not unusual that a sale of the property will result in a loss, since a selling expense is generally incurred. The Service attempts to disallow the loss stating that the property is personal property to the ultimate recipient(s) of the property.
4. However, an estate cannot have personal assets by definition of its existence and an individual beneficiary can deduct the loss if there is an immediate attempt to rent or sell the property under the guidance of two court cases (**Campbell, N. Stuart, (1954) 5 T.C. 272 and Carnrick, George (1947) 9 T.C. 756.**
5. In other court cases it was ruled that even though a beneficiary was living in the house after the decedent's death it did not prevent the deduction of the loss as long as the beneficiary indicates their intention to move and does so within a reasonable time under all the surrounding facts and circumstances. (**Watkins, H.V., T.C. Memo 1973-167**).
6. In the Horrmann case a mere attempt to rent out the property was not enough to secure the loss (**Horrmann, William, (1951), 17 T.C. 903.**
7. The sale of the property by either the estate or the beneficiary is reported on **Schedule D**. The adjusted basis of the property is the FMV on the date of death plus the selling expenses.
8. The issue of FMV may in fact be the selling price of the property. The facts and circumstances surrounding the property value on the date of death versus the date of sale must be reviewed.

U. Passive Losses of the Decedent and Unused PALS: Form 1040

1. Unused “passive activity losses” (PALs) of the decedent **cannot be transferred** to the estate or the beneficiaries
2. **§469(g)(2)** provides that the *decedent's* suspended PALs of prior years are recognized on the final **Form 1040** to the extent the suspended PAL is *greater than* the amount of the **§1014** step-up in basis of the related property received.
3. This test is calculated on an *activity by activity basis* and not by aggregating all of the decedent's passive activities.

EXAMPLE: Decedent has two rental properties on the date of death valued at **\$100,000** each. The **adjusted basis** of each property is **\$60,000**. Therefore, the step-up in basis for each is **\$40,000**. **Property #1** has a suspended PAL of **\$45,000** and **Property #2** has a suspended PAL of **\$35,000** calculated as follows:

	<u>Property #1</u>	<u>Property #2</u>
FMV	\$100,000	\$100,000
Adjusted Basis	<u>(60,000)</u>	<u>(60,000)</u>
§1014 Step-Up in Basis	<u>40,000</u>	<u>40,000</u>
Suspended PAL	\$45,000	\$35,000
Less: Step-Up in Basis	<u>(40,000)</u>	<u>(40,000)</u>
Deducted Suspended PAL on Final Form 1040	<u>\$5,000</u>	N/A

V. The Estate's Suspended PAL In Rental Real Estate Activities : Form 1041

1. If the executor of estate continues to **actively participate** in the management of a real property then the estate is permitted to take advantage of the special rental real estate allowance of up to \$25,000 for the estate's first two "tax years" and has the same limitations as an individual taxpayer. **Any unused losses are suspended.**
2. If the entity holds onto the real estate beyond the first two "tax years" of the estate then the passive losses cannot be used and are "suspended" until the estate has "passive income" in a subsequent year or is sold in a "fully taxable event."
3. The **losses** of the estate remain suspended until the property is transferred to the beneficiary. However, the beneficiaries **do not retain** the character of the PALs when received.
4. The PALs are **added to the adjusted basis** of the property transferred to the beneficiaries.

5. When the beneficiary **disposes** of the property the PAL reduces the realized gain or increases the realized loss on the disposition of the real estate.
6. The PALs do **not** increase the basis of the rental property for purpose of deducting depreciation.

III. Income and Expenses

A. Cash Basis Taxpayer vs. Accrual Basis Taxpayer

1. Income actually or constructively received and expenses actually paid up to the date of death are reported on the final **Form 1040** of the decedent.
2. **Constructive receipt** means that the income was available to the decedent without restriction.
3. If the decedent used the accrual method of accounting then all the items are included in the final **Form 1040** when earned.
4. If the sole proprietor had inventory, then there is a requirement that the **gross profit** be reported on an accrual method and the operating expenses are on a cash method.

B. Self-Employment Income Issues of a Decedent

1. On the final **Form 1040**, the personal representative should include self-employment income actually or constructively received or accrued, depending on the decedent's accounting method.
2. For self-employment tax purposes *only*, the decedent's self-employment income will include the decedent's distributive share of a partnership's income or loss *through the end of the month* in which death occurred.
3. For this purpose only, the partnership's income or loss is considered to be earned ratably over the partnership's tax year.

C. Income and Expenses After Death

1. If the cash basis method of accounting was used by the decedent then there would be **IRD** and **DRD** for the income earned and expenses incurred before death.

D. Net Operating Losses of Decedent (NOL): Form 1040

1. If the decedent had unused **NOL** carryovers, they cannot be transferred to the estate or to the beneficiaries. (Use them or lose them.)
2. Surviving spouses of decedents **cannot** use the **NOL** of the decedent **except** in the decedent's year of death.

E. Net Operating Losses (NOL) of the Estate: Form 1041

1. If the **estate** continues to operate the business of the decedent then the income and expenses earned and incurred are attributed only to the estate.
2. Losses during the **administration period** are not passed through to the beneficiaries.
3. The **NOL** is accounted for just like an individual. They can be carried back and carried forward for the allowable statutory periods.

Tax Professional Note: Only in the "termination year" of the estate may the **NOL** carryforwards be transferred to the beneficiaries.

F. Rental Income, Expenses and Depreciation

1. The income received and the expenses paid *prior* to death are deducted on the decedent's final **Form 1040**.
2. Income accrued and expenses incurred *prior to* death are reported by the estate or underlining beneficiaries as **IRD & DRD**.
3. Income received and expenses incurred *after* death are reported on the Estate or to the beneficiaries.
4. Depreciation is *prorated* for the period ending on the decedent's date of death.

5. If the estate continues to operate the decedent's business or rental property, then depreciation is based on a **§1014 FMV** on the date of death under the new statutory method and life. **§1014** could cause both a step-up or a step-down in basis.
6. The **estate** is not permitted to *elect* **§179** expensing on personal property acquired *after* the decedent's death.
7. The "short year" rules for depreciation apply for any tax year the **estate** has which is less than 12 full months.

G. Subchapter S Corporation Income (Loss): Pro-rata Share Allocation Method (General Rule) vs. §1377(a)(2) Election to Close S-Corp Books

1. The law provides a **general rule** that shareholders of an S-Corporation share in separately stated and non-separately stated items of profit and loss based on a **per-share, per-day allocation**.
2. The decedent's final **Form 1040** includes the percentage of ownership for the number of days the stock was held in the final year.
3. The Estate's **Form 1041** includes the same ownership percentage for the number of days *after* the decedent's death.
4. **§1377(a)(2)** allows the corporation to *elect* to close the books of the S-Corp on the date of death thereby using the actual profit or loss through the date of death.
5. **100%** of the shareholders who held stock during the tax year must consent to the corporation's election.

H. Partnership Income (Loss): Partnership Closes Books on Date of Death

1. The decedent's income and losses up to the date of death would be included in the final **Form 1040**.
2. All income and loss *after the* date of death is reported on the **Form 1041** of the estate or the **Form 1040** of the beneficiary.
3. The death of a partner closes the partnership's tax year for that partner. Generally, it does not close the partnership's tax year for the remaining partners. The decedent's distributive share of partnership items must be calculated *as if* the partnership's tax year ended on the date the partner died.

4. In order to avoid an interim closing of the partnership books, the partners can agree to estimate the decedent's distributive share by prorating the amounts the partner would have included for the entire partnership tax year.
5. On the decedent's final return, the fiduciary should include the decedent's distributive share of partnership items for the following periods:
 - a. The partnership's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
 - b. The period, if any, from the end of the partnership's tax year in (a) above to the decedent's date of death.

EXAMPLE: Mary was a partner in a partnership and reported her income on a tax year ending **December 31**. The partnership uses a tax year ending **June 30**. Mary died **August 31, 20XX**, and her estate established its tax year through **August 31**.

The distributive share of partnership items based on the decedent's partnership interest is reported as follows:

- **Final Return for the Decedent Mary:** January 1 through August 31, 20XX, includes the partnership items from:
 - (a) the partnership tax year *ending* **June 30, 20XX**, and
 - (b) the partnership tax year *beginning* **July 1, 20XX**, and *ending* **August 31, 20XX** (the date of death).
- **Income Tax Return of the Estate: September 1, 20XX,** through **August 31, 20XX**, includes partnership items for the period **September 1, 20XX**, through **June 30, 20XX**.

I. IRA and Pension Distributions: Decedent's Distributions Prior to Death

1. Amounts received *prior to death* are on the final **Form 1040**.
2. An amount *distributable before death and received after death* is **IRD** to the estate or designated beneficiaries.

3. Distributions *after death* are also **IRD** and **not** subject to **10%** early withdrawal penalty.
4. If the surviving spouse is the decedent's beneficiary, then it can be rolled into the surviving spouse's own **IRA** and not currently taxes.
5. **Inherited IRAs:** If a beneficiary receives a lump-sum distribution from a traditional IRA that was inherited, then all or some of it may be taxable. The distribution is taxable in the year received as income in respect of a decedent up to the decedent's taxable balance. This is the decedent's balance at the time of death, including unrealized appreciation and income accrued to the date of death, *minus* any basis (nondeductible contributions).
6. Amounts distributed that are *more than* the decedent's entire IRA balance (includes taxable and nontaxable amounts) at the time of death are the income of the beneficiary.
7. The 2006 Pension Act requires that employer plans allow rollovers of qualified pension plans to *designated* non-spouse beneficiaries for distributions *after* December 31, 2009.
8. If the **RMD** rules are applicable then **Prop. Reg. §1.401(a)(9)-5** provides a general rule that the required minimum distributions from an **IRA** or a qualified pension plan is calculated by dividing the account balance as of the end of the year preceding each distribution year by the "age-based" factor from an IRS table.
9. This table is identical to the minimum distribution incidental benefit (MDIB) divisor table used by the old proposed regs in order to determine lifetime payouts where a non-spouse beneficiary is more than 10 years younger than the decedent.

J. Post Death Required Minimum Distribution (RMD) Rules

1. If the IRA or qualified pension plan has a **designated** beneficiary then the remaining account balance is distributed over the remaining life expectancy of the **beneficiary** whether or not the decedent died before or after the required beginning date.

Tax Professional Note: The life expectancy of the beneficiary is determined using the expected return multiples of **Table V of Reg. §1.72-9**.

2. If the plan does **not** have a designated beneficiary and the decedent dies *after* the required beginning date (generally April 1 following the year in which the decedent owner dies) then the remaining balance is paid out over the remaining life expectancy of the **decedent** owner of the **IRA** or qualified plan.
3. If the **IRA** or qualified plan does not have a designated beneficiary and the decedent owner dies *before* the required beginning date then the account balance must be distributed **within 5 years after the year** of the decedent owner's **death**. (**Prop. Reg. §1.401(a)(9)-3, Q&A 1 and Prop. Reg. §1.401(a)(9)-5, Q&A 5**).

K. Roth IRA Issues

1. Qualified distributions from a Roth IRA are not subject to tax. A distribution made to a beneficiary or to the Roth IRA owner's estate *on or after* the date of death is a qualified distribution if it is made *after* the 5-tax-year period beginning with the first tax year in which a contribution was made to any Roth IRA of the owner.
2. Generally, the entire interest in the Roth IRA must be distributed by the *end* of the fifth calendar year *after* the year of the owner's death *unless* the interest is payable to a designated beneficiary over his or her life or life expectancy.
3. If paid as an annuity, then the distributions must begin *before the end* of the calendar year *following the year* of death. If the sole beneficiary is the decedent's spouse, then the spouse can delay the distributions *until*:
 - a. the **decedent** would have reached age **70 ½**, or
 - b. the surviving spouse can treat the Roth IRA as their own Roth IRA.
4. The part of any distribution made to a beneficiary that is not a qualified distribution may be includible in the beneficiary's income. Generally, the part includible is the earnings in the Roth IRA. Earnings attributable to the period ending with the decedent's date of death are income in respect of a decedent. Additional earnings are the income of the beneficiary.

L. Coverdell Education Savings Account (ESA) Issues

1. Generally, the balance in a Coverdell ESA must be distributed *within 30 days after* the individual for whom the account was established reaches age 30 or dies, whichever is earlier. The treatment of the Coverdell ESA at the death of an individual *under* age 30 depends on who acquires the interest in the account.

Tax Professional Note: The age 30 limitation does not apply if the individual for whom the account was established or the beneficiary that acquires the account is an individual with special needs. This includes an individual who, because of a physical, mental, or emotional condition (including a learning disability), requires additional time to complete his or her education.

2. If the decedent's spouse or other family member is the **designated beneficiary** of the decedent's account, then the Coverdell ESA becomes that person's Coverdell ESA.
3. Any other beneficiary (including a spouse or family member who is not the designated beneficiary) must include the earnings portion of the distribution in income. Any balance remaining at the close of the 30-day period is deemed to be distributed at that time.
4. The amount included in income is reduced by any qualified education expenses of the decedent that are paid by the beneficiary *within one year after* the decedent's date of death.

M. Income Tax Issues of an Installment Sale Contract

1. The decedent's final **Form 1040** includes the actual amount received up to the date of death.
2. Any payments received *after* death are **IRD**
3. The Estate or beneficiary uses the **same gross profit percentage** used by the decedent.
4. If the installment sales contract is cancelled due to the death of the decedent then gain is **recognized by the estate** on **Form 1041** causing a "deemed" receipt by the estate.

N. Medical Expenses of the Decedent

1. All medical expenses paid by the decedent *before* death are deducted on the final **Form 1040** subject to the **7.5% AGI** limitation.
2. However, if qualified medical expenses paid before death by the decedent are paid with a tax free distribution from a Health Savings Account (HSA) or a Medical Savings Account (MSA) or Medicare Advantage MSA then those medical expenses are **not** deductible.
3. The general rule provides that if there are unpaid medical expenses at death, then they are allowable deductions on the decedent's Estate Tax Return **Form 706**. Medical expenses not paid at the time of death are liabilities of the estate.
4. However, **§213(d)** provides that the executor may *elect* to deduct medical expenses on the decedent's final **Form 1040** if those expenses are paid *within* one year of the decedents' death.
5. The *election* must be made *before* the close of the statute of limitations on the final **Form 1040** which is three years *after* the due date plus extensions.

Tax Professional Note: The *election* can be made on an amended **Form 1040**. This *election* applies *only to* expenses incurred for the decedent and not to expenses incurred to provide medical care for dependents.

6. The *election* is made by **attaching a statement** in duplicate to the original or amended **Form 1040**.
7. The **election statement** must also include a "waiver" statement which waives the executor's right to claim the medical expenses as a debt deduction on the Estate Tax Return **Form 706**.

EXAMPLE: Bill used the cash method of accounting and filed his income tax return on a calendar year basis. Bill died on **June 1**, of the current year, after incurring **\$8,000** in medical expenses. Of that amount, **\$5,000** was incurred in **the prior tax year** and **\$3,000** was incurred in the current tax year. Bill itemized his deductions when he filed his prior year income tax return. The personal representative of the estate paid the entire \$8,000 liability in August of the current year.

The personal representative may file an amended return (**Form 1040X**) for the prior tax year claiming the **\$5,000** medical expense as a deduction, subject to the 7.5% or 10% limit. The **\$3,000** of expenses incurred in the current year can be deducted on the final income tax return if deductions are itemized, subject to the 7.5% or 10% limit. The personal representative must file a statement in duplicate with each return stating that these amounts have not been claimed on the federal estate tax return (**Form 706**), and waiving the right to claim such a deduction on **Form 706** in the future.

8. **Medical expenses not paid by the estate:** If a taxpayer paid medical expenses for a deceased spouse or dependent, then claim the expenses on the taxpayer's tax return for the year in which they are paid, whether they are paid before or after the decedent's death.

Tax Professional Note: If the decedent was a child of divorced or separated parents, then the medical expenses can usually be claimed by both the custodial and noncustodial parent to the extent paid by that parent during the year.

Example of a §213(d) Election Statement

IRC §213(d) ELECTION STATEMENT WAIVER OF ESTATE TAX DEDUCTION FOR DECEDENT'S MEDICAL EXPENSES PAID WITHIN ONE YEAR OF DEATH BY ESTATE

Decedent's Name:
Personal Representative:
Address:
City and State:
Year:

Decedent's SS#:
Estate EI #:

Pursuant to **§213(d)**, the personal representative hereby **elects** to claim medical expenses in the amount of \$_____ as a deduction on the decedent's income tax return. They have not been allowed as a deduction under **§2053** in computing the taxable estate for purposes of the estate tax imposed by **§2001**.

The personal representative hereby **waives** any and all rights to have these medical expenses allowed as a deduction under **§2053**.

X _____ X _____
Date Personal Representative Signature

9. Medical expenses are **never** deducted on the Estate's Form **1041**.
10. The **tax benefit rule of §111** provides that the estate or beneficiary should include as income any refund of an amount deducted by the decedent for medical expenses on *any* **Form 1040** of the decedent.

O. HSA, Archer MSA and Medicare Advantage MSA

1. The treatment of an HSA, Archer MSA or a Medicare Advantage MSA at the death of the decedent depends on who acquires the interest in the account.
2. **§220(f)(8)(A)** and **§223(f)(8)(A)** both provide that if the decedent's spouse is the designated beneficiary of the account, then the account becomes that spouse's Archer MSA, HSA, or Medicare Advantage MSA.
3. **§220(f)(8)(B)** and **§223(f)(8)(B)** both provide that any other beneficiary (including a spouse that is not the designated beneficiary) must include in income the fair market value of the assets in the account on the decedent's date of death.
4. This amount must be reported for the beneficiary's tax year that includes the decedent's date of death. The amount included in income is *reduced* by any qualified medical expenses for the decedent paid by the beneficiary *within one year after* the decedent's date of death.

P. Accelerated Death Benefits

1. **§101(g)(1)** provides that certain taxpayers can **exclude** from gross income any accelerated death benefits received on the life of an insured individual if certain requirements are met.
2. Accelerated death benefits are amounts received under a life insurance contract *before* the death of the insured.
3. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider.
4. **§101(g)(1)(A) and (B)** provide that this exclusion applies *only if* the insured was a *terminally ill* individual or a *chronically ill* individual.

5. **§101(g)(4)(A)** defines a *terminally ill* individual is an individual who has been **certified by a physician** as having an illness or physical condition that is **expected** to result in death in **24** months or less from the date of certification.
6. **§101(g)(4)(B)** defines a *chronically ill* individual is an individual who has been **certified** within the preceding **12**-month period by a **licensed health care practitioner** as:
 - a. being unable to perform (without help) at least two activities of daily living (**ADL**) for at least 90 days due to a loss of functional capacity,
 - b. having a level of disability similar to that described in (a), or
 - c. requiring substantial supervision to protect the individual from threats to health and safety because of severe cognitive impairment.
7. If the insured was a chronically ill individual, then the exclusion of accelerated death benefits is limited to the cost incurred in providing qualified long-term care services for the insured.
8. In determining the cost incurred in providing qualified long-term care services do not include amounts paid or reimbursed by medicare insurance or otherwise.

Q. Funeral Expenses

1. Funeral expenses are **never** deducted on **Form 1040** or **Form 1041**.
2. Funeral expenses can **only** be deducted on **Form 706**.

R. Interest Expenses

1. The provisions of **§163** state that interest is deductible depending on its sources such as:
 - a. qualified mortgage interest
 - b. investment interest
 - c. passive interest

- d. business interest
2. The interest is deductible on the final **Form 1040** depending on the appropriate classification.
3. Personal interest is **never** deductible.

S. Charitable Contributions

1. Charitable contributions are deducted to the extent of the 50% of AGI limitation.
2. Any amounts **not** deducted on the **final Form 1040** are lost. They are not transferred to the estate's **Form 1041** or beneficiary's **Form 1040**.
3. Charitable contributions **made by the estate** after the decedent's death are **deductible only if** the decedent's will provides that the contributions be paid out of **taxable income** of the estate.
4. This is true even if the beneficiaries agree that a contribution can be made from the estate funds.

T. Real Estate and State and Local Income Taxes

1. Any taxes of the decedent paid *prior* to death are deducted on the final **Form 1040**.
2. Any taxes of the decedent paid *after* the date of death (**DRD**) are deducted by Estate on **Form 1041** and on **Form 706**.

U. Unrecovered Investment in an Annuity Contract

1. The decedent's unrecovered contribution in an Annuity Contract is deducted on the **decedent's final Form 1040** a miscellaneous itemized deduction on **Schedule A**, "not" subject to the 2% AGI limitation.
2. It is **not** a capital transaction reported on **Schedule D**.

V. Tax Forgiveness for Members of the Armed Forces and Victims of Terrorism

1. Income tax liability may be forgiven for a decedent who dies due to service in a combat zone or due to military or terrorist actions as a result of a terrorist attack.
2. If a member of the Armed Forces of the United States dies while in active service in a combat zone or from wounds, disease, or injury incurred in a combat zone, then the decedent's income tax liability is abated (forgiven) for:
 - a. the entire year in which death occurred and
 - b. any prior tax year ending on or after the first day the person served in a combat zone in active service.
 - For this purpose, a qualified hazardous duty area is treated as a combat zone.
3. If the tax (including interest, additional to the tax, and additional amounts) for these years has been assessed, then the assessment will be forgiven. If the tax has been collected (regardless of the date of collection), then that tax will be credited or refunded.
4. Any of the decedent's income tax for tax years *before* those mentioned above that remains unpaid as of the actual (or presumptive) date of death will not be assessed. If any unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, then this assessment will be forgiven. Also, if any tax was collected *after* the date of death, then that amount will be credited or refunded.
5. The date of death of a member of the Armed Forces reported as missing in action or as a prisoner of war is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier.

Tax Professional Reference: For other tax information for members of the Armed Forces, see **Publication 3**, *Armed Forces' Tax Guide*.

6. **Military or Terrorist Actions:** The decedent's income tax liability is forgiven if, at death, he or she was a military or civilian employee of the United States who died because of wounds or injury incurred:
- a. while a U.S. employee, and
 - b. in a military or terrorist action.
7. The forgiveness applies to the tax year in which death occurred and for any earlier tax year, *beginning with the year before* the year in which the wounds or injury occurred.

EXAMPLE: The income tax liability of a civilian employee of the United States who died in the current year because of wounds incurred while a U.S. employee in a terrorist attack that occurred 4 years prior, will be forgiven for the current year and for all prior tax years. Refunds are allowed for the tax years for which the period for filing a claim for refund has not ended.

8. **Military or terrorist action defined:** A military or terrorist action means the following:
- a. Any terrorist activity that most of the evidence indicates was directed against the United States or any of its allies.
 - b. Any military action involving the U.S. Armed Forces and resulting from violence or aggression against the United States or any of its allies, or the threat of such violence or aggression.
9. Terrorist activity includes criminal offenses intended to coerce, intimidate, or retaliate against the government or civilian population. Any multinational force in which the United States is participating is treated as an ally of the United States.

Tax Professional Note: Military action does not include training exercises. In **determining if a terrorist activity or military action has occurred**; you may rely on published guidance from the IRS to determine if a particular event is considered a terrorist activity or military action.

10. **Claim for Credit or Refund:** If any of these tax-forgiveness situations applies to a prior year tax, then any tax paid for which the period for filing a claim has not ended will be credited or refunded. If any tax is still due, then it will be cancelled. The normal period for filing a claim for credit or refund is 3 years *after* the return was filed or 2 years *after* the tax was paid, whichever is later.
11. If death occurred in a combat zone or from wounds, disease, or injury incurred in a combat zone, then the period for filing the claim is extended by:
- a. The amount of time served in the combat zone (including any period in which the individual was in missing status), **plus**
 - b. The period of continuous qualified hospitalization for injury from service in the combat zone, if any, **plus**
 - c. The next 180 days.
12. Qualified hospitalization means any hospitalization outside the United States and any hospitalization in the United States of not more than 5 years.
13. This extended period for filing the claim also applies to a member of the Armed Forces who was deployed outside the United States in a designated contingency operation.
14. For purposes of filing a claim, use the following procedures:
- a.. If a **Form 1040** has not been filed, then you should make a claim for refund of any withheld income tax or estimated tax payments by filing **Form 1040**. (Form W-2, Wage and Tax Statement, must accompany all returns.)
 - b. If a **Form 1040** has been filed, make a claim for refund by filing **Form 1040X**. You must file a *separate* **Form 1040X** for each year in question.
15. These returns and claims are filed at the following address for regular mail:
- Internal Revenue Service
333 W. Pershing, P5-6503
Kansas City, MO 64108

16. Identify all returns and claims for refund by writing “Iraq-KIA,” “Enduring Freedom-KIA,” “Kosovo Operation-KIA,” “Desert Storm-KIA,” or “Former Yugoslavia-KIA” in bold letters on the top of page 1 of the return or claim. On **Form 1040** and **Form 1040X**, write the same phrase on the line for total tax. If the individual was killed in a terrorist or military action, then put “KITA” on the front of the return and on the line for total tax.
17. Include an attachment showing the computation of the decedent’s tax liability and a computation of the amount to be forgiven. On joint returns, make an allocation of the tax as described below under *Joint returns issues* below. If you cannot make a proper allocation, then attach a statement of all income and deductions allocable to each spouse and the IRS will make the proper allocation for the taxpayer.
18. You must attach **Form 1310** to all returns and claims for refund. However, for exceptions to filing **Form 1310**, see **Form 1310** exceptions discussed previously.
19. You must also attach proof of death that includes a statement that the individual was a U.S. employee on the date of injury and on the date of death and died as the result of a military or terrorist action.
20. For military and civilian employees of the Department of Defense, attach **DD Form 1300**, Report of Casualty. For other U.S. civilian employees killed in the United States, attach a death certificate and a certification (letter) from the federal employer. For other U.S. civilian employees killed overseas, attach a certification from the Department of State.
21. If you do not have enough tax information to file a timely claim for refund, then you can suspend the period for filing a claim by filing **Form 1040-X**. Attach **Form 1310**, any required documentation currently available, and a statement that you will file an amended claim as soon as you have the required tax information.
22. **Joint returns issues:** If a joint return was filed, then only the decedent’s part of the income tax liability is eligible for forgiveness. Determine the decedent’s tax liability as follows:
 - a. Calculate the income tax for which the decedent would have been liable if a separate return had been filed.

- b. Calculate the income tax for which the spouse would have been liable if a separate return had been filed.
- c. Multiply the joint tax liability by a fraction. The numerator of the fraction is the amount in (a), above. The denominator of the fraction is the total of (a) and (b).

The resulting amount from (c) above is the decedent's tax liability eligible for forgiveness.

W. Income Tax Benefits of Survivors of the Decedent

1. Survivors can qualify for certain benefits when filing their own income tax returns.
2. **Joint return by surviving spouse:** A surviving spouse can file a joint return for the year of death and may qualify for special tax rates for the following 2 years, as explained under *Qualifying widows and widowers*, later.
3. **Decedent as a dependent:** If the decedent qualified as a dependent or a part of the year before death, then you can claim the exemption for the dependent on the tax return, regardless of when death occurred during the year.
4. If the decedent was a qualifying child, then you may be able to claim the child tax credit or the earned income credit.
5. **Qualifying widows and widowers:** If a spouse died within the 2 tax years preceding the year for which return is being filed, then the survivor may be eligible to claim the filing status of qualifying widow(er) with dependent child and qualify to use the married-filing-jointly tax rates.
6. **Requirements:** Generally, a taxpayer may qualify for this special benefit if the taxpayer meets all of the following requirements:
 - a. Survivor was entitled to file a joint return with spouse for the year of death whether or not actually filed jointly,
 - b. Survivor did not remarry *before the end* of the current tax year,

- c. Survivor had a child, stepchild, or foster child who qualifies as a dependent for the tax year,
- d. Survivor provides *more than* half the cost of maintaining a home, which is the principal residence of that child for the entire year except for temporary absences.

EXAMPLE: Joe's wife died 2 years ago. Joe has not remarried and continued for the next 2 years to maintain a home for himself and his dependent child. For the year of death he was entitled to file a joint return for himself and his deceased wife. For the next 2 years, he qualifies to file as a qualifying widower with dependent child. For later years, he may qualify to file as a head of household since he has a qualifying child.

Tax Professional Reminder: The last year that a survivor can file jointly with, or claim an exemption for, a deceased spouse is the year of death.

Supplement

Form 1041

- **Simplex Trust (S-1 to S-3)**
- **Complex Trust - Final Year with Capital Losses (C-1 to C-5)**
- **Estate (E-1 to E-4)**