KANSAS PROBATE AND ESTATE ADMINISTRATION

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III. Handling Tax Reporting Obligations

Stephen M. Johnson, Presenter

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A. Decedent's Final Income Tax Returns
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III. Handling Tax Reporting Obligations

Stephen M. Johnson[1]

For this session, we pull our focus back away from Kansas probate law, and pan our lens out to a related but different picture: state and federal taxes. As we survey the canvas of the tax landscape, we will explore three types of tax returns – individual, fiduciary, and inheritance taxes - to see both the big picture and how each tax's intricate parts fit together. Probate law is the exclusive province of state law, but tax law weaves federal and state (or even local) threads into the probate tapestry.[2] Kansas has fiduciary income taxes, but no state level estate, gift, or generation skipping transfer (GST) taxes.[3]

When a person dies, all his or her assets (and liabilities) become his or her estate.[4] And like a living person, a decedent's estate or trust will have streams of income and expenses.[5] But the decedent may well also distribute waves of gifts or inheritances that flow to the beneficiaries.[6]

A decedent's estate must file tax returns on the decedent's behalf to show these income and expense streams or account for these waves of money flowing to family members or charities. These tax returns could include (1) her final Form 1040 individual income tax return, (2) her estate and/or trust's Form 1041 fiduciary income tax return, (3) her estate's Form 706 estate tax return, (4) her estate's Form 709 gift tax return, and/or (5) her estate's Form 709 GST return.[7] This universe of five tax returns boils down to a nebula of three types of returns, which cover two kinds of taxes – income taxes (1040 and 1041) and gratuitous transfer taxes (706 and 709). We explore the tax landscape contours in turn.

A. Decedent's Final Income Tax Return: Form 1040

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[2] K.S.A. §59-101 et seq.; V.A.M.S. §473.010 et seq.

[3] K.S.A. §79-3220(c) et seq.; V.A.M.S. §143.311. Some states or local areas have estate, gift, or GST taxes, so an attorney should be alert for those issues. Charles J. Andres and D. Michael Dwyer, eds., *Probate and Trust Administration After Death* (7th ed. 2008) ("Kansas Probate Handbook"), §§5.2-5.4. K.S.A. §79-15,253; V.A.M.S. §§145.011 – 145.955.

[4] A person's death and the simultaneous birth of the estate triggers the probate law, K.S.A. §§59-101 et seq., or V.A.M.S. §§473.010 et seq.

[5] Navigating the decedent's income and expense streams is like picking a fly or fishing lure, reading the water, and casting the line into the water to catch a fish – where you fish, when you fish, what you fish with, and your skill as a fisherman affects what you catch.

[6] In our fishing metaphor, these waves are like daily releases of trout in a trout stream, or like ocean waves crashing on a beach.

[7] Select federal and Kansas forms and schedules are in the appendix.

The decedent's final Form 1040 due date is the same as if the decedent lived for the whole tax year.[8] For a decedent who filed her Form 1040 on a fiscal year, the final Form 1040 will be due on the 1st day of the 4th month after the close of her final tax year.[9] The final Form 1040 covers the decedent's income from January 1 through the decedent's date of death, while the Form 1041 captures income from the decedent's date of death through December 31.[10] The decedent's personal representative files the decedent's final Form 1040 on the decedent's behalf.[11] If the decedent was married at death, the decedent's personal representative can file a joint Form 1040 with the decedent's surviving spouse.[12] The decedent's short year final Form 1040 can "produce tax savings": "income earned in only part of a year is entitled to a full year's exemption and full standard deduction, if claimed."[13] Since all of an individual's income and deduction items are the same for a decedent's return, the decedent's personal representative must determine the decedent's gross income and various applicable deductions for the decedent's final tax year.[14]

1. *Net Investment Income Tax (NIIT)*

Passive activities may trigger net income investment taxes for an estate or trust.[15] Form 8960 is filed with the IRS to report NIIT, a tax added to the federal income tax landscape by the Affordable Care Act (2010). For individuals, the NIIT applies if a U.S. citizen or legal resident has net investment income (NII) and modified adjusted gross income over $250,000 if married filing jointly, $200,000 if single and head of household, or $125,000 if married filing separately. Individual taxpayers report NIIT tax from Form 8960 on Line 60, box b (page 2) of Form 1040.

The NIIT can apply to individuals, estates, and trusts. The NIIT is a 3.8% Medicare contribution tax on NII of some taxpayers effective for 2013 and beyond. NII includes interest (including substitute interest), dividends (including constructive dividends, and distributions treated as dividends), non-qualified annuities, royalties, rents (other than income derived in the ordinary course of a trade or business that is not a passive trade or business), trades and businesses the client is passively involved in or trades or businesses that consist of trading financial instruments or commodities, investment of working capital, and some capital gains.[16] NII does <u>not</u> include: sale of some active interests in partnerships and S corporations, distributions from certain qualified plans, or self-employment income.

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[8] Code §6072(a); Treas. Reg. §1.6072-1(b).

[9] Treas. Reg.§ 1.6072-1(b).

[10] Jonathan G. Blattmachr and F. Ladson Boyle, *Blattmachr on Income Taxation of Estates & Trusts* (PLI, 16th ed. 2014), §2:1 – 2:2. This assumes the decedent was a calendar year taxpayer, which most individuals are; as one commentator notes "Fiscal year individuals are most rare." *Id*., §2:2.

[11] *Id*., §2:2.

[12] Code §6013(a)(2); Blattmachr, *Income Taxation*, §2:2.

[13] Blattmachr, *Income Taxation*, §2:2.

[14] *Id*., §2:2.

[15] Code §1411 (NIIT); Treas. Regs. §§1.1(i)-1T, 1.1411-4 ("net investment income" defined), 1.1411-5, 1.1411-6 (working capital investment), 1.1411-7 (exclusion for sale of active interests in partnerships and S corps), 1.1411-8 (exclusion for qualified plan distributions), 1.1411-9 (exclusion for self-employment income); Form 8960 instructions; Acker, *Income Taxation*, A-64 – A-75.

[16] See e.g. Publication 550; Publication 559, pp. 15-24 (Form 1041); Publication 925.

Estates and trusts, unless specifically exempted from the NIIT, have NIIT liability if they have undistributed net investment income and their adjusted gross income is over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year. For estates and trusts, the 3.8% NIIT tax applies to the lesser of (a) undistributed net investment income or (b) mount of AGI in excess of the dollar amount at which the highest tax bracket applicable to an estate or trust begins for the tax year. Estates and trusts report and pay NIIT on Form 1041.

NIIT Trust Exemptions
The NIIT does not apply to trusts (1) which are exempt from federal income taxes, (2) whose unexpired interests (present or future interests) are devoted to charitable purpose(s), (3) grantor trusts, (4) or trusts not classified as trusts for federal income tax purposes.[17]

The personal representative can choose where some deductions or exclusions are taken. Examples include medical expenses, reinvested gains from condemnation awards, prorated depreciation, tax-free Code §1031 exchanges.[18] For these items, the fiduciary or personal representative should consider advantageous tax treatment and best interests. As we will discuss later, when allocating deductions to a particular tax return that can be taken on a variety of tax returns, the estate or trust and its fiduciary need to seek out accounting, tax, and/or legal counsel to make a wise decision – tax allocation questions often need to be answered case-by-case with a tailored solution.

B. Fiduciary Income Tax Return: Form 1041

1. *Fiduciary: To Appoint or Not to Appoint*
A fiduciary is (1) a person who (2) acts for another person's benefit, and (3) is bound to act in that other person's best interest.[19] Fiduciary relationships include a personal representative, executor, administrator, guardian, conservator, or a trustee.[20] When a fiduciary or personal representative is appointed to represent an estate and/or a trust in the decedent's place, the individual or corporate fiduciary will owe duties to the estate and/or trust: duties of loyalty, of care, of serving the estate and/or trust's best interest, and so on.[21] Justice Benjamin Cardozo wrote a fiduciary duty is very high indeed: "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is … the standard of behavior… the level of conduct for fiduciaries [is] …. kept at a level higher than that trodden by the crowd."[22] A Kansas fiduciary has various duties: (1) the duty to administer the estate in good faith, (2)

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[17] Code §§170(c)(2)(B), 671-679, 1411(e)(2); Prop. Reg. §1.1411-3(b).
[18] *Id.*, §2:2.
[19] Bryan A. Garner, *Black's Law Dictionary* (8th ed., 2004), 658.
[20] K.S.A. §§59-102(2) (personal representative), 59-102(3) (fiduciary), 59-701 (executor), 59-705 (administrator), 59-3051(d) (conservator), 59-3051(e) (guardian), 58a-103(19) (trustee). Giving bond is a pledge of the fiduciary's call to duty. K.S.A. §§58a-702 (trustee's bond); 59-1101 ("Every fiduciary … before entering upon the duties of his … trust shall execute and file a bond").
[21] *Black's Law Dictionary*, 545.
[22] *Meinhard v. Salmon*, 249 N.Y. 458, 464 (N.Y. 1928) (Cardozo, J.)

the duty of loyalty "solely" to the beneficiaries' interests, (3) the duty of impartiality, (4) the duty of prudent administration, and (5) the duty to inform and report.[23]

Once a fiduciary has been appointed, the best practice is to file a Form 56 with the IRS, alerting the Service of the fiduciary's existence and role.[24] Once a fiduciary has been appointed and finished its duties, the fiduciary may be relieved of further liability by filing a written notice and evidence of the fiduciary role termination with the IRS.[25]

But appointing a fiduciary may not always be in the estate's or the proposed fiduciary's best interest.[26] A fiduciary takes on personal liability in her official role in the estate, so if a tax deadline is missed or a tax lien is imposed, the IRS can sue her and pursue her individually for the taxes, not just her in her fiduciary capacity for the estate.[27] If appointing a fiduciary is deemed unwise or infeasible for an estate, Kansas probate law allows an estate to be settled without appointing a fiduciary, including by a determination of descent.[28]

2. *Fiduciary Taxes*

Regardless of whether a fiduciary is appointed, a Form 1041 fiduciary income tax return reflects estate and/or trust income and may need to be filed with the IRS.[29] An estate files Form 1041 if the estate had: (1) gross income of at least $600 for the tax year or (2) a nonresident alien beneficiary.[30] A trust files Form 1041 if the trust had: (1) any taxable income for the tax year, (2) gross income of at least $600 for the tax year, or (3) a nonresident alien beneficiary.[31] Schedule K-1 (of Form 1041) is used to report an estate and/or trust beneficiary's share of income, deductions, credits, or other items.[32] When the Form 1041 is filed, each beneficiary's share would be reflected on their individual Schedule K-1 (of Form 1041), which flows into their Form 1040 income tax returns, regardless of what property form of their share takes. Form 1041 and the Schedule K-1 exhibit a tax symmetry: the Form 1041 reports the estate or trust's macro income tax picture, while the Schedule K-1 tells each beneficiary (1) who received a distribution or

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[23] K.S.A. §§58a-801 (administer), 58a-802 (loyalty), 58a-803 (impartiality), 58a-804 (prudent administration), 58a-813 ("reasonably inform" and report to trust beneficiaries). The 58a-801 administration duty is read through 58a-804's prudent administration lens. Prudent administration requires the trustee to "exercise reasonable care, skill, and caution." K.S.A. §58a-804. The duty to administer includes taking "reasonable steps to take control of and protect the trust property" and collect trust property from a prior trustee. K.S.A. §§58a-809, 58a-812. The trustee also takes "reasonable steps" to (1) "enforce" the trust's claims and (2) "defend" the trust against claims. K.S.A. §58a-811.

[24] Code §6903; Treas. Reg. §301.6903-1(b); Blattmachr, *Income Taxation*, §2:2. The author commends Edward Jones' fine *2015 U.S. Master Tax Guide* and *2015 U.S. Master Estate & Gift Tax Guide*.

[25] Treas. Reg. §301.6903-1.

[26] Andres, *Kansas Probate Handbook*, §§5.1.2(b), 5.1.6(b)(2), 5.2.11(a), 5.5.2.

[27] Andres, *Kansas Probate Handbook*, §5.1.6(a).

[28] K.S.A. §59-2250. In Missouri, this is a determination of heirship. V.A.M.S. §473.663.

[29] Frederick M. Sembler & Michael J. Feinfeld, *Planning an Estate* (4th ed., 2014-2015), §§15:3-15:4.

[30] Code §§641, 6012(a)(3), (5); Form 1041 instructions, pg. 4. Alan S. Acker, *Income Taxation of Trusts and Estates*, Bloomberg BNA (852-4th, 2014), A-75; Blattmachr, *Income Taxation*, §8:3.

[31] Code §641; Form 1041 instructions, pg. 4; Blattmachr, *Income Taxation*, §8:3.

[32] Code §6034A(a); Form 1041 instructions, pp. 36-40.

(2) to whom an allocation was made during the tax year, his or her micro income tax picture, to wit, what she needs to report on her income tax return.[33]

3. *Death and Taxes*
Benjamin Franklin wrote nothing was certain in life but death and taxes.[34] But with careful planning, taxes can be deferred and minimized.[35] Since 1917, federal income tax has been imposed on a person, their estate, and/or their trust.[36] An estate customarily applies for its own entity identification number (EIN), since it is a separate taxpayer and legal entity from the deceased person.[37] When a person dies, the estate's fiduciary or personal representative will file two tax returns for the tax year: (1) a final Form 1040 for the decedent and (2) a Form 1041 for the decedent's estate and/or trust.[38] Often both tax returns are short year returns, since they likely cover less than 12 months.[39] The final Form 1040 is filed with the IRS branch office where the fiduciary or personal representative lives.[40] Likewise, Form 1041 is filed at the IRS Service Center where the personal representative lives.[41] A final Form 1041 may be filed jointly with the decedent's surviving spouse.[42]

For future tax years, the estate and/or trust will only need to file a Form 1041, and the Form 1041 will be marked as "final" for the tax year when the estate and/or trust is fully distributed to the beneficiaries. Estate and/or trust expenses will be reported on the applicable lines or schedules of Form 1041. Some excess expenses might carry over to next year for a final year deduction. Form 1041 captures the estate and/or trust's taxable income and corresponding expenses or deductions.

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[33] Code §6034A(a). A symmetry arises between returns for other entity level and individual level taxpayers.
[34] *The Works of Benjamin Franklin* (1817) ("In this world nothing can be said to be certain, except death and taxes"). Franklin borrowed from Daniel Defoe, *The Political History of the Devil* (1726) ("Things as certain as Death and Taxes, can be more firmly believ'd") A novelist wrote: "Death, taxes and childbirth! There's never any convenient time for any of them." Margaret Mitchell, *Gone With the Wind* (1936).
[35] "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810-11 (2nd Cir. 1934) (Hand, J.). As real estate's mantra is "location, location, location," so ours is "defer, defer, defer." Keith Schiller, *Art of the Estate Tax Return (2nd ed. Bloomberg BNA 2014),* §2.5.
[36] The federal income tax arose in 1917, after the 16th Amendment (1913) cured the old tax apportionment issue. Laurence H. Tribe, *American Constitutional Law* (Foundation Press: 2nd ed., 1988), 300, n.8.
[37] Treas. Regs. §§1.645-1(d)(1), 301.6109-1(a)(3). An estate or trust can obtain an EIN by filing a Form SS-4 or applying on the IRS website.
[38] Code §§443(a)(2), 6012(b)(2). IRS Publication 559, pp. 3-15 (final Form 1040), 15-24 (Form 1041); Andres, *Kansas Probate Handbook*, §§5.5.3 (final Form 1040), 5.5.4 (Form 1041).
[39] Code §443; Treas. Reg. §1.443-1.
[40] Code §6091(b)(1)(A); Treas. Reg. §1.6091-2(a)(1).
[41] Treas. Reg. §1.6091-2(a).
[42] Code §§6013(a)(2); John R. Price and Samuel A. Donaldson, *Price on Contemporary Estate Planning* (2013), §§12.3.1 – 12.3.3.

4. *Mind the Gap: Estate and Income Taxes Dance a Tango*[43]
Just as there are three roles in a trust (grantor, trustee, and beneficiary), so a trust can be taxed in three different ways: a trust's income taxes are paid by the trust's (a) grantor, (b) trustee, or (c) beneficiary. Most trusts are designed so the trustee pays income taxes out of the trust's income and/or principal. But many trusts are designed so the grantor or the beneficiary picks up the tax bill.

Usually the trustee pays the trust's income taxes from the trust's assets, as reported on Form 1041. But trusts can be designed so the beneficiary or the grantor pays the trust's income taxes, while the trust assets are not included in the beneficiary or grantor's estate. This trust quirk arises from a 60-year-old gap between America's income and estate tax laws.[44] Some irrevocable trusts need a third party trustee to avoid income tax issues when making distributions to a beneficiary, but a beneficiary can guide the trust's investment strategy (even as "investment trustee"). Control is the hinge – if the IRS allows a person to exclude assets from their estate, the person cannot control those assets.

Normally, assets only get a stepped up basis when they are sold to a third party or inherited from someone's estate. But irrevocable trusts can give the beneficiaries a stepped up basis (without including the assets in the grantor's estate) by either (1) substituting or swapping assets trust assets (swapping out highly appreciated assets for liquid assets with minimal (if any) appreciation) or (2) selling the trust appreciation assets in exchange for the grantor's assets or cash. A sale between a grantor trust and the grantor is disregarded and not taxable.[45]

a. *Beneficiary Defective Inheritor's Trust (BDIT)*
A beneficiary could have a beneficiary defective trust, where the trust income is taxable to the beneficiary/recipient, but the trust money is not included in the beneficiary's estate, since the trust is irrevocable and outside the beneficiary's control, while the beneficiary pays the trust's income tax bills.

b. *Intentionally Defective Grantor Trust (IDGT)*
The grantor could start an intentionally defective grantor trust, where the trust income is taxable to the grantor and the trust money is not included in the grantor's estate, since the trust is irrevocable and outside the grantor's control, while the grantor pays the trust's income tax bills.[46]

5. *Income Taxes and Revocable Trusts*
In some cases, income tax effects arise from using a revocable trust during the decedent's lifetime.[47] First, some stock losses (Code §1244) may not be allowed if the trust owns stock. Second, transferring an IRA interest could be a taxable IRA distribution. Third,

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[43] Schiller, *Art of Estate Tax,* §§6.10, 15.11; Blattmachr, *Income Taxation*, Ch. 5. Since 1969, passengers have been told to "mind the gap" on the London subway.
[44] This feature goes back to the 1954 IRS Code.
[45] Rev. Rul. 85-13.
[46]http://www.journalofaccountancy.com/Issues/2008/Nov/Intentionally+Defective+Grantor+Trusts.htm.
[47] This section draws on Blattmachr, *Income Taxation*, §9:2.

transferring an annuity contract could block income tax deferral. Fourth, transferring stock options or rights to a revocable trust could avoid "favorable tax benefits."[48] Beyond the potential income tax effects, there are a variety of other non-tax effects, which could be favorable or adverse, depending on the facts.[49] Beyond taxes, trusts often "serve the vital non-tax interest of protecting the financial interests" of the decedent's family from "conflicting agendas" - whether from other family members or from a third party.[50]

6. *Income Taxes and Revocable Trusts after Death*

When a fiduciary or personal representative has a choice between distributing an asset under the decedent's will or trust, the tax effect should be carefully weighed.[51] An estate can claim a $600 annual personal exemption.[52] Most trusts only get a $100 exemption, but trusts that must distribute all accounting income get a $300 personal exemption.[53] A trust can take various income tax deductions after the grantor's death.[54]

7. *Kansas Fiduciary Income Tax*

The trustee of a Kansas trust must file a K-41 return about Kansas income.[55] The trustee of a non-Kansas trust must file a return for Kansas source income.[56] Kansas follows the IRS' treatment of grantor trusts and trustees of nongrantor trusts can take a distribution deduction.[57] Nongrantor trusts have a Kansas income tax rate of 4.60%.[58]

8. *Tax Selection: Calendar Year vis-à-vis Fiscal Year*

The estate or trust's personal representative can select the tax year.[59] Taxable income is calculated for the taxpayer's tax year, to wit, the annual accounting period the taxpayer uses to track income for in the books and records.[60] The taxpayer can usually elect to use

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48 Blattmachr, *Income Taxation*, §9:2.

49 *Id.*

50 Schiller, *Art of Estate Tax,* §2.1 (and related QTIP discussion).

51 This section draws on Blattmachr, *Income Taxation*, §9:3. Often where "[tax] differences arise, they … favor property passing by will rather than by revocable trust," but sometimes "a revocable trust['s]" "postmortem tax effect" is "better." Blattmachr, *Income Taxation*, §9:3.

52 Code §642(b); Treas. Reg. §1.642(b)-1; Blattmachr, *Income Taxation*, §9:3.

53 Blattmachr, *Income Taxation*, §9:3.

54 Blattmachr, *Income Taxation*, §9:3.

55 See Richard W. Nenno, *State Income Taxation of Trusts* (Bloomberg BNA Tax Portfolio 869, 2013), A-58 – A-59. K.S.A. §79-32, 109(d). Similarly, the trustee of a Missouri trust must file a Missouri MO-1041 return if a federal Form 1041 is due. Nenno, *State Income Taxation of Trusts*, A-61 – A-62. V.A.M.S. §§143.481(3), (5).

56 K.S.A. §§79-3220(c); 79-32, 110(d); 79-32, 134; 79-32, 136; 79-32, 1375. Likewise, the trustee of a trust administered outside of Missouri must file a Missouri return for Missouri source taxable or gross income of $600 or more. V.A.M.S. §§143.481(3), (5).

57 K.S.A. §§79-32, 116, 79-32, 117; 79-32, 134. Missouri also follows the IRS' treatment of grantor trusts and trustees of nongrantor trusts can take a distribution deduction. V.A.M.S. §§143.011, 143.111, 143.121; 143.431.

58 K.S.A. §§79-32, 110(a)(2)(B)-(G). Andres, *Kansas Probate Handbook*, §5.2.12. Kansas recently overhauled its income tax law. Martin B. Dickinson, Stephen W. Mazza & Michael R. Keenan, "The Revolutionary 2012 Kansas Tax Act," 61 Kan. L. Rev. 295 (2012). In Missouri, nongrantor trusts have a Missouri income tax rate of up to 6% on Missouri source income over $9,000. V.A.M.S. §§143.011, 143.061. Missouri trusts do not owe estimated tax payments. MO-1041 instructions, pg. 1.

59 Sembler, *Planning an Estate*, §§15:13 – 15:15.

60 Code §441.

a calendar or fiscal year, unless certain rules apply.[61] A calendar tax year begins January 1 and ends December 31, while a fiscal tax year is more flexible: any "12 month period ending on the last day of any month other than December."[62] A small estate, which closes in under one year, can pass an excess deduction to the beneficiaries.[63]

a. *Estate Tax Year*
An estate can choose a calendar or fiscal year to file its Form 1041.[64] The Form 1041 filing deadline depends on whether the estate is a calendar year or fiscal year taxpayer. This in turn hinges on how the initial fiduciary income tax return was filed. (It is possible, albeit difficult, to change the estate's tax year with the IRS' consent.) A calendar year estate must file its Form 1041 by April 15, while a fiscal year estate must file its Form 1041 by the 15th day of the 4th month after the tax year closes.[65] An estate can elect a tax year as long as (1) the tax year ends of the last day of the month and (2) the year only has 12 months. An estate's tax year is elected when the initial Form 1041 is filed, by entering the start and end dates at the top of Form 1041 ("For calendar year 2014 … and ending…"). E-filing a Form 1041 does not appear to not allowed: addresses to mail a paper Form 1041 to the IRS are provided in the 1041 instructions, depending on where the estate is located and whether a check or money order are enclosed.[66]

Most taxpayers, including estates, file on a calendar year basis unless there is some reason to be a fiscal year taxpayer.[67] While most executors want to finish the estate administration and tax reporting process as soon as possible, it may or may not be possible to complete tax reporting in the year final distributions are made, depending on the trust's tax year and how the initial Form 1041 was filed. A short year return may be filed in some cases.[68]

b. *Trust Tax Year*
Most trusts are required to use calendar tax years.[69] If a trust's terms call for its termination upon an event's occurrence, the trust tax year does not end when the event occurs. Instead, the trustee has a reasonable time after the event's occurrence to finish trust administration.[70] While a trust must use a calendar year, a trust beneficiary is not required to use a calendar year for its tax year, so the trust and its beneficiary could each

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[61] Treas. Reg. §1.441-1. Code §444 does not allow estates and trusts to make the election.
[62] Code §441(e); Acker, *Income Taxation*, A-31.
[63] Code §642(h).
[64] Code §443, 7701(a)(1), (14); Acker, *Income Taxation*, A-31; Andres, *Kansas Probate Handbook*, §5.5.7(a).
[65] Code §6072(a); Form 1041 instructions, pg. 8; Price, *Contemporary Estate Planning*, §12.7.
[66] Form 1041 instructions, pg. 8
[67] See Caron Beesley's blog post on the Small Business Administration's website, available at (https://www.sba.gov/blogs/calendar-or-fiscal-which-tax-year-right-your-small-business). Calendar year is the default choice. If a taxpayer attempts to elect a fiscal year, but does not have an annual accounting period, does not keep good books or records, or the current tax year does not qualify as a fiscal year, the IRS will require the taxpayer to use a calendar year. Treas. Reg. §1.441-1.
[68] Code §443; Treas. Reg. §1.443-1.
[69] Code §644(a); Blattmachr, *Income Taxation*, §§3:7.3, 9:3; Price, *Contemporary Estate Planning*, §10.4.15.
[70] Treas. Reg. §1.641(b)-3(b); Blattmachr, *Income Taxation*, §3:7.3.

have a distinct tax year. If the §645 election is made, the estate and the trust use the same fiscal year.[71]

9. *When to File Form 1041*[72]

When choosing between a calendar tax year and a fiscal tax year for an estate, the calculus will vary based on different variables. The estate could have (1) IRA income, (2) IRD issues, (3) a capital gain, or (4) fiscal year reporting could determine when the money is taxed to the beneficiaries.[73] The tax year choice can be used to: (1) finesse income and defer income taxes, (2) match the estate's and/or trust's best interest with the beneficiary's best interest, (3) sync income reporting so there is only one tax return to file when the probate estate is settled, (4) handle tax losses so losses reflected on the final return flow through to the beneficiaries for items like attorney's fees and itemized deduction items on Schedule A (of Form 1040), and (5) allow the estate and trust to be treated as one taxpayer via the §645 election.[74] Assuming the estate meets the Form 1041 threshold requirements, the Form 1041 must be filed on either a calendar or fiscal year basis as described above. In some cases, it is possible to coordinate or sync the tax years to minimize the number of returns that must be filed, even to one return for the tax year. The estate's personal representative or executor files both returns, by April 15 of the year after the tax year.[75]

10. *IRD and DRD*

Income in respect of a decedent (IRD) is income due and payable, but not yet realized by the decedent at death.[76] IRD money is earned by the taxpayer *before* death, but not actually paid until *after* death.[77] IRD is reported on the Form 1041, not the final Form 1040, if the money was received after the decedent's death. IRD money is taxed the same way in the beneficiary's hands as the income would have been taxed in the decedent's hands while the decedent was alive. If the estate or someone else entitled to IRD transfers their right to IRD before receiving and reporting the IRD as income, the transfer may trigger accelerated IRD reporting.[78]

The income tax's architecture squares nicely: IRD has a parallel provision in deductions in respect of a decedent (DRD).[79] Just as IRD is income earned during the decedent's life

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[71] Blattmachr, *Income Taxation*, §9:3.
[72] Form 1041 instructions, pg. 8.
[73] Natalie Choate, *Life and Death Planning for Retirement Benefits* (7th ed. 2011). This raises the fiduciary's loyalty stake (whose duty lies with the estate), since a beneficiary may seek a favorable tax election vis-à-vis the estate. And what if the fiduciary is also a beneficiary?
[74] A fiscal year estate can finesse distribution timing: a beneficiary who receives a distribution in one calendar year may not need to report the income until the next calendar year, since a beneficiary's income is deemed distributed on the last day of the estate's fiscal year, regardless of when the distribution was paid. Code §662(c); Acker, *Income Taxation*, A-31; Andres, *Kansas Probate Handbook*, §5.5; Price, *Contemporary Estate Planning*, §§12.7, 12.9 - 12.10.
[75] Code §6012(b)(1); Treas. Reg. §1.6072-1(b).
[76] Code §691.
[77] Blattmachr, *Income Taxation*, §2:3; Alan S. Acker, *Income in Respect of a Decedent*, Bloomberg BNA (862-3rd).
[78] Code §691(a)(2); Blattmachr, *Income Taxation*, §2:3.2.
[79] Code §691(b); Blattmachr, *Income Taxation*, §2:3.3.

but not paid until after the decedent's death, so DRD are expenses accrued during the decedent's life but not paid until after the decedent's death. But the income tax geometry is imperfect: DRD cuts a narrower swath than IRD.[80]

11. *The §645 Election: Treating a Trust as Part of an Estate*

Code §645 looks at treating an estate and a trust as one - an estate and trust's income tax returns need not be filed separately, despite having distinct EINs.[81] A qualified revocable trust (QRT) may elect to be treated as part of the decedent's estate using Form 8855.[82] This treatment is desirable if reporting trust income on a fiscal year basis would be beneficial, as estates may file on a fiscal year basis, but trusts cannot. The §645 election is irrevocable and must be made by the filing deadline for the estate's first Form 1041.[83]

The trustee of the trust and the executor of the estate make the §645 election by filing Form 8855.[84] If there's no executor of the client's estate, the trustee can make the §645 election unilaterally.[85] While the §645 election stands, the estate's executor files one Form 1041 for the estate *and* the trust under the estate's name and EIN.[86] But the §645 election doesn't affect the estate's and trust's separate treatment for tax procedure and administration questions, only for income tax purposes. An estate's 2 year estimated tax payment exception applies to a trust making the §645 election.[87]

The §645 election stands until the "applicable date," which is the later of (a) 2 years after the decedent's death or (b) 6 months after estate tax liability is determined.[88] When an estate makes a valid §645 election, the estate doesn't terminate until the earlier of (a) the "applicable date" or (b) the day when the qualified revocable trust <u>and</u> the estate have distributed all their assets.[89] The final estate tax day is (the applicable date's prong "b") is the earliest of (a) 6 months after an estate tax closing letter is issued, (b) the final disposition of a refund claim resolving estate tax liability, (c) execution of a settlement agreement resolving estate tax liability, (d) a court decision or order resolving estate tax liability, or (e) the statute of limitation expiring for collecting estate taxes.[90]

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[80] DRD eligible expenses include trade or business expenses (Code §162), deductible interest (Code §163), deductible taxes (Code §164), investment expenses (Code §212), and the depletion deduction (Code §611). Blattmachr, *Income Taxation*, §2:3.3. Unfortunately, DRD does not include alimony due before the decedent's death and paid after death, losses deductible under Code §§165-166, the charitable deduction carryover, the net operating carryover, the capital loss carryover, or the decedent's unpaid medical expenses. *Id.*

[81] Andres, *Kansas Probate Handbook*, §5.5.7(d); Price, *Contemporary Estate Planning*, §10.15.

[82] A QRT is a revocable trust created before death. While the decedent is alive, the QRT's income is taxable under the grantor trust rules. The trust agreement will specify QRT status. Code §645(b)(1).

[83] Code §645(c); Treas. Regs. §§1.645-1(c), 1.645-1(1)(e)(1).

[84] Treas. Reg. §1.645-1(c)(1)(i).

[85] Treas. Reg. §1.645-1(c)(1)(i).

[86] Treas. Reg. §1.645-1(e)(2)(ii).

[87] Code §6654(1)(2)(A); Treas. Reg. §1.645-1(e)(4).

[88] Code §§645(a), 645(b)(2); Treas. Reg. §1.645-1(f)(2)(ii).

[89] Treas. Reg. §1.641(b)-3.

[90] Code §6501; Treas. Reg. §1.645-1(f)(2)(ii).

The §645 election doesn't relieve the trust from filing an initial Form 1041 for the tax year ending with the client's death, but the trustee doesn't need to file Form 1041 for the short year of the trust (from the client's death until December 31).[91]

a. *§645 Impacts on Form 1041*

The §645 election has five impacts on Form 1041. First, the estate's and trust's income, deductions, and credit are combined, and only one personal exemption is allowed.[92] Second, the executor and trustee must reasonably apportion tax liability between the estate and trust.[93] Third, the executor and trustee must timely pay the estate and trust's shares of the tax bill.[94] Fourth, the estate and trust are treated as separate shares for calculating distributable net income (DNI) and certain distributions.[95] Fifth, a charitable deduction is granted to the estate and trust.[96]

b. *§645 Advantages and Disadvantages*

The §645 election has various advantages and disadvantages, which must be weighed. A §645 election does not allow (a) splitting income with another taxpayer and (b) allocating depreciation or depletion between the fiduciary and beneficiaries may be better for a trust than an estate. But the §645 election allows (a) the ability to use a non calendar year, (b) to deduct some passive losses, (c) to deduct and amortize some reforestation expenses, (d) to receive a charitable deduction beyond unrelated business income.[97]

12. *DNI*

Distributable net income (DNI) is the trust income ready to distribute to trust beneficiaries.[98] DNI is also income ceiling taxable to a trust beneficiary. DNI is reported on Schedule B (of Form 1041), as determined by the trust instrument. A trust's income distribution deduction is the lesser of (a) DNI or (b) distributions to beneficiary (excluding distributed tax exempt interest). Trusts must take the income distribution deduction, so trusts cannot elect to pay taxes on distributions for beneficiaries.[99] DNI is the upper limit of the income distribution deduction, which a trust can take.

13. *Trust: Simple or Complex?*

A complex trust is a trust where (1) not all income has to be distributed current, (2) that allows income to be distributed or set aside for charitable contributions, or (3) that distributes principal (including a simple trust in its final year).[100] The IRS considers a

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[91] Treas. Reg. §1.645-1(d)(2)(i).
[92] Treas. Reg. §1.645-1(e)(2)(ii).
[93] Treas. Reg. §1.645-1(c)(1)(ii).
[94] Treas. Reg. §1.645-1(c)(1)(ii).
[95] Treas. Reg. §§1.645-1(e)(2)(iii)(A); 1.663(c)-4. Code §§661 and 662. But the separate share rule only applies to allocating DNI, not to creating DNI. Treas. Reg. §1.663(c)-1.
[96] Code §642(c); Treas. Reg. §1.645-1(e)(2)(iv). Blattmachr, *Income Taxation*, §9:3 (usually an estate or trusttakes "an unlimited income tax deduction for gross income paid to a charity" under the will or trust).
[97] Passive activity losses (Code §469(i)) and charitable deduction beyond unrelated business income (Code §681(a)). A §645 election can also affect the trust's state and local taxes where state fiduciary taxes are driven by federal AGI or federal taxable income.
[98] Code §643; Treas. Regs. §§1.643(a)-0 – 1.643(a)-7; Price, *Contemporary Estate Planning*, §10.4.4.
[99] Code §§652 and 662.
[100] Treas. Reg. §1.661(a)-1.

trust a simple trust if (1) all income is distributed currently, (2) no income can be distributed or set aside for charitable contributions, and (3) the trust does not distribute principal, while any trust that does not fit those criteria is a complex trust.[101] The simple or complex trust determination is made annually based on the trust's terms. Estates follow the complex trust income tax rules.

14. *Separate Share Rule*
The separate share rule protects multiple beneficiaries of an estate or trust from paying taxes on each other's money.[102] When separate shares exist, DNI must be calculated separately for each share. The separate share rule provides that a beneficiary is taxed only on the income belonging to and distributed to that beneficiary's separate share. The separate share rule keeps a beneficiary from being taxed on all DNI being distributed, including income paid to another beneficiary. Separate share calculations and each beneficiary's DNI should be reported on separate statements attached to Form 1041.

B. Inheritance Tax Reporting: Forms 706 & Form 709

The Form 1041 fiduciary income tax return is distinct from the Form 706 estate tax return and the Form 709 gift tax return. Form 706 needs to be filed if (1) estate tax is owed or (2) the surviving spouse elects portability. And Form 709 needs to be filed if the decedent made a gift to a family member or friend of more than annual exclusion amount or beyond the lifetime gift tax exemption, or non-exempt generation skipping gifts.[103] Inheritance taxes are paid by the donor, not the recipient.

1. *Estate Tax*
America's estate tax debuted in 1916 to help fund the Great War.[104] Estate taxes are owed when a person dies with a gross estate that exceeds the estate tax's lifetime threshold.[105] For 2014, an estate's first $5.34 million was exempt from estate tax; and for 2015, the first $5.43 million is exempt.[106] The estate tax is 40% of the amount the gross estate is over the threshold. The estate tax is computed by subtracting certain deductions from the gross estate and reported on Form 706.[107]

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[101] Code §§651-652; Treas. Reg. §1.651(a)-1; Price, *Contemporary Estate Planning*, §10.49. Code §§661-663, Price, *Contemporary Estate Planning*, §16.4.10. Allocate a simple trust's deduction. Treas. Reg. §1.652(b)-3.
[102] Code §663(c); Treas. Regs. §§1.663(c)-1 - 1.663(c)-5; Price, *Contemporary Estate Planning*, §12.37.
[103] Code §§2503(b) and 2505(a).
[104] See the IRS history (http://www.irs.gov/pub/irs-soi/ninetyestate.pdf). The estate tax and the gift tax were linked in the IRS Code in 1932.
[105] Code §§2033-2044; Andres, *Kansas Probate Handbook*, §5.14; Price, *Price on Contemporary Estate Planning* §2.13; Sembler, *Planning an Estate*, §§2:3-2:35.
[106] Rev. Proc. 2013-35 (2014 level); Rev. Proc. 2014-61 (2015 level).
[107] Code §§2001(b) (gross estate), 2051 (taxable estate), 2053-2058 (estate tax deductions). Form 706 instructions; William M. McGovern, Jr and Sheldon F. Kurtz, *Wills, Trusts and Estates* (West, 2004), §15.3. Andres, *Kansas Probate Handbook*, §5.1.5(a). A prior transfer credit is allowed against the estate tax (Code §2013). Schiller, *Art of Estate Tax*, §§2.3-2.4.

Form 706 includes various schedules depending on a case's facts.[108] The Form 706 estate tax is filed in person at the local IRS office or by mail in Cincinnati, Ohio, but cannot be efiled.[109] Late filing penalties for a Form 706 estate tax return can be substantial.[110]

Estate beneficiaries receive a stepped up basis in each asset.[111] A protective special use valuation election is available.[112] No payment extension is available.[113] Estate tax liens may be imposed if the full tax owed is not paid promptly.[114] The marital deduction and charitable deduction are powerful tools to reduce estate tax owed.[115] The Form 706 estate tax return is due within 9 months after the decedent's date of death.[116] A sample cover letter and required documents checklist should be consulted.[117]

2. *Gift Tax*

America's gift tax was added to the IRS Code in 1932.[118] A gift occurs when one person transfers an asset to someone else in exchange for less than the asset's fair market value.[119] Depending on the amount involved and the timing, gift tax could be owed.[120] If gift tax is owed, it is up to a 40% federal gift tax on any gift over the annual exclusion amount ($14,000 per recipient) or the lifetime exclusion amount ($5.34 million in 2014 or $5.43 million in 2015), along with filing a Form 709 to report the gift's taxable portion.[121]

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[108] Schedules B, C, D, E, F, G, H, I, J, K, L, M, O, P, Q, R, and U. Schiller, *Art of Estate Tax*, Chs. 10-26, respectively.

[109] Schiller, *Art of Estate Tax*, §5.2.

[110] Schiller, *Art of Estate Tax*, §§5.6, 5.8, Ch. 27. Jonathan G. Blattmachr, Mitchell M. Gans, and Damien Rios, *The Circular 230 Deskbook* (PLI, 2015), §3:2.2.

[111] Code §1014; Price, *Price on Contemporary Estate Planning* §2.15.

[112] Andres, *Kansas Probate Handbook*, §5.1.4(c)(3). Valuation disputes often trigger estate tax audits. Schiller, *Art of Estate Tax,* §4.6. Schiller, *Art of Estate Tax*, Ch. 9 (special use valuations).

[113] Code §§6151(a), 6311; Treas. Reg. §301.6311-2; Andres, *Kansas Probate Handbook*, §5.1.5(d).

[114] Code §§6321, 6323; Andres, *Kansas Probate Handbook*, §5.1.2.

[115] Code §2056, 2055(a); Andres, *Kansas Probate Handbook*, § 5.1.3(b), (d). The marital deduction only applies to a U.S. citizen surviving spouse. If the surviving spouse is not a U.S. citizen, a qualified domestic trust (QDOT) can be used. Code §2056A; Blattmachr, *Income Taxation*, §2:3.5.

[116] Code §6075(a); Treas. Reg. §20.6075-1. An estate tax return's due date is a nondelegable fiduciary duty. *U.S. v. Boyle*, 469 U.S. 241 (1985); Schiller, *Art of Estate Tax*, §§5.1, 5.4 – 5.5. Form 4768 affords 6 extra months to file Form 706 and 12 months more to pay any estate tax owed. Form 4768 extensions are routine, but an explanation letter may be helpful. Schiller, *Art of Estate Tax*, §2.5.

[117] Treas. Reg. §20.6016-4; Andres, *Kansas Probate Handbook*, §5.1.5(b), (c).

[118] Veteran Congressman and attorney C. William Ramseyer (1875-1943) (R-Iowa) was the Congressional architect of America's estate and gift taxes. Jay A. Soled and Mitchell M. Gans, "Asset Preservation and the Evolving Role of Trusts in the Twenty- First Century," 72 Wash. & Lee L. Rev. 257 (2015); Jeffrey A. Cooper, "Ghosts of 1932: The Lost History of Estate and Gift Taxation," 9 Fla. Tax. Rev. 875 (2010). See also the IRS' history (http://www.irs.gov/pub/irs-soi/11pwcompenaddgift.pdf).

[119] Code §§2503(b), 2505(a), 2511(a); Treas. Reg. §§25.2511-1(a), (c); Andres, *Kansas Probate Handbook*, §5.1.7; Price, *Contemporary Estate Planning*, §2.4; Sembler, *Planning an Estate*, §§2:36-2:48.

[120] Schiller, *Art of the Estate Tax*, Ch. 6; Blattmachr, *Circular 230 Deskbook*, §3:2.3.

[121] Rev. Proc. 2013-35 (2014 level); Rev. Proc. 2014-61 (2015 level). A QTIP election can be made for inter vivos lifetime gifts by the gift tax return. Schiller, *Art of the Estate Tax*, §3.2.

Gift tax is paid by the donor, not the recipient. A gift recipient receives the donor's carryover basis.[122] If the gift donor is married and the donor's spouse co-owns the property, the donor and spouse could elect to gift split and give $28,000 tax free to the recipient.[123] The gift splitting election is made by checking a box on Form 709 and filing Form 709, even where no gift tax is owed.[124]

3. *Generation Skipping Transfer (GST) Tax*[125]

The GST was enacted in 1976 to deter dynastic wealth in America.[126] The GST tax is triggered by a transfer from generation one (a grandparent) to generation three (a grandchild), where generation two (the child - the grandchild's parent) is skipped.[127] GST taxes are reported on Form 709, but the GST "is the only transfer tax" often "assessed many years after the transfer."[128] For 2014, the first $5.34 million of GST is exempt; and for 2015, the first $5.43 million of GST is exempt.[129] The GST design is often used in wealthy families to transfer monies from one generation to another when the middle generation (children) is already wealthy and does not want the older generation's (grandparents) inheritance, so the inheritance skips to the younger generation (grandchildren). The child whose generation is skipped over is called a "skip person."[130] In a wealthy family, each spouse's GST exemption should be carefully allocated.[131] The GST tax is triggered by: (1) a taxable termination, (2) a taxable distribution, or (3) a direct skip.[132] A taxable termination happens when a trust interest ends (by death, time lapse, or release of power of appointment), causing a skip person to receive the trust interest.[133] A taxable distribution happens when trust income or principal are distributed to a skip person other than by a taxable termination (e.g. a normal trust distribution to a skip person).[134] A direct skip is a property transfer subject to the estate or gift tax which is made to a skip person, such as a grandparent giving a grandchild property taxable by the estate and/or gift taxes.[135] The GST also has exclusions and exemptions.[136] The GST tax rate is the maximum estate tax rate (currently 40%) times the GST inclusion ratio.[137]

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[122] Code §1015; Price, *Contemporary Estate Planning*, §2.4.5.
[123] Code §2513; Price, *Contemporary Estate Planning*, §2.7.
[124] Price, *Contemporary Estate Planning*, §§2.10, 2.10.4; Schiller, *Art of the Estate Tax,* §6.2.6.
[125] Schiller, *Art of the Estate Tax*, Ch. 25.
[126] See GST history (https://www.naepc.org/journal/issue01f.pdf).
[127] Code §§2601-2663. See McGovern, *Wills, Trusts and Estates,* §15.4; Carol A. Harrington, *Generation-Skipping Transfer Tax* (Bloomberg BNA Tax, 850-2nd, 2014); Andres, *Kansas Probate Handbook*, §5.18; and Sembler, *Planning an Estate*, §§5:27-5:36. This section draws on Thomas W. Abendroth's paper, "Ticking Timebombs of the GST Tax," to the Kansas City Estate Planning Symposium (April 23-24, 2015), on file with the author.
[128] Thomas W. Abendroth, "Ticking Timebombs of the GST Tax," 127.
[129] Rev. Proc. 2013-35; Rev. Proc. 2014-6; Price, *Contemporary Estate Planning*, §2.27.
[130] Code §2613(a); Andres, *Kansas Probate Handbook*, §5.1.8(c)(4).
[131] Price, *Contemporary Estate Planning*, §§2.29, 2.41.
[132] Price, *Contemporary Estate Planning*, §§2.24 – 2.41.9.
[133] Code §2612(a); Treas. Regs. §§26.2612-1(d), 26.2651-1, 26.2612-1(b); Andres, *Kansas Probate Handbook*, §5.1.8(d); Price, *Contemporary Estate Planning*, §§2.25.2, 2.32.3.
[134] Code §2612(b); Treas. Reg. §26.2612-1(c); Andres, *Kansas Probate Handbook*, §5.1.8(e); Price, *Contemporary Estate Planning*, §§2.25.3, 2.32.2.
[135] Code §2612(c); Treas. Reg. §26.2612-1(a); Andres, *Kansas Probate Handbook*, §5.1.8(f); Price, *Contemporary Estate Planning*, §§2.32.1, 2.38.1.

The Form 709 GST tax return must be filed by the responsible party.[138] GST tax triggered by a direct skip (not in a trust) is due when the estate or gift tax returns are due.[139] All other GST tax returns are due by the 15th day of the 4th month of the tax year close for the return year – usually April 15 after the GST triggering event.[140]

4. *GST and Income Taxes*
Where GST is due, two possible income tax deductions are available. First, where GST tax is owed from a taxable termination or a direct skip, an income tax deduction is allowed for GST taxes paid.[141] Second, if GST taxes arise on income distributions, an income tax deduction can apply.[142]

5. *Audit*
When a tax return is filed, an audit risk exists. And the best "tax audit is the one that never arises."[143] The best way to avoid an audit is to file a well documented tax return with supporting evidence and documents.[144]

6. *To Port or Not to Port: Whether to File Form 706, That is the Question*[145]
Form 706 is the fount of portability.[146] Portability is a great estate planning tool for married couples.[147] Portability began in 2010 and is now a permanent part of the estate planning landscape.[148] Just as estate planning has undergone a sweeping paradigm shift from an estate tax focus to an income tax focus, so "portability may be viewed as a paradigm shift in estate planning for married couples."[149] Portability is part of Congress' favorable treatment of married taxpayers, along with the marital deduction and unlimited gifting between married spouses. Portability is not available for a spouse's unused gift or GST tax exemptions. This may be due to dynastic wealth concerns. Portability has triggered "an explosion" of estate tax filings "where no estate tax is due."[150] Indeed, few

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[136] Code §§2611(b), 2642(c); Andres, *Kansas Probate Handbook*, §5.1.8(g); Price, *Contemporary Estate Planning*, §2.30.
[137] Code §§2641, 2642(a); Andres, *Kansas Probate Handbook*, §5.1.8(c)(5).
[138] Code §2662(a)(1); Treas. Reg. §26.2662-1(c); Price, *Contemporary Estate Planning*, §2.38.
[139] Code §2662(a)(2)(A); Price, *Contemporary Estate Planning*, §2.39.
[140] Code §2662(a)(2)(B); Blattmachr, *The Circular 230 Deskbook*, §3:2.2[A].
[141] Code §691(c)(3); Blattmachr, *Income Taxation*, §2:3.6.
[142] Code §164(a)(4), (b)(4); Blattmachr, *Income Taxation*, §2:3.6.
[143] Schiller, *Art of Estate Tax*, §§4.1, 4.5, 4.6.
[144] Schiller, *Art of Estate Tax*,§4.2.
[145] With apologies to Hamlet, Act III, Scene i, Line 57. Jonathan G. Blattmachr, Austin W. Bramwell, and Diana S.C. Zeydel, "Portability or No: The Death of the Credit Shelter Trust?" Journal of Taxation, 118:5 (May 2013); Schiller, *Art of Estate Tax,* §§4.5A and 7A.8.
[146] Treas. Reg. §20.2010-2T(a); Schiller, *Art of the Estate Tax*, §4.5A.
[147] Schiller, *Art of the Estate Tax*, Ch. 7A.
[148] Thanks to the American Taxpayer Relief Act (2012). Code §2010 ("portability" as the "deceased spousal unused exclusion amount" or "DSUE amount"). And Code §2010(c)(2) tells us the applicable exclusion amount is "the sum of (A) the basis exclusion amount, and (B) [for a surviving spouse], the deceased spousal unused exclusion amount." Price, *Contemporary Estate Planning*, §§2.12, 12.27.
[149] Blattmachr,"Portability or No," 233.
[150] Schiller, *Art of the Estate Tax*, §1.2.

estates need to file a Form 706 to pay estate taxes, but many states file Form 706 to claim portability.[151]

Often portability is a good idea - especially for spouses whose net worth is close to or could become close to the federal estate tax exemption during their remaining lifetime.[152] But portability may not be as useful to spouses with lower net worth or income where there is no possibility of reaching the federal estate tax exemption. For those clients, portability may actually be uneconomical – the pursuit of a phantom tax benefit, which incurs more time and expenses than it is worth.

Portability presents a choice between inheriting outright vis-à-vis inheriting in trust.[153] Portability has numerous advantages vis-à-vis using trusts in an estate plan, including: (1) simplicity, (2) stepped up basis when the surviving spouse dies, (3) use with depreciating assets, (4) use with retirement assets, (5) use with a residence, (6) IRD tax efficiency (by not funding the first spouse's unused estate tax exemption with IRD), (7) market declines after the first spouse's death, (8) lower state exemption amount (for states with an estate tax), (9) avoid state estate taxes, (10) create a grantor trust for descendants, and (11) avoiding complex tax funding formulas.[154]

But trusts also have some advantages over portability: (1) using the first spouse's GST exemption (which can be wasted with portability), (2) creditors' claims of the surviving spouse, (3) protection from unwise financial decisions, (4) no DSUE indexing for inflation, (5) estate tax credits (which can be wasted with portability), (6) remarriage forfeiture if the surviving spouse remarries and survives the new spouse, (7) shelter of appreciation and income, and (8) avoiding potential audit issues with filing Form 706.155 By using portability (and not a trust), various issues arise: (1) income tax consequences, (2) Form 706 must be filed, (3) the effect of inherited exemptions, and (4) second marriages.[156] A trust can shift income to any beneficiary, so that it is not taxed in the surviving spouse's hands.[157] If a trust is used instead of portability, Form 706 may not be required. A trust can be beneficial for a surviving spouse is the first spouse did not use their gift tax exemption and left a large unused estate tax exemption. And a QTIP trust would work better in a second marriage scenario.[158]

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151 Schiller, *Art of the Estate Tax*, §5.3.
152 Schiller, *Art of the Estate Tax*, §1.3 (Portability election as "outstanding insurance" against estate and income taxes for a "vast swath of the married population"). The martial deduction and QTIP trusts are useful. Schiller, *Art of the Estate Tax*, §1.10, n.118, Ch. 2).
153 This section draws on excellent portability materials presented by Thomas W. Abendroth, Esq, of Schiff Hardin LLP (Chicago, IL), to the Kansas City Estate Planning Symposium (April 23-24, 2015). Abendroth and Blattmachr's papers are on file with the author and have been incorporated here.
154 Blattmachr,"Portability or No," 234-236.
155 Id., 236.
156 Id., 238-240.
157 Id., 239.
158 Id., 240. A qualified terminable interest property (QTIP) trust qualifies for the marital deduction. A QTIP is (1) a trust, under which (2) the surviving spouse is entitled to the trust's income for life, and (3) the property cannot be appointed to anyone but the surviving spouse. A reverse QTIP election treats the first spouse as the GST transferor. A partial QTIP election allocates assets between (1) the QTIP trust for the surviving spouse's benefit and (2) the deceased spouse's estate. Code §2056; Treas. Regs. §§ 20.2056(b)-

Portability is useful where: (1) a small first estate exists, (2) with very wealthy clients to fund a grantor trust for descendants, (3) to achieve stepped up basis flexibility, (4) state death tax planning, (5) for a small nonmarital share, (6) to avoid funding the nonmarital share with IRD assets, or (7) for older couples without children.[159] Portability must be elected by filing a Form 706 estate tax return for the deceased spouse.[160]

7. *Allocating Tax Deduction Items*

Just as taxes can be a labyrinthine maze, so allocating deductible items can be very complicated. Some deductible items are only deductible on one tax return, but several items can potentially be deducted in different places to various effects. For example, the decedent's final medical expenses can be deducted on the decedent's final Form 1040 income tax return or on the estate's Form 706 estate tax return.[161]

8. *Deducting Estate Expenses*

Estate administration and other expenses are deductible, usually on Form 706 to determine the gross estate's value, and thus the estate tax (if any) owed.[162] Medical expenses paid before the decedent's death can be included in the medical expense deduction on the decedent's final Form 1040. Estate administration expenses can be deducted on the final Form 1040 if the executor or trustee waives the right to deduct expenses on Form 706, such as where Form 706 need not be filed. The executor can elect to treat medical expenses paid by the estate as paid by the decedent when the medical services were provided, but the expenses have to be paid within a year of the decedent's death. For this election, the executor should attach a statement to the decedent's final Form 1040 stating the expenses (1) were not and (2) will not be claimed on the Form 706 estate tax return.[163] Importantly, medical expenses deducted from estate taxes (Form 706) are fully deductible, while medical expenses deducted from income taxes are only deductible if over 10% of the decedent's AGI (7.5% of the decedent's AGI for taxpayers over 65 years old).[164]

The decedent's final Form 1040 can take the standard deduction, which the trust cannot claim on Form 1041, but the trust avoids self employment income tax, which the estate does not.[165] A simple trust can take a $300 exemption, but a complex trust only a $100

5(f)(4), 20.2056(b)-7(d)(2); Price, *Contemporary Estate Planning*, §5.23 (QTIP); Code §2652(a)(1); Treas. Reg. §26.2652-2(a); Price, *Contemporary Estate Planning*, §2.28 (reverse QTIP); Treas. Reg. §20.2056(b)-7(b)(2); Price, *Contemporary Estate Planning*, §5.23.4 (partial QTIP). A "QTIP trust (or at least a trust to which a marital QTIP election may or may not be made) is superior to either a general power of appointment trust or outright bequest when it comes to post-death estate tax planning." Schiller, *Art of Estate Tax*, §3.2.

[159] Id., 241-242.

[160] Code §2010(c)(5). The American Institute of Certified Public Accountants recommended the IRS adopt a short Form 706-EZ, allowing the portability election where no estate tax is owed.

[161] Price, *Contemporary Estate Planning*, §12.13.

[162] Price, *Contemporary Estate Planning*, §2.16; Sembler, *Planning an Estate*, §§15:16 – 15:31.

[163] Treas. Regs. §§1.642(g)-1; 20.2053-1(d).

[164] Code §213; Price, *Contemporary Estate Planning*, §12.3.4.

[165] Code §63(c)(6); Price, *Contemporary Estate Planning*, §10.4.6.

exemption.[166] Estates usually follow the income tax rules for complex trusts, but can take a $600 personal exemption.[167]

Deductible expenses include funeral expenses and administration expenses. A deductible administration expense must be actually and necessarily incurred to administer the estate, including (1) asset collection, (2) debt payment, and (3) distributions to heirs.[168] Attorney's fees, executor's or trustee's commissions, and other related expenses are also deductible. Credits against the estate tax would be claimed.[169]

9. *Tracing*
Another Form 1040 vis-à-vis Form 1041 issue is tracing income and expenses. Tracing arose before the 1954 IRS Code and the *Dean* case, but DNI and the 1954 Code simplified the tracing issue.[170] When deciding whether an income or expense item is properly allocated to Form 1040 or 1041, look at whether the item is associated with the decedent's Social Security number (Form 1040) or the estate's EIN (Form 1041).

10. *Form 706 vis-à-vis Form 1041 Deductions*
When weighing allocating deductions to Form 706 vis-à-vis Form 1041, best interests and tax efficiency questions arise – where will the items yield the greatest tax savings or beneficial impact for the client?

Traditionally, accountants and attorneys recommended allocating deductions to Form 706 in lieu of Form 1041. But historically the federal estate tax was a major estate planning focus during the client's life and a sizable tax issue after the client's death, to be paid from life insurance proceeds or by liquidating a large part of the estate or trust. Since Congress has dramatically raised the federal estate tax exemption in recent years and apparently made those changes a permanent feature of the tax landscape, estate tax planning is often not an issue for clients and portability is then the only reason to file an estate tax return. And portability carries a cost-benefit analysis: many clients wish to avoid the cost of preparing the Form 706, especially if the surviving spouse's net worth and expected future income puts them well below the estate tax threshold, so that some clients could see claiming portability as an exercise in futility.[171] If either spouse's net worth is millions of dollars below the tax trigger, why do expensive planning for an unlikely contingency?

In the wake of Congress' sweeping estate tax gambit, many accountants and attorneys see a paradigm shift from estate taxes to income tax planning, and a renewed focus on the Form 1041, while often relegating Form 706 to the fabled typewriter table from a bygone

[166] Code §642(b); Price, *Contemporary Estate Planning*, §10.4.6.
[167] *Id.*
[168] Treas. Reg. §20.2053-3(a).
[169] Code §§2010-2016; Price, *Contemporary Estate Planning*, §2.17.
[170] Acker, *Income Taxation*, A-4; *Dean v. IRS*, 102 F.2d 699 (10th Cir. 1939).
[171] *Ecclesiastes* 1.2.

era.[172] Where countless estate plans used to be designed with A-B credit shelter and marital trusts, to keep assets out of the spouse's estate and avoid large estate tax liabilities, while using gifts (and carryover basis) to drain the estate's deep money reservoir to tax free shallows, now many estate plans are being designed to hold assets outright until death to give the heirs a stepped up basis (a major income tax benefit) as more and more estates' volume is a mere bucket from the rising oceans of estate tax exemption.[173] Estates and trusts is now a brave new world where income taxes trump transfer taxes.[174]

Let's review each form's deductible items in more depth. The 10 Form 1041 deductibles include: (1) interest[175], (2) taxes[176], (3) fiduciary fees[177], (4) charitable deduction[178], (5) attorney, accountant, and return preparer fees[179], (6) other deductions not subject to the 2% floor (attach schedule)[180], (7) net operating loss deduction[181], (8) allowable miscellaneous itemized deductions subject to the 2% floor[182], (9), income distribution deduction[183], (10) estate tax deduction including certain generation-skipping taxes (attach computation)[184], and (11) exemption.[185] The 13 final Form 1040 deductibles include: (1) educator expenses[186], (2) certain business expenses[187], (3) the health savings account deduction[188], (4) moving expenses[189], (5) self employment tax deduction[190], (6) self employed SEP, simple, or qualified plan deduction[191], (7) self employed health insurance deduction[192], (8) early savings withdrawal penalty[193], (9) alimony paid[194], (10) IRA deduction[195], (11) student loan interest deduction[196], (12) the tuition and fees

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[172] One commentator notes a "marked decline" of estate tax returns. Schiller, *Art of the Estate Tax*, §1.2. He dubbed the pre-ATRA era "the chaos of congressional uncertainty." *Id.*, §1.1. But for portability, most attorneys will rarely see a Form 706 where estate tax is due.
[173] Code §1015(a) (carryover basis); Code §1014(a)(1) (stepped up basis).
[174] This paradigm shift looks hopeful, unlike Aldous Huxley's classic novel *Brave New World* (1932).
[175] Form 1041, Line 10; Form 1041 instructions, pg. 22.
[176] Form 1041, Line 11;Form 1041 instructions, pp. 22-23.
[177] Form 1041, Line 12; Form 1041 instructions, pg. 23.
[178] Form 1041, Line 13; Code §§642(c), 170; Acker, *Income Taxation*, A-43 – A-45.
[179] Form 1041, Line 14;
[180] Form 1041, Line 15a; Form 1041 instructions, pp. 23-24.
[181] Form 1041, Line 15b; Form 1041 instructions, pg. 24; see Blattmachr, *Income Taxation,* §3:2.1[D]; Acker, *Income Taxation*, A-36; Code §642(d).
[182] Form 1041, Line 15c; Form 1041 instructions, pp. 24-25; Acker, *Income Taxation*, A-46 – A-47; Code §67; Price, *Contemporary Estate Planning*, §10.4.7.
[183] Form 1041, Line 18; Form 1041 instructions, pg. 25; Code §§651-652, 661-663; Price, *Contemporary Estate Planning*, §10.4.5.
[184] Form 1041, Line 19; Form 1041 instructions, pg. 25.
[185] Form 1041, Line 20; Form 1041 instructions, pg. 25.
[186] Form 1040, Line 23; Form 1040 instructions, pg. 30.
[187] Form 1040, Line 24; Form 1040 instructions, pg. 30.
[188] Form 1040, Line 25; Form 1040 instructions, pg. 30.
[189] Form 1040, Line 26; Form 1040 instructions, pg. 30.
[190] Form 1040, Line 27; Form 1040 instructions, pg. 31.
[191] Form 1040, Line 28; Form 1040 instructions, pg. 31.
[192] Form 1040, Line 29; Form 1040 instructions, pp. 31-32.
[193] Form 1040, Line 30; Form 1040 instructions, pg. 32.
[194] Form 1040, Line 31a; Form 1040 instructions, pg. 32.
[195] Form 1040, Line 32; Form 1040 instructions, pp. 32-35.

deduction[197], and (13) the domestic production activities deduction.[198] An elections checklist could be consulted as a guide.[199] Estate taxes paid are deductible, to eliminate double taxation – income taxes and estate taxes on the same IRD item.[200]

The 9 Form 706 deductions include: (1) funeral expenses and estate administration expenses (subject to claims)[201], (2) decedent's debts[202], (3) mortgages and liens[203], (4) net losses during estate administration[204], (5) estate administration expenses (not subject to claims)[205], (6) bequests to surviving spouse[206], (7) charitable or public bequests[207], (8) Treas. Reg. §20.2010-2T(a)(7)(ii) assets[208], and (9) state death tax deduction.[209] A smart Form 706 elections checklist should also be consulted.[210]

11. *Fiduciary Fees*

Fiduciary fees are a key overlap area, deductible on both the Form 706 and Form 1041. Under *Knight*, an estate's fiduciary fees are often subject to the 2% itemized deduction floor.[211] A person may take a miscellaneous itemized deduction to the extent the item's cost exceeds 2% of the person's adjusted gross income.[212] Some itemized deductions are deductible in full, but any costs outside Code §67(b)'s ambit are miscellaneous itemized deductions, so the 2% floor applies.[213] An estate's fiduciary fees, including for investment advisory services, are not on the §67(b) list, so the 2% floor applies.[214] An individual's investment advisory expenses are fully deductible costs.[215] Using this logic, an estate can only fully deduct fiduciary fees if the money was (a) "paid or incurred in connection with" the estate's administration and (b) "would not have been incurred if the property" was not in the estate.[216] *Knight* teaches that the 2% floor often applies to an estate's fiduciary fees.

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[196] Form 1040, Line 33; Form 1040 instructions, pg. 36.
[197] Form 1040, Line 34; Form 1040 instructions, pg. 37.
[198] Form 1040, Line 35; Form 1040 instructions, pg. 37; Code 199; Acker, *Income Taxation*, A-36 – A-37.
[199] Price, *Contemporary Estate Planning*, §12.49.
[200] Code §691(c); Acker, *Income Taxation*, A-45; Blattmachr, *Income Taxation*, §2:3.4.
[201] Schedule J (Form 706) and Form 706, Part 5, Item No. 14; Form 706 instructions, pp. 31-32.
[202] Schedule K (Form 706) and Form 706, Part 5, Item No. 15; Form 706 instructions, pp. 32-33.
[203] Schedule K (Form 706) and Form 706, Part 5, Item No. 16; Form 706 instructions, pp. 32-33.
[204] Schedule L (Form 706) and Form 706, Part 5, Item No. 19; Form 706 instructions, pp. 33-34.
[205] Schedule L (Form 706) and Form 706, Part 5, Item No. 20; Form 706 instructions, pp. 33-34.
[206] Schedule M (Form 706) and Form 706, Part 5, Item No. 21; Form 706 instructions, pp. 34-37. Jeffrey N. Pennell, *Estate Tax Marital Deduction* (Bloomberg BNA, 843-3rd).
[207] Schedule O (Form 706) and Form 706, Part 5, Item No. 22; Form 706 instructions, pp. 37-38. Edward J, Beckwith & Natanya H. Allan, *Estate and Gift Tax Charitable Deductions* (Bloomberg BNA, 839-2nd).
[208] Form 706, Part 5, Item No. 23; Form 706 instructions, pg. 16.
[209] Form 706, Part 2, Line 3b; Form 706 instructions, pp. 5-6.
[210] Price, *Contemporary Estate Planning*, §12.49.
[211] *Knight v. IRS*, 552 U.S. 181 (2008); Publication 559, pg. 23 (fiduciary fees). *Knight* was about trusts, "but the analysis applies equally to estates." *Knight,* 552 U.S. 181, n.1. See Robert S. Balter and Jonathan G. Blattmachr, "*Knight v. Comr.*: The Two Percent Floor and a Fiduciary's Investment Advisory Fees," *Tax Management Memorandum* (Bloomberg BNA, 2008).
[212] Code §§63(d), 67(a).
[213] Code §67(b) (fully deductible itemized deductions a/k/a 2% AGI floor exceptions).
[214] Code §67(e).
[215] Code §212.
[216] Code §67(e)(1).

12. *Federal Estate Tax*

If the federal estate tax is owed, Form 706 deductions should be taken first, as the federal estate tax is up to 40% of the estate's value. Second, Form 1041 deductions would be taken, since the fiduciary income tax rate reaches the highest individual income tax level at a mere $12,150 of income. And last but not least, the final Form 1040 deductions would be taken, since the individual income tax rate applies to a decedent's estate.[217]

13. *No Federal Estate Tax*

If the federal estate tax is not owed (and regardless of whether portability is elected on the federal estate tax return), Form 1041 deductions would be taken first, since the fiduciary income tax rate reaches the highest individual income tax level at a mere $12,150 of income. And second, the final Form 1040 deductions would be taken, since the individual income tax rate applies to a decedent's estate.[218]

Circular 230

Last, but not least, we explore Circular 230.[219] Circular 230 began in 1921 to regulate tax practice before the IRS. Circular 230 is complex - we simply look at four highlights and commend excellent full dress treatments for your study.[220] Circular 230 was revised in June 2014.[221]

A. *Covered Opinions*

Of particular interest to estate planners and probate attorneys is the repeal of Section 10.35, the covered opinion rules. The covered opinion rules required "written tax advice on designated categories of transactions the IRS saw as potentially abusive comply with detailed requirements for the opinion's form and content."[222] The covered opinion rules led many accountants and attorneys to include a Circular 230 disclaimer in emails, letters, websites, papers, and even blogs.[223] The latest Circular 230 revision repeals the covered opinion rules, so the opt out disclaimer is no longer required.

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[217] Price, *Contemporary Estate Planning*, §12.11.

[218] Price, *Contemporary Estate Planning*, §12.12.

[219] IRS Circular 230 governs an attorney's tax reporting obligations, so we explore it in this paper. Circular 230 is referenced in the probate ethics paper.

[220] See Jonathan G. Blattmachr, Mitchell M. Gans, and Damien Rios, *The Circular 230 Deskbook* (PLI, 2015). Other revisions were made in 2014 and many other parts of Circular 230 exist. A free IRS webinar on Circular 230 is available at (http://www.irsvideos.gov/Circular230Overview_June_25_2014/).

[221] Circular 230 is available from the IRS at (http://www.irs.gov/pub/irs-pdf/pcir230.pdf). See Mary L. Blatch, James F. Bresnahan II, Gerard H. Schreiber Jr., Norma J. Schrock, and Thomas J. Purcell III, "New Rules on Written Tax Advice and Other Reivsions to Circular 230 and Their Effect on CPAs," *The Tax Adviser*, December 01, 2014. The prior revision was 2005. See Jonathan G. Blattmachr, Mitchell M. Gans, and Tracy L. Bentley, "The Application of Circular 230 in Estate Planning," *Tax Notes*, April 4, 2005.

[222] Blatch, "New Rules on Written Tax Advice."

[223] A Circular 230 disclosure might state: "IRS CIRCULAR 230 Disclosure: Unless expressly stated otherwise, any U.S. federal tax advice contained in this website or related blogs, including links, diagrams, pictures, videos, or attachments, is not intended or written to be used to avoid IRS or other tax penalties, and any tax advice cannot be used for the purpose of avoiding penalties that may be imposed by the IRS."

B. *Written Tax Advice*
But to paraphrase the ancient sage Job, "the government giveth and the government taketh away."[224] Section 10.37 was revised to affirmatively cover any written communications of tax advice.[225] Now any written tax advice must: (1) be based on "reasonable factual and legal assumptions," (2) "reasonably consider all relevant facts the practitioner knows or reasonably should know," (3) use "reasonable efforts to identify and ascertain" relevant facts to written advice on any federal tax matter, (4) not rely on any "unreasonable" representations, statements, findings, or agreements from the taxpayer or another person, (5) "relative applicable law and authorities to facts," and (6) "not take into account the possibility that a tax return will not be audited" or that a federal tax matter "will not be raised on audit."[226]

Revised Circular 230's preamble allows a tax practitioner to "consider [1] the scope of the engagement, [2] the type and specificity of the advice the client seeks, [3] and other appropriate facts and circumstances to determine the extent to which elements must be included" in client communications.[227] Revised Circular 230 keeps the same "standard for tax return positions under Section 10.34(b)."[228]

C. *Competence*
Revised Circular 230 has followed the states' lead in adopting ethics rules about competence. Section 10.35 states that each "practitioner must possess the necessary competence" to work on tax matters.[229]

D. *Compliance*
Revised Circular 230 now extends Section 10.36's compliance rules to "all matters governed by Circular 230."[230]

Conclusion
We have explored estate and trust taxes. Regardless of an estate or trust's size, careful tax planning is vital for the fiduciary to satisfy the estate and/or trust's (or beneficiary's) best interests. Tax planning is vital during the client's life and after the client's death via their

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[224] *Job* 1.21.
[225] Circular 230's written tax advice rule applies to "email advice" and "text message[s]." Blatch, "New Rules on Written Tax Advice." Circular 230 applies to any "Federal tax matter," which the IRS "define[s] broadly." Blatch, "New Rules on Written Tax Advice."
[226] Blatch, "New Rules on Written Tax Advice." Section 10.37 allows "reliance on another adviser" if the "reliance is [1] reasonable and is [2] grounded in good faith," but do not allow reliance that is "not reasonable." Blatch, "New Rules on Written Tax Advice"; Blattmachr, *Circular 230 Deskbook*, §2:3.2. The "reasonable practitioner standard" also applies to email. Blatch, "New Rules on Written Tax Advice." Section 10.37 does not require a tax practitioner to "audit or verify information [from] clients, other third parties" "unless there is a reason to do so." Blatch, "New Rules on Written Tax Advice."
[227] Blatch, "New Rules on Written Tax Advice." Indeed, Circular 230's preamble "encourages practitioners to describe all facts, law, analysis, and assumptions in appropriate circumstances."
[228] Blatch, "New Rules on Written Tax Advice."
[229] Section 10.35; Blatch, "New Rules on Written Tax Advice."
[230] Section 10.36; Blatch, "New Rules on Written Tax Advice." But like the legal ethics rules, this Circular 230 revision is designed to "encourage firms to self regulate." Blatch, "New Rules on Written Tax Advice."

estate and/or trust. Portability, various other tax elections, and/or allocating different credits and deductions could be appropriate or tax efficient in some cases for clients, but not in others. A fiduciary should make the decisions in consultation with an accountant and an attorney to ensure optimal tax treatment.

A tax idea could be a once in lifetime chance, like withering leaves of grass or falling flower petals, leaving but memories as the seasons change.[231] We should serve clients by seizing beneficial opportunities, since as the poet Rudyard Kipling reminds us, these moments of possibility "vanish at the morning's breath!"[232]

[231] *Isaiah* 40.8 and *Ecclesiastes* 3.1-8; Walt Whitman, *Leaves of Grass*.

[232] "Possibilities," in Rudyard Kipling, *Complete Verse* (Doubleday, 1989), 44. Rudyard Kipling (1865-1936) was the first English Nobel Laureate in 1907 and the youngest Laureate in Literature in history.