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SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

1041 Deskbook

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Interactive Self-study CPE

Companion to PPC's Guide to 1041 Deskbook

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

INTRODUCTION

Companion to PPC's 1041 Deskbook consists of two interactive self-study CPE courses. These are companion courses to *PPC's 1041 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 1

REPORTING VARIOUS INCOME ITEMS FOR ESTATES AND TRUSTS (T41TG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to various items reported in the income section of Form 1041. Lesson 1 covers how an estate and trust would report interest income, property, and interest on U. S. savings bonds and how an estate and trust would deal with postmortem distributions for qualified plans, traditional IRAs, Roth IRAs and the proceeds from life insurance policies. Lesson 2 addresses the allocation of income to the fiduciary or deceased partner or shareholder, eligible S corporation shareholders, and the Form 1041 reporting requirements of pass-through income from partnerships and S corporations and rental and royalty income. Finally, Lesson 3 concentrates on the generally accepted treatment of passive activity losses incurred by estates and trusts, including loss limitations determined at the entity level and reporting to a beneficiary.

PUBLICATION/REVISION DATE: December 2010

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

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

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FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Income from Investments, Retirement and Life Insurance

Completion of this lesson will enable you to:

- Determine how to report different types of interest income, property and dividends in estates and trusts.
- Identify the reporting requirements of interest on U.S. savings bonds and the issues facing bondholders when bond are purchased at a premium, for a discount or between interest payment dates.
- Recognize the conditions governing postmortem distributions for qualified plans, traditional IRAs and Roth IRAs and how proceeds from life insurance policies would be treated.

Lesson 2—Income from Rents, Royalties, and Pass-through Entities

Completion of this lesson will enable you to:

- Identify how specific items reported on a partnership K-1 will affect the income tax reporting of the deceased or fiduciary partner, and if estates and various types of trusts are permitted S corporation shareholders.
- Determine the requirements for reporting pass-through income or loss from S corporations, pass-through income from other fiduciaries and rental and royalty income.

Lesson 3—Passive Activity Loss Rules

Completion of this lesson will enable you to:

- Describe the generally accepted treatment of passive activity losses incurred by estates and trusts, including loss limitations determined at the entity level and reporting to a beneficiary.

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Lesson 1: Income from Investments, Retirement and Life Insurance

INTRODUCTION

Quite often, estates and trusts derive a significant amount of income from investments and retirement accounts. To properly report interest and dividend income, the practitioner must:

- report the proper amount,
- under the proper classification,
- in the proper year,
- to the proper taxpayer.

The proper amount of income to report can be complicated by circumstances in which an estate or trust owns bonds. Bond purchases between interest dates and tax-exempt income causes unique reporting issues for estates and trusts. This lesson addresses these concerns.

The tax impact of distributions from IRAs and other retirement accounts owned by a decedent depends on (a) whether the decedent had reached his or her required beginning date and (b) who the designated beneficiary is.

Occasionally, an estate receives insurance proceeds when it is named as the beneficiary of an insurance policy or when no beneficiary has been named upon the insured's death. For a discussion of the tax consequences and reporting of life insurance proceeds by an estate or trust see later in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how to report different types of interest income, property and dividends in estates and trusts.
- Identify the reporting requirements of interest on U.S. savings bonds and the issues facing bondholders when bond are purchased at a premium, for a discount or between interest payment dates.
- Recognize the conditions governing postmortem distributions for qualified plans, traditional IRAs and Roth IRAs and how proceeds from life insurance policies would be treated.

Reporting Amounts Inconsistent with Form 1099 Reporting

For many types of income, fiduciaries are instructed to attach a corresponding form from the Form 1040 series to Form 1041. However, Form 1040, Schedule B (Interest and Dividend Income), is not required. Therefore, preparers of fiduciary returns should focus on determining the correct amount and proper classification of income, which may not agree with Form 1099.

Decedent's Accounting Method Determines Who Reports Income

The method of accounting regularly used by a decedent before death determines the income to be included on the final Form 1040. Since most individuals use the cash method for reporting investment income, only those items actually or constructively received through the date of death are reported on the final return. When interest income accrues during the period that includes the date of death of a cash-basis taxpayer, the interest earned at the date of death but posted after death is income in respect of the decedent (IRD) and is reportable by the estate or other recipient when received.

Example 1A-1 Interest accrued at date of death and constructively received before death.

Pop Werner, a cash-basis individual, invested $100,000 in a 4%, one-year certificate of deposit on October 1, 2010, with interest credited to his account on a monthly basis. Pop died on December 1, 2010. The CD

matured, and the principal and interest were paid to his estate on October 1, 2011. The Form 1099-INT reported the entire $4,000 interest income in 2011 to Pop, using his social security number.

Since Pop was a cash-basis taxpayer, but was in constructive receipt of the interest income earned up to the date of his death, $667 of the $4,000 interest income should be reported on Pop's final Form 1040, whereas $3,333 is taxable to the estate in 2011.

Variation: If the interest earned on the certificate of deposit was not credited to Pop's account until the maturity date, none of the interest would be reported on Pop's final Form 1040 because he was not in constructive receipt of the interest before then. The entire $4,000 interest income would be reported on the estate's fiduciary income tax return. The $667 interest earned through Pop's date of death is income in respect of a decedent (IRD).

Example 1A-2 Unredeemed bond coupons held at date of death.

Maude Laird died July 2, 2010. At the time of her death, she owned $5,000 of interest coupons on SBC bonds, payable June 30, 2010. The executor discovered the coupons during an inventory of her safe deposit box, and redeemed the coupons for cash.

Maude is considered to have constructively received the $5,000 of interest income before her death. Thus, the interest is reportable on her final Form 1040 and not on Form 1041, even though the estate received the cash. The IRD rules do not apply in this example.

If an individual dies after dividends are declared but before the date of record, the dividends will be included in the gross income of the estate, because the estate will be the owner of record on the record date. If the individual dies after the date of record but before the dividends are received, the dividends will be included in the individual's gross estate for estate tax purposes and will be IRD to the estate (or other recipient) when received for income tax purposes.

Example 1A-3 Dividends received shortly after death.

Jack Horner died on August 18, 2010. At the time of his death, Jack owned 100 shares of Acme Corporation common stock. On July 15, Acme had declared a $15 per share dividend payable to shareholders of record on August 1, payable on August 10. The Form 1099-DIV from Acme for 2010 included the August 1 dividend under Jack's name and social security number.

Generally, dividends are constructively received when available for use by the decedent without restriction (i.e., on the date they are payable). Since Jack died after the time the dividend was declared and after the payment date, the dividend is not taxable on his final individual return. The executor may, however, consider reporting the dividend on Form 1040, Schedule B and then "backing" it out, to comply with the IRS matching program for Forms 1040. Furthermore, since Jack died after the date of record, the dividends are IRD.

Short-term Capital Gain from Mutual Funds

Regulated investment companies (e.g., mutual funds) are required to report short-term capital gains as ordinary dividends. Trusts and estates should report such dividends as ordinary income and include them in distributable net income (DNI). However, the short-term capital gain portion of the dividends may not be includable in fiduciary accounting income, depending upon the terms of the governing instrument or applicable state law.

Nominee Reporting Not Required for Estates and Trusts

Anyone receiving a Form 1099 for amounts that belong to another taxpayer should generally file a Form 1099 showing the actual owner as the recipient and the nominee as the payer. The nominee, not the original payer, is responsible for filing the subsequent Forms 1099. However, nominee reporting is not required for interest and dividend income when the record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and taxpayer identification number of the actual owner.

Example 1A-4 Nominee reporting not required.

Assume the same facts as discussed in Example 1A-3. Even though a Form 1099 was mailed to the decedent's address and used the decedent's social security number, no further information reporting is required, provided the dividends are reported on Form 1041. The usual nominee reporting requirements do not apply to interest and dividend income included on Form 1041.

Jointly Held Property

When property (including cash) is owned jointly with right of survivorship (i.e., in joint tenancy), income from the property received prior to death generally is split according to who contributed the funds to acquire the property. However, if the account is held jointly by husband and wife, state law may require a 50/50 split. If the income is accrued before death but received after death by the surviving joint tenant, the decedent's portion is considered IRD and taxed to the survivor recipient under the IRD rules. Income accrued and received after death is taxed to the surviving joint tenant, but is not IRD because the estate had no interest in the property (since the decedent's interest terminated at the moment of death).

Example 1A-5 Jointly held bank account.

Tom Brown and his daughter Debbie had a jointly owned certificate of deposit (CD) when Tom died on June 1, 2010. $500 of interest earned on the CD was accrued but not received as of the date of death. Tom initially contributed all of the funds used to purchase the CD. The CD earned an additional $600 in interest in 2010 after Tom's death. The CD matured and all principal and interest was distributed to Debbie in December 2010.

Debbie is taxed on the entire $1,100 of income earned on the CD in 2010. Of that amount, $500 is IRD since Tom initially contributed the funds to purchase the CD. If Tom's estate was subject to estate tax, Debbie may claim a deduction on her personal income tax return for any federal estate tax attributable to the inclusion of the $500 of IRD in Tom's gross estate.

Community Property

Married taxpayers domiciled in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin) generally own assets as community property. Community property (and the income earned by the property) is usually treated as owned one-half by each spouse. Income earned and credited before death on the decedent's one-half community share is reported on the decedent's final Form 1040. The decedent's one-half community income credited to the decedent's estate after death (including income earned but not credited before death) is reported on the initial Form 1041. The surviving spouse's one-half community share of the income is not reported on the Form 1041 for the decedent's estate.

Example 1A-6 Community property income.

Bob and his wife, Amy, are domiciled in Texas and file a joint income tax return. They owned 100 shares of AT&T stock as community property when Bob died on April 15, 2010. AT&T declared a dividend of $0.41 per share payable to stockholders of record at April 9, 2010. The dividends were paid to stockholders on May 1, 2010.

Of the $41 (100 × $0.41) dividend received on May 1, $20.50 ($41 × 50%) is Amy's community share. Amy is taxed in 2010 on her $20.50 one-half community share of the dividend paid in 2010. None of Bob's community share is reported on the 2010 Form 1040 as the dividend was not constructively received by the date of his death. The $20.50 of dividend income representing Bob's community share is reported on the estate's initial Form 1041 since the dividend was paid to his estate after his date of death. The $20.50 dividend reported by Bob's estate is IRD as it was earned (but not paid) before his death.

Determining Proper Classification of Interest and Dividends

Confusion often arises when income that appears to be interest is reported as dividends by payers. The following general guidelines apply when reporting dividends and interest on Form 1041:

1. Report dividends paid on deposits or on share accounts in mutual savings banks, savings and loan associations, and credit unions as interest income.

2. Report amounts received from money market mutual funds as dividend income. (These amounts do not qualify for the lower tax rates on qualified dividend income.)

3. Report income from bank and thrift money market accounts as interest income.

4. Increase the amount of dividends by foreign taxes withheld and consider taking a foreign tax credit.

5. Dividends on life insurance policies are a return of premiums, and hence, nontaxable. However, interest earned on these dividends held by the insurance company is taxable *interest* income.

6. Report short-term capital gains reported as ordinary dividend income by a regulated investment company (mutual fund) as dividend income.

Tax-exempt Income Impact

Gross income of an estate or trust generally does not include interest on bonds issued by state and local governments. Exceptions apply to certain private activity bonds, arbitrage bonds, and unregistered bonds. Tax-exempt bonds are relatively common in fiduciary entities, due in part to the compressed tax rate structure that makes tax-exempt income particularly attractive.

Interest income from certain private activity bonds issued after August 7, 1986, is not tax-exempt for alternative minimum tax (AMT) purposes. However, certain types of tax-exempt housing bonds issued after July 30, 2008 are not considered private activity bonds and thus, are not included as preference items for AMT purposes.

Disclosure of Tax-exempt Income on Form 1041

As is the case with individuals, estates and trusts are required to disclose the amount of tax-exempt income. A question in the "Other Information" section on the bottom of page 2 of Form 1041 requires a box to be checked "Yes" if the fiduciary received any tax-exempt income during the tax year, and a line is provided for disclosure of the amount of such income.

Effect on Deductions

The price paid for the benefit of income exclusion is the disallowance or reduction of certain otherwise deductible expenses. A deduction for expenses allocable to tax-exempt income is disallowed. Therefore, if all income is tax-exempt, no deductions are allowed because *all* expenses are allocated to tax-exempt income. If the fiduciary has both taxable and tax-exempt income, any expenses directly allocable to a particular type of income are allocated to that income (e.g., rental expenses to rental income). In addition, a reasonable proportion of indirect expenses are to be allocated to each class of income, based on the facts and circumstances . In such situations, a schedule of the related computations must be attached to the return.

When an estate or trust has tax-exempt interest income, the expenses affected by the Section 265 requirements are those that otherwise would be deductible under IRC Sec. 212, relating to expenses incurred in the production of income (e.g., trustee fees).

Example 1B-1 Allocating indirect expenses to tax-exempt income.

The Joe Jones Testamentary Trust had the following items of income and expense:

Taxable interest	$ 9,000
Tax-exempt interest	3,000
Trustee fees	1,000

Trustee fees are indirect expenses and must be allocated between taxable and tax-exempt interest income on a reasonable basis. Since 25% [$3,000 ÷ ($9,000 + $3,000)] of the income is tax-exempt, 25% of the trustee fees are allocable to the tax-exempt interest and, thus, nondeductible. Page 1 of Form 1041 will reflect a $750 deduction for trustee fees, and the $3,000 of tax-exempt interest income will be disclosed on page 2. A schedule should be attached to the return showing how the $750 deduction was calculated.

This is a simple example designed to show the basic requirements of IRC Sec. 265.

Effect of Tax-exempt Income on the Deduction for Charitable Contributions

Unless the governing instrument provides otherwise, charitable contributions made by estates and trusts are deemed made from a ratable portion of each class of income, including tax-exempt income. The portion of the charitable contribution deemed paid from tax-exempt interest is not deductible. Tax-exempt interest allocated to the charitable contribution is reported on line 2 of Schedule A.

Example 1B-2 Allocating tax-exempt interest to charitable contribution.

The Travis Austin Trust earned $50,000, comprised of the following types and amounts of income:

Qualified dividends	$ 10,000
Taxable interest	25,000
Tax-exempt interest	15,000
Total Income	$ 50,000

In the same year, the trust made a $10,000 charitable contribution to a qualified charity, made no distributions to income beneficiaries, and incurred no expenses. The trust instrument did not specify the type of income from which charitable contributions were to be made.

Charitable contributions are deemed to be made ratably from all classes of income, including tax-exempt interest, unless the governing instrument directs otherwise. Therefore, a portion of the $10,000 contribution was made from the tax-exempt interest and will not be deductible. The nondeductible portion is computed as follows:

$$\$10{,}000 \times \frac{\$15{,}000}{\$50{,}000} = \$3{,}000$$

Tax-exempt Interest Income and the Distribution Deduction

The *distributable net income* (DNI) of an estate or trust is the taxable income of the entity, recomputed with certain modifications. One such modification is to add tax-exempt interest income (as reduced by allocated expenses under IRC Sec. 265, discussed above) to taxable income. DNI is generally the upper limit of the entity's distribution deduction and the maximum amount required to be included in the beneficiaries' gross income. DNI is also used to determine the character of items passing through to beneficiaries.

When computing the income distribution deduction, the estate or trust is not allowed a deduction for any component of DNI not included in the gross income of the estate or trust. Thus, for purposes of computing the income distribution deduction on Schedule B, Form 1041, the net tax-exempt interest is added to adjusted total income to determine DNI, and then subtracted to determine the distribution deduction.

Example 1B-3 Effect of tax-exempt interest on DNI and the distribution deduction.

The Betsy Ross Trust had the following items of income and expense in 2010:

Qualified dividends	$ 25,000
Taxable interest	15,000
Tax-exempt interest	20,000
Trustee fees (all allocated to income per trust instrument)	3,000

The instrument requires all income to be distributed currently. DNI and the distribution deduction are computed as follows:

Qualified dividends	$ 25,000
Taxable interest	15,000
Trustee fees (3,000 × [(25,000 + 15,000) ÷ (25,000 + 15,000 + 20,000)]	(2,000)
Exemption	(300)
Taxable income before distribution	37,700
Net tax-exempt interest[a]	19,000
Exemption	300
DNI	57,000
Net tax-exempt interest	(19,000)
Distribution deduction	$ 38,000

Note:

[a] $20,000 gross tax-exempt interest − $1,000 allocated trustee fees [$20,000 ÷ ($25,000 + 15,000 + 20,000) × $3,000]

How Dividends are Reported

Ordinary Dividends

Prior to the 2003 Jobs and Growth Tax Relief Reconciliation Act, trusts and estates were subject to income tax at ordinary rates on dividends that were not a return of capital. Ordinary dividends continue to be taxed at regular income tax rates through 2010 unless they are *qualified dividends*.

Qualified Dividends

The 2003 Tax Act created a category of dividend income referred to as qualified dividends. As a result, qualified dividends are taxed at the same rate as adjusted net capital gain for both the regular tax and the alternative minimum tax. Although taxed at the same rate, qualified dividends are *not* included when determining net capital gain, however. Therefore, they do not offset capital losses in excess of capital gains, except to the extent that up to $3,000 of capital loss can be deducted against other income (including dividends) for any tax year.

Qualified dividends is a distribution of cash or property received by noncorporate taxpayers from domestic corporations and qualified foreign corporations. Qualified dividend income does *not* include the following:

1. any dividend on any share of stock not held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (These periods are doubled in the case of preferred stock);

2. any dividend on any share of stock to the extent that a taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property;

3. payments in lieu of dividends paid with respect to stock that a broker has loaned to a customer where the dividends are paid to the short sale buyer before the short sale is closed;

4. any amount that the taxpayer takes into account as investment income. Thus, an estate cannot offset investment interest expense with qualified dividend income.

5. any dividend from a corporation that is tax-exempt under IRC Sec. 501 or 502 when the distribution is made in the prior tax year;

6. any amount paid by mutual savings banks and allowed as a dividends paid deduction under IRC Sec. 591; or

7. any dividend from certain employer securities [as described in IRC Sec. 404(k)].

If qualified dividends are included in the decedent's gross estate as IRD, the recipient will be entitled to an income tax deduction for any estate taxes paid on the dividends. However, the amount of qualified dividends subject to the lower capital gains rate must be reduced by the amount of the Section 691(c) deduction [IRC Sec. 691(c)(4)]. This prevents the recipient from receiving a double benefit by using the Section 691(c) deduction to reduce income taxed at a higher rate while benefiting from the lower tax rate on qualified dividends.

When allocating qualified dividends between the beneficiaries and an estate or trust, the qualified dividends allocated to the beneficiaries is determined according to the following formula:

(Total Income Distribution/Distributable Net Income) $\times$ Total Qualified Dividends

For simple trusts, the entire qualified dividend amount is reported to the beneficiaries even if there are indirect expenses being allocated to various types of income. Thus, the entire amount of qualified dividends should be reported on Form 1041 line 2b(1) and no entry on line 2b(2).

For an estate or complex trust, the amount of qualified dividends allocable to the beneficiaries on Form 1041 line 2b(1) will be less than the total qualified dividend amount allocated to the beneficiaries on line 2b of their Schedules K-1 whenever there are expenses properly allocable to the fiduciary's gross qualified dividend income. This is because the amount on line 2b of each Schedule K-1 is reduced by expenses properly allocable to the gross qualified dividend amount distributed to each beneficiary.

Extraordinary Dividends or Taxable Stock Dividends

When a simple trust receives extraordinary dividends (whether in cash or property) or taxable stock dividends, such dividends are excluded from distributable net income (DNI) if, for accounting purposes, the fiduciary allocates such amounts to principal under the terms of the governing instrument or applicable state law. The significance of this rule is that the income is taxable to, yet not distributable by, the simple trust. The trust will be taxed on the dividends because the dividend amount is not included in the distribution deduction.

Example 1C-1 Taxable stock dividends received by a simple trust.

The Joe Jones Testamentary Trust received certain stock dividends taxable under IRC Sec. 305(b). The terms of the trust agreement provide that all income is to be distributed currently, and the instrument does not provide for any charitable contributions. Only fiduciary accounting income was distributed during the year. Therefore, the trust is a simple trust under IRC Sec. 651(a). Though the stock dividends are taxable for federal income tax purposes, the trustee properly allocated the dividends to principal in accordance with state law.

Although all income is required to be distributed currently, the trust will be subject to tax on the stock dividends. DNI, and thus the distribution deduction, does not include taxable stock dividends or extraordinary dividends received by a simple trust and properly allocated to principal.

When a complex trust or an estate receives extraordinary or taxable stock dividends, the dividends are included in DNI, even if allocated to principal by the fiduciary.

Neither the Code nor the regulations provide a definition of "extraordinary" dividends for purposes of DNI inclusion. "Extraordinary" in this context apparently refers to a corporate distribution other than an "ordinary" dividend that belongs to accounting income as defined by the governing instrument or applicable local law.

SELF-STUDY QUIZ

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

1. Which of the following is correct regarding how a fiduciary should report investment income on a decedent's return?

   a. If an individual uses the accrual method of accounting before death, items that are actually received through the date of death should be reported on the final return.

   b. Whatever method of accounting that an individual employed before their death will establish the investment income to be included on the final return.

   c. A fiduciary is required to attach Form 1040, Schedule B to Form 1041 when filing the return.

   d. If interest accrues on investments after death of a cash-basis taxpayer, but before the return, all interest, whether paid or not, in the year should be included in the final return.

2. On February 12, 2010, Sarah Golden passed away. At the time of her death, Sarah owned 250 common stock shares of Henson Corporation. On January 15, 2010, Henson declared a $20 per share dividend payable to all shareholders as of February 1, 2010, payable on February 28. How will the dividends be accounted for in 2010?

   a. The dividends will not be considered IRD to the estate since they were declared when Sarah was alive.

   b. The dividends will be included in the individual's gross estate for estate tax purposes.

   c. The dividends are considered received by Sarah since the dividends are declared before she passes away.

3. If property is jointly held (joint tenancy) and one of the owners passes away in the year, how is the property treated?

   a. Accrued income received after death to the surviving joint tenant is considered IRD.

   b. Income received from the property prior to one of the owners passing away is split equally between the two owners, if there is a right to survivorship.

   c. The decedent's portion of the income will be reported on the decedent's final Form 1041.

   d. If income is accrued before death, but received after death by the surviving joint tenant, the surviving recipient is taxed under the IRD rules.

4. Which of the following is true for tax-exempt income included in an estate or trust?

   a. Estates and trusts are required to disclose the amount of tax-exempt income on Form 1041 for the year.

   b. Interest income on bonds issued by state and local governments are normally included in the gross income of an estate or trust.

   c. Interest income that is tax-exempt for estates and trusts are always preference items for AMT purposes on the taxpayer's return.

   d. A deduction is allowed for expenses that are related to tax-exempt income for estates or trusts.

5. The Logan Trust earned $60,000 in 2010, broken down as follows:

Qualified dividends	$20,000
Taxable interest	25,000
Tax-exempt interest	15,000
Total income	$60,000

In addition, The Logan Trust donated $20,000 to Read to the Kids, a qualified charity, made no distributions to income beneficiaries and did not incur any expenses related to the trust. The trust did not specify which income funds were used for the charitable contribution. Which of the following is true regarding the charitable contribution from the trust?

a. Any tax-exempt interest allocated to the charitable contribution will be reported in the "Other Information" section of page 2 of Form 1041.

b. The entire $20,000 donated would be deductible for The Logan Trust since it was donated to a charitable organization.

c. $5,000 of the tax-exempt interest will be nondeductible for The Logan Trust.

6. Katie is a beneficiary of a simple trust, created by her grandfather's will. The trust receives qualified dividend income from numerous investments in domestic corporations. Which of the following is correct regarding the reporting of the qualified dividend amount by the trust?

a. The trust should report the entire amount of qualified dividend income on line 2b(2) of Form 1041.

b. The trust would report the entire qualified dividend amount allocable to Katie, even if there are indirect expenses associated to various types of income in the trust.

c. The expenses would be allocated to the gross qualified dividend amount distributed to each beneficiary of the trust.

d. Qualified dividends would be distributed between Katie and the trust by dividing total income distributable by distributable net income and multiplying by total dividends received by the trust.

SELF-STUDY ANSWERS

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

1. Which of the following is correct regarding how a fiduciary should report investment income on a decedent's return? **(Page 3)**

   a. If an individual uses the accrual method of accounting before death, items that are actually received through the date of death should be reported on the final return. [This answer is incorrect. If an individual uses the cash method of accounting for reporting investment income, not the accrual method, only those items actually or constructively received through the date of death are reported on the final return according to the IRC Section 691.]

   b. Whatever method of accounting that an individual employed before their death will establish the investment income to be included on the final return. [This answer is correct. As stated in IRC Section 691, the method of accounting regularly used by a decedent before death determines the income to be included on the final Form 1040.]

   c. A fiduciary is required to attach Form 1040, Schedule B to Form 1041 when filing the return. [This answer is incorrect. For many types of income, including investment income, fiduciaries are instructed to attach a corresponding form from the Form 1040 series to Form 1041. However, Form 1040, Schedule B (Interest and Dividend Income) is not required by the IRS.]

   d. If interest accrues on investments after death of a cash-basis taxpayer, but before the return, all interest, whether paid or not, in the year should be included in the final return. [This answer is incorrect. When interest income accrues during the period of the return that includes the date of death of a cash-basis taxpayer, the interest earned at the date of death but posted after death is income in respect of the decedent (IRD) and is reportable by the estate or other recipient when received as stated in IRC Section 691.]

2. On February 12, 2010, Sarah Golden passed away. At the time of her death, Sarah owned 250 common stock shares of Henson Corporation. On January 15, 2010, Henson declared a $20 per share dividend payable to all shareholders as of February 1, 2010, payable on February 28. How will the dividends be accounted for in 2010? **(Page 3)**

   a. The dividends will not be considered IRD to the estate since they were declared when Sarah was alive. [This answer is incorrect. If the individual dies after the date of record but before the dividends are received, the dividends will be IRD to the estate (or other recipient) when received for income tax purposes as required by the IRS.]

   b. The dividends will be included in the individual's gross estate for estate tax purposes. [This answer is correct. If the individual dies after the date of record, but before the dividends are received, the dividends will be included in the individual's gross estate for estate tax purposes according to the IRS.]

   c. The dividends are considered received by Sarah since the dividends are declared before she passes away. [This answer is incorrect. Generally, dividends are constructively received when available for use by the decedent without restriction (i.e., on the date they are payable). Since the dividends were not payable until February 28, 2010 and Sarah died on February 12, they were not constructively received.]

3. If property is jointly held (joint tenancy) and one of the owners passes away in the year, how is the property treated? **(Page 3)**

   a. Accrued income received after death to the surviving joint tenant is considered IRD. [This answer is incorrect. Income accrued and received after death is taxed to the surviving joint tenant, but is not IRD because the estate had no interest in the property (since the decedent's interest terminated at the moment of death).]

b. Income received from the property prior to one of the owners passing away is split equally between the two owners, if there is a right to survivorship. [This answer is incorrect. When property (including cash) is owned jointly with right of survivorship (i.e., in joint tenancy), income from the property received prior to death generally is split according to who contributed the funds to acquire the property. The only exception to this is when the property is held jointly by a husband and wife, then state law may require a 50/50 split.]

c. The decedent's portion of the income will be reported on the decedent's final Form 1041. [This answer is incorrect. With jointly held property, generally the decedent's estate will not report the income on Form 1041. If the property is held in a community property state and the decedent's one-half community income is credited to the decedent's estate after death (including income earned but not credited before death), it is reported on the initial Form 1041.]

d. If income is accrued before death, but received after death by the surviving joint tenant, the surviving recipient is taxed under the IRD rules. [This answer is correct. If the income is accrued before death but received after death by the surviving joint tenant, the decedent's portion is considered IRD and taxed to the survivor recipient under the IRD rules according to the IRS.]

4. Which of the following is true for tax-exempt income included in an estate or trust? **(Page 6)**

a. Estates and trusts are required to disclose the amount of tax-exempt income on Form 1041 for the year. [This answer is correct. Estates and trusts are required to disclose the amount of tax-exempt income as required by the IRS. A question in the "Other Information" section on the bottom of page 2 of Form 1041 requires a box to be checked "Yes" if the fiduciary received any tax-exempt income during the tax year, and a line is provided for disclosure of the amount of such income.]

b. Interest income on bonds issued by state and local governments are normally included in the gross income of an estate or trust. [This answer is incorrect. Gross income of an estate or trust generally does not include interest on bonds issued by state and local governments as detailed by the IRS. Exceptions as stated in IRC Sec. 103(b) apply to certain private activity bonds, arbitrage bonds, and unregistered bonds.]

c. Interest income that is tax-exempt for estates and trusts are always preference items for AMT purposes on the taxpayer's return. [This answer is incorrect. Interest income from certain private activity bonds issued after August 7, 1986 is not tax-exempt for alternative minimum tax (AMT) purposes. However, certain types of tax-exempt housing bonds issued after July 30, 2008 are not considered private activity bonds and thus, are not included as preference items for AMT purposes as indicated in IRC Sec. 57(a)(5)(C)(iii).]

d. A deduction is allowed for expenses that are related to tax-exempt income for estates or trusts. [This answer is incorrect. According to IRC Sec. 265(a), a deduction for expenses allocable to tax-exempt income is disallowed. Therefore, if all income is tax-exempt, no deductions are allowed because all expenses are allocated to tax-exempt income.]

5. The Logan Trust earned $60,000 in 2010, broken down as follows:

Qualified dividends	$20,000
Taxable interest	25,000
Tax-exempt interest	15,000
Total income	$60,000

In addition, The Logan Trust donated $20,000 to Read to the Kids, a qualified charity, made no distributions to income beneficiaries and did not incur any expenses related to the trust. The trust did not specify which income funds were used for the charitable contribution. Which of the following is true regarding the charitable contribution from the trust? **(Page 7)**

a. Any tax-exempt interest allocated to the charitable contribution will be reported in the "Other Information" section of page 2 of Form 1041. [This answer is incorrect. Tax-exempt interest allocated to the charitable

contribution is reported on line 2 of Schedule A of Form 1041, the income tax return for estates and trusts as designated by the IRS. All tax-exempt income received during the year is disclosed in the "Other Information" section.]

b. The entire $20,000 donated would be deductible for The Logan Trust since it was donated to a charitable organization. [This answer is incorrect. Only a portion of the amount donated to charitable contribution would be deductible for The Logan Trust, based on a ratable portion of each class of income, including tax-exempt income as stated in Reg. 1.643(a)-5.]

c. $5,000 of the tax-exempt interest will be nondeductible for The Logan Trust. [This answer is correct. According to Reg. 1.643(a)-5(b), charitable contributions are deemed to be made ratably from all classes of income, including tax-exempt interest. The nondeductible portion was be computed as follows: $20,000 × ($15,000/$60,000) = $5,000.]

6. Katie is a beneficiary of a simple trust, created by her grandfather's will. The trust receives qualified dividend income from numerous investments in domestic corporations. Which of the following is correct regarding the reporting of the qualified dividend amount by the trust? **(Page 8)**

a. The trust should report the entire amount of qualified dividend income on line 2b(2) of Form 1041. [This answer is incorrect. The trust should report the entire amount of the qualified dividends on Form 1041 line 2b(1) and no entry on line 2b(2) as required by the IRS.]

b. The trust would report the entire qualified dividend amount allocable to Katie, even if there are indirect expenses associated to various types of income in the trust. [This answer is correct. For simple trusts, the entire qualified dividend amount is reported to the beneficiaries even if there are indirect expenses being allocated to various types of income in the simple trust as directed by the IRS.]

c. The expenses would be allocated to the gross qualified dividend amount distributed to each beneficiary of the trust. [This amount is incorrect. For an estate or complex trust, the amount of qualified dividends allocable to the beneficiaries on Form 1041 2b(1) will be less than the total qualified dividend amount allocated to the beneficiaries on line 2b of their Schedules K-1 whenever there are expenses properly allocable to the fiduciary's gross qualified dividend income. This is because the amount on line 2b of each Schedule K-1 is reduced by expenses properly allocable to the gross qualified dividend amount distributed to each beneficiary. However, this does not apply to simple trusts.]

d. Qualified dividends would be distributed between Katie and the trust by dividing total income distributable by distributable net income and multiplying by total dividends received by the trust. [This answer is incorrect. When allocated qualified dividends between the beneficiaries and an estate or trust, the qualified dividends allocated to the beneficiaries is determined according to the following formula: (Total income distribution / Distributable net income) × Total qualified dividends. So, the formula includes only qualified dividends, not total dividends received by the trust. However, in a simple trust, all income is distributed to the beneficiary. Therefore, no allocation is necessary.]

U.S. Savings Bonds Interest Reporting

General Rules

Series E and EE U.S. savings bonds are zero coupon investments issued at a discount. The interest is paid at maturity when the coupons are redeemed for their full face value. Each year prior to maturity, the bond's redemption value increases. This annual increase in value represents the interest accrual for each year. Series E bonds were last issued in 1979. Since then, U.S. savings bonds have been designated as Series EE.

Series H and HH U.S. savings bonds are issued at face value and pay taxable interest in cash twice a year (taxable on receipt by cash-basis taxpayers). Series H bonds were issued until 1979. Subsequent coupon payment bonds have been designated as Series HH. Series HH bonds are acquired only by exchanging Series E or EE bonds. Series H and HH bonds allow the taxpayer to *continue* to defer the accumulated interest from the exchanged E or EE bonds until the H or HH bonds mature, up to 20 additional years. However, any cash received upon the exchange is taxable to the extent of deferred interest earned on the bonds traded. No new series HH bonds were issued after August 31, 2004.

Series I U.S. savings bonds combine the features of deferring taxes on the interest until maturity with inflation protected growth. Series I bonds are 30-year instruments. They were first issued in September 1998 and contain a fixed interest rate and an inflation-adjusted rate. The bonds are issued at face value. Interest is added to the bond monthly, compounded semi-annually, and paid when the bond is redeemed. Series EE bonds cannot be exchanged for Series I bonds and Series I bonds cannot be exchanged for Series HH bonds.

The government has extended the maturity date for most (but not all) Series E and EE bonds. Interest continues to accrue on these bonds past the original maturity date. This post-maturity date interest is reported using the same method as applied before maturity.

Zero coupon bonds other than Series E and EE bonds are generally subject to the original issue discount rules. However, Series E, EE, and I bonds are exempt from the OID rules.

Cash-basis taxpayers generally report interest earned on Series E and EE bonds in the year of maturity (or in the year redeemed, if earlier). Alternatively, taxpayers can elect to report the interest on the accrual method (i.e., as earned). This election should also apply to Series H and HH bonds received in exchange for E or EE bonds, as well as the new Series I bonds. Once made, the election applies to all U.S. savings bonds owned currently (year of election) and subsequently acquired. In the year of election, the taxpayer reports all income accrued on the bonds from the date of acquisition.

The election to convert to the accrual method for U.S. savings bond interest should be considered and weighed against the lost "time value of money" when:

1. Additional current income would be taxed at a lower rate than income in the bond's year of maturity.

2. The tax rate is relatively low for the final return of a deceased taxpayer in relation to the tax rate of the estate or beneficiaries. (The tax implications of U.S. savings bonds owned at death are discussed later in this lesson.)

3. Additional current income may go untaxed (e.g., taxable income is below the filing limit).

4. A net operating loss or other carryforward item is expiring or otherwise could be used to offset the additional income.

5. Additional current income would be offset by expenses in the year of termination [the beneficiary may not be able to deduct the excess deductions, because they are reduced by 2% of AGI].

Making the Election

The taxpayer can make the election to accrue interest income in any year prior to selling or otherwise disposing of U.S. savings bonds.

To properly elect the accrual method for U.S. savings bond interest, the election must be made on a timely filed return, presumably including extensions, although the regulations do not specifically state this. The election cannot be made on an amended or delinquent return. However, if the election is missed, the taxpayer should consider electing the accrual method the following year. Although the election, once made, is irrevocable without IRS consent, it does not bind a later holder of the same bond if the taxpayer transfers ownership by gift or otherwise.

Calculating the Annual Income Accrual

Tables available from the U.S. Government Printing Office show the current redemption value for all U.S. savings bonds and can be accessed at **www.treasurydirect.gov**. As a practical matter, most financial institutions have access to the bond redemption information. In the election year, the current reportable income is the end-of-the-year redemption value for all such bonds owned on the last day of the year, less their purchase price. In subsequent years, the annual income is the difference between the redemption value at the current year-end and the redemption value at the previous year-end.

Application of Election to Other Bonds

Once made, the election to use the accrual method of reporting interest from U.S. savings bonds applies to all such bonds held at the time of election and all bonds acquired thereafter.

Transfer to a Trust

When Series E or EE bonds are transferred to an irrevocable trust, the transferor is required to recognize all interest accrued to the date of transfer, to the extent not previously recognized. However, if the trust is a grantor trust, and the increase in value of the bonds (i.e., the interest) continues to be taxable to the grantor, the grantor may continue to defer reporting the interest earned each year.

Example 1D-1 Transfer of Series EE bonds to a trust.

Joe Jones funded an irrevocable trust with Series EE U.S. Savings Bonds. He purchased the bonds several years ago for $15,000, and never made the Section 454 election to ratably accrue interest each year. At the time he funded the trust, the unreported increment in the value of the bonds was $7,500.

Joe must recognize the $7,500 unreported increment in value as interest income on his personal return for the year of the transfer to the trust.

The same rule would apply to previously unreported interest on Series E or EE bonds if the transfer to the trust consisted of Series H or HH bonds previously acquired in exchange for Series E or EE bonds.

In the case of an outright gift of the bonds, previously unreported interest income is recognized by the donor in the year of the gift.

U.S. Savings Bonds Owned by Decedents

The manner of reporting interest income on Series EE or Series E Bonds after death of the owner depends on the accounting and income reporting method previously used by the decedent. If the decedent used the accrual method or the cash method with an election to report the interest each year, the interest earned in the year of death up to the date of death must be reported on the decedent's final return. The estate or other person who acquires the bonds includes in income only interest earned after the date of death.

If the transferred bonds were owned by a decedent who used the cash method, did not report the interest each year (i.e., had not made the election to accrue interest), and bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways:

1. An election under IRC Sec. 454 may be made on the decedent's final income tax return to include all of the interest earned on the bonds from their acquisition date to the decedent's date of death. The election is also available if the savings bonds were held in a revocable trust at the time of the decedent's death . The estate or whoever acquires the bonds then includes in income only interest earned after the date of death.

2. If no Section 454 election is made on the decedent's final return, interest earned up to the date of death is income in respect of the decedent, which should not be included in the decedent's final return. Instead, all of the interest earned both before and after the decedent's death is income either:

   a. when the estate makes a Section 454 election,

   b. upon maturity, or

   c. when the bonds are sold or redeemed by the estate or other person who acquires the bonds.

Example 1D-2 Series EE bonds owned by a decedent.

At the time of Pop Werner's death, he owned $10,000 (face value) of Series EE bonds purchased for $5,000 several years ago. Pop had never made the election to recognize accrued interest on the bonds, and the accrued but unrecognized interest at the time of his death was $4,500.

The executor has two choices with respect to the accrued interest. He can make a Section 454 election to recognize the $4,500 on Pop's final return. If the marginal tax bracket on that return is less than on the income tax return of the estate (or other recipient of the bonds), the election is beneficial. This is often the case if the estate, without a Section 454 election, would recognize the interest income. (For 2010, an estate is in a 35% income tax bracket beginning at $11,200 of taxable income, while this same bracket is not reached on a joint individual return until taxable income is $373,650.)

If a Section 454 election is made, the estate or legatee includes the remaining $500 in income when the bonds are cashed at maturity or when it makes a Section 454 election of its own.

If the executor does not make the Section 454 election (either on Pop's final Form 1040 or on the Form 1041 for the estate), the estate or legatee will include the entire $5,000 of unrecognized interest as income when the bonds mature. The $4,500 unrecognized interest at the date of death is income in respect of the decedent (IRD), and will be included in Pop's gross estate (if he died before or after 2010) and in the gross income of the recipient under IRC Sec. 691. In addition, if the estate was subject to federal estate tax (for estates created in a year other than 2010), the recipient (the party who cashes in the bonds at maturity) can claim a miscellaneous itemized deduction, not subject to the 2% limit, for the estate tax attributable to the $4,500.

If Pop had exchanged Series E or EE bonds for H or HH bonds prior to his death, the executor would face the same two choices. All accrued but unrecognized interest on the Series E or EE bonds at the date of death could be included on the final return if the executor made a Section 454 election. On the other hand, if no election is made, the EE bond interest can continue to be deferred until the HH bonds mature. However, the interest on the HH bonds is taxable when received (pre-death interest is IRD).

If Pop and his estate never make a Section 454 election but his estate distributes the EE bonds in satisfaction of a pecuniary (fixed-dollar) bequest (see Example 1D-3), the estate recognizes the interest earned to the date of Pop's death (as IRD), plus any additional interest earned to the date of distribution. The recipient will be responsible for reporting only the interest earned after the transfer.

Pecuniary Bequests Satisfied with U.S. Savings Bonds

If an estate distributes Series E, EE, H, HH, or I bonds in satisfaction of a pecuniary (fixed-dollar) bequest, the interest accrued to the date of the decedent's death, plus any additional interest accrued to the date of distribution, is income reportable by the estate, assuming the decedent had made no Section 454 election. The recipient will be responsible for reporting only the interest earned after the transfer.

Example 1D-3 Series EE bonds distributed in satisfaction of a pecuniary bequest.

Tom Clark died in 2010. His will directed the estate to distribute $20,000 to his nephew Jeff. The executor distributed $30,000 face value of Series EE bonds to Jeff in satisfaction of the bequest. Tom originally purchased the bonds for $15,000, which had accrued but unrecognized interest of $5,000 at the time of the distribution to Jeff.

The estate must recognize the $5,000 of interest in the year of distribution (as IRD). Jeff recognizes only the interest earned after the distribution.

Form 1099 Reporting of Interest Income

When a Series E, EE, H, HH, or I bond is cashed in, the bank or other payer redeeming it will issue a Form 1099-INT prepared on the assumption that no interest had ever been recognized. The amount shown on the Form 1099-INT therefore will be overstated when:

1. a Section 454 election had been made, by an individual or a fiduciary, to report the interest as it accrued each year; or

2. ownership of the bond has been transferred to an irrevocable trust. (See Example 1D-1.)

To avoid IRS matching issues, preparers should either report the entire amount and "back out" the overstated amount (as a negative line item), or report the correct amount with an explanatory statement attached to the tax return.

Revoking the Election

The election to accrue interest on U.S. savings bonds is irrevocable without IRS consent. However, taxpayers may obtain expeditious consent to change back to the cash method for reporting interest income from U.S. savings bonds. Filing Form 3115 is no longer required to make the change. The return must be timely filed (including extensions). The change back to the cash method cannot be made retroactively. No IRS user fee is required for this accounting method change.

Special Problems for Bondholders

Estates and trusts frequently hold fixed-income securities, including bonds. Unique problems arise when bonds are purchased at a premium, for a discount, or between interest payment dates. Note, however, that although the value of inherited bonds may be stepped up (or down) at the decedent's date of death (or alternate valuation date if applicable), the difference between this value and par does not create a premium or discount. For purposes of amortization (not for determining gain or loss on the sale or exchange), bond premiums and discounts are generated only upon purchase—not on inheriting the bond.

Bonds Purchased at a Discount

When a debt security is acquired at less than the stated redemption amount (i.e., at a discount), the difference can be due to either original issue discount (OID), market discount, or both. OID arises at the original purchase (issue) of a debt security, while market discount can occur anytime subsequent to its issuance.

When a debt security (such as a bond) is issued at a price less than the stated redemption price (i.e., at a discount), the difference is referred to as OID. Under IRC Sec. 1272(a), the OID is included in income over the security's term, using the constant rate method.

De Minimis OID. OID is ignored if the discount is less than a *de minimis* amount. The *de minimis* amount is .25% of the stated redemption price at maturity, multiplied by the number of complete years from the original issuance date to maturity. When the OID is considered *de minimis*, the regular OID rules do not apply. Instead, the *de minimis* OID is included in income as principal payments are received. The amount of *de minimis* OID to be included in income equals the *de minimis* OID multiplied by a fraction. The numerator of the fraction is the amount of the principal payment received, and the denominator is the bond's stated principal amount. In addition, any gain attributable to *de minimis* OID that is recognized upon the sale or exchange of the bond is capital gain if the bond is a capital asset in the hands of the bondholder.

Example 1E-1 OID *de minimis* amount.

A bond issued on January 1, 2010, is redeemable on September 15, 2013, for $100,000. The *de minimis* threshold is .25% × $100,000 × 3, or $750. Accordingly, if the issue price exceeds $99,250, any OID is

considered *de minimis*, and is included in income on a prorata basis as principal payments are received. The bond's stated interest is not required to be recomputed under the OID rules. In this example, all of the *de minimis* OID is included in the bondholder's income at maturity because the bond calls for only one payment of principal at maturity.

Recognition of OID. OID on bonds is recognized as follows:

1. *Government Bonds Issued before July 2, 1982.* OID is recognized as ordinary income in the year of maturity.

2. *Corporate Bonds Issued after May 27, 1969, and before July 2, 1982.* OID is recognized over the life of the bond on a straight-line basis.

3. *Government and Corporate Bonds Issued after July 1, 1982, and before January 1, 1985.* OID is recognized using a constant interest rate method over the life of the bond assuming annual compounding, based on the bond's anniversary date.

4. *Government and Corporate Bonds Issued after December 31, 1984, and before April 4, 1994.* OID is calculated using a constant interest rate method assuming semiannual compounding.

5. *Government and Corporate Bonds Issued after April 3, 1994 (also may be relied upon for bonds issued after December 21, 1992, and before April 4, 1994).* OID is generally calculated using a constant interest rate method compounded over any period not to exceed one year (i.e., different accrual periods may be used as long as no period extends more than one year, and each scheduled payment of principal and interest occurs at the end of the accrual period).

Securities Exempt from OID Rules. U.S. savings bonds, short-term obligations (i.e., fixed maturity dates one year or less from the date of issue, such as short-term CDs and Treasury bills), and loans less than $10,000 between two individuals are exempt from the OID rules; their income is taxable at maturity (or sale date, if earlier). However, an election is available under IRC Sec. 1282(b)(2) to recognize income and acquisition discount on short-term obligations as it accrues before maturity or sale. The election, once made, applies to all short-term obligations acquired by the taxpayer on or after the first day of the first tax year to which the election applies.

Reporting OID. Taxpayers holding debt instruments (bonds) with OID should receive a Form 1099-OID showing the amount of OID income for the year. The 1099-OID will also show any periodic interest paid on the security for the tax year. Both the OID and the periodic interest must be reported.

In certain situations, the OID shown on the Form 1099-OID must be recomputed. Recomputing OID is needed when:

1. The debt instruments were purchased at a premium or acquisition premium. When purchased at a premium (i.e., a cost that exceeds the total of all remaining principal payments), no OID is reported. If purchased at an acquisition premium (i.e., a cost that exceeds the original issue price increased for prior OID, but less than the total of all remaining principal payments), the amount of OID to report will be less than that shown on the Form 1099-OID.

2. The debt instrument is a stripped bond or coupon (including zero coupon bonds available through the U.S. Treasury Department's STRIPS program). These include, for example, CATS, TIGRs, and TIPs.

When reporting OID that includes an adjustment, the amount of OID shown on the Form 1099-OID may be entered, followed by the adjustment identified as "OID Adjustment."

The owner of a bond having OID may sell or redeem it before its maturity. Capital gain or loss on the sale or early redemption is determined by the difference between the sale or redemption price and the bond's basis (original cost plus OID accrued and included in the bondholder's income to date). If the bond is held to maturity, no gain or loss results from the redemption because the bond's basis is equal to its face value (unless the bond was acquired in the secondary market at a premium or discount and the taxpayer did not elect to accrue the discount or amortize the premium—see the following discussion in this lesson). However, the taxpayer must still report the redemption on Schedule D.

Market Discount Bonds

Market discount is generally defined as the excess of (1) the bond's stated redemption price at maturity over (2) the taxpayer's basis in such bond immediately after acquisition in the secondary market (i.e., not at original issue). Changes in interest or other factors affecting the quality of the debt generally give rise to market discount and such discount can occur in connection with the purchase of a bond that may or may not include OID. However, market discount is computed differently from bonds with OID.

The market discount rules do not apply to the following bonds: (1) short-term obligations having a fixed maturity date not more than one year from the issue date (e.g. Treasury Bills), (2) tax-exempt obligations acquired before May 1, 1993, and (3) U.S. Savings bonds. In addition, a *de minimis* rule excludes bonds with a market discount of less than .25% of the stated redemption price multiplied by the number of complete years to maturity (after the taxpayer acquired the bond).

A taxpayer can elect to accrue (include currently) market discount in interest income ratably or by applying the OID (constant interest) rules. If no election is made, market discount is not recognized until the bond is disposed of, redeemed, or matures. Gain on the disposition of a bond having market discount is taxed as ordinary income (i.e., interest) to the extent of its accrued market discount, which is total market discount multiplied by the number of days the bondholder owned the bond divided by the number of days remaining in the bond's term after its purchase in the secondary market. Alternatively, a taxpayer can elect to calculate accrued market discount by applying the OID rules as if the bond had been originally issued on the date it was acquired by the taxpayer.

Market Discount and OID. A bond originally issued at a discount may be purchased in the secondary market at a discount exceeding the amount of its OID. In this case, the bond's market discount is the excess of its revised issue price (original issue price plus OID accrued and included in the income of all previous bondholders) over its basis immediately after its purchase in the secondary market. Gain on the disposition of a bond having market discount is taxed as ordinary income (i.e., interest) to the extent of its *accrued market discount*, which is total market discount multiplied by the number of days the bondholder owned the bond divided by the number of days remaining in the bond's term after its purchase in the secondary market.

Example 1E-2 Market discount bond with OID.

On January 1, 2010, Trust Z, a cash basis taxpayer, purchased a newly issued bond of MDB, Inc. The trustee paid $9,600 for a $10,000 bond with stated annual interest payments of $700 each December 31. The bond matures on December 31, 2014.

Since Trust Z is the original purchaser, the $400 discount is OID. The $400 discount is not *de minimis* OID because it is greater than the *de minimis* amount, $125 ($10,000 × .25% × 5). Therefore, OID and stated interest are to be reported in accordance with the following schedule.

Year	Imputed Interest[a]	Qualified Stated Interest[b]	Allocated OID[c]
2010	$ 768	$ 700	$ 68
2011	773	700	73
2012	779	700	79
2013	786	700	86
2014	792	700	92
	$ 3,898	$ 3,500	$ 398

Notes:

[a] Interest calculated using the constant interest method. The bond's adjusted issue price is multiplied by its effective yield. When it was issued for $9,600, the bond had an effective yield of 8%. The effective yield is the discount rate that, when used in computing the present value of the

bond's principal and interest payments, sets the computed present value of the payments equal to the bond's issue price. Imputed interest is computed as follows:

2010	$9,600	×	.08	=	$768
2011	($9,600 + $68)	×	.08	=	$773
2012	($9,600 + $68 + $73)	×	.08	=	$779
2013	($9,600 + $68 + $73 + $79)	×	.08	=	$786
2014	($9,600 + $68 + $73 + $79 + $86)	×	.08	=	$792

[b] The bond's annual interest payments are qualified stated interest, and are included in gross income each year when received. They are not included in OID.

[c] The OID allocable to each accrual period is the difference between the interest computed using the constant interest method (Note a) and the bond's qualified stated interest (Note b). This is normally reported on Form 1099-OID, Box 1.

Trust Z recognizes OID of $68 in 2010 and $73 in 2011, in addition to the $700 annual payments of qualified stated interest. On January 1, 2012, Trust Z sells the bond to Trust A, a cash basis taxpayer for $9,400. The bond's basis and adjusted issue price to Trust Z is $9,741 ($9,600 + $68 + $73). Trust Z therefore recognizes a capital loss of $341 ($9,400 − $9,741).

The bond is a market discount bond to Trust A. The bond's revised issue price is $9,741 ($9,600 + $68 + $73). The bond's market discount is $341 ($9,741 − $9,400), which is not *de minimis* market discount because it is greater than the *de minimis* amount, $75 ($10,000 × .25% × 3).

Trust A recognizes OID income of $79 in 2012 and $86 in 2013, in addition to the $700 annual payments of interest. On January 1, 2014, Trust A sells the bond for $9,900. The bond's basis to Trust A is $9,565 ($9,400 + $79 + $86). Trust A realizes a gain of $335 ($9,900 − $9,565). Of this gain, $228 is treated as ordinary income (i.e., interest), and the remainder is treated as capital gain. The $228 treated as ordinary income represents the market discount accrued while Trust A owned the bond ($341 market discount × 730 days held by Trust A ÷ 1,094 days remaining in the bond's term after it was purchased by Trust A).

Alternatively, a taxpayer can elect to apply the OID rules as if the bond had been originally issued on the date it was acquired in the secondary market.

Example 1E-3 Election to apply OID rules.

Assume the same facts as in Example 1E-2, except the bond was not newly issued but rather purchased in the secondary market. Also assume the bond was purchased on an interest payment date and therefore the purchase price does not include any accrued interest. Also assume there was no OID.

Trust Z can accrue the $400 market discount ratably over the five-year period or it can elect to use the same method as under the OID rules. The differences in the two methods are summarized below.

	Accrue Ratably	Elect to Use OID	Difference
Year 1	$ 80	$ 68	$ 12
Year 2	80	73	7
Year 3	80	79	1
Year 4	80	86	(6)
Year 5	80	92	(12)
Total	$ 400	$ 398	$ 2

Additionally, a taxpayer may elect to include any market discount in income currently and adjust the basis in the bond each year by the amount of income recognized. The basis of the bond is increased by the amount of market discount included in gross income under this election.

Bonds Purchased with Accrued Interest

When bonds are bought between interest payment dates, the accrued interest is included in the purchase price paid to the seller at the time of sale. While this "purchased interest" is taxable to the seller, the purchaser may receive a Form 1099 showing the total interest paid for the year. Thus, an adjustment is required to report the correct amount of interest on Form 1041.

Example 1E-4 Purchased interest offsets interest received.

The Rich Sums Testamentary Trust purchased a $10,000 30-year U.S. Treasury bond yielding 6% on March 1 for $10,150 ($10,000 face amount plus $150 accrued interest). During the year, the trust received $600 in interest payments, which included the $150 of interest purchased on March 1.

The trust should include the full amount of interest, but below the subtotal of all interest income reported, the trust will enter $150 of "Accrued Interest Purchased" as a subtraction. This way, it will report the net $450 of interest on Form 1041. An accounting entry is required on the trust's books to offset the $600 received with the $150 of purchased interest.

Bonds Purchased at a Premium

When a debt instrument such as a bond is acquired at a price in excess of its face (or maturity) value, such excess is referred to as a bond premium. A premium can be paid either (1) at the bond's original issue or (2) when purchased in the secondary market. When an estate or trust purchases a taxable bond at a premium, the fiduciary can elect to amortize the premium over the life of the bond. If made, the election applies to all taxable bonds purchased at a premium and held at the beginning of the year or purchased thereafter. As the premium is amortized, the basis of the bond is reduced correspondingly. Thus, the election has the effect of converting a capital deduction into an ordinary income deduction. If the election is not made, the premium remains as part of the basis in the bond until disposal or maturity and recognized as a capital loss.

How bond premium amortization on taxable bonds is reported depends on when the bond was acquired. For bonds acquired after 1987, the amortization is a reduction of interest income. For bonds acquired after October 22, 1986, but before 1988, the amortization is treated either as investment interest expense or, if elected, as a reduction of interest income. For bonds acquired before October 23, 1986, the amortization is treated as "Other deductions not subject to the 2% floor."

Amortization of bond premiums is deducted directly on Form 1041 and is not allocated among the fiduciary and beneficiaries in the same manner as depreciation and depletion.

The election to amortize the premium over the life of the bond is made on the return for the first tax year the fiduciary desires it to be effective, without regard to such an election made by the decedent or grantor. The election is made by claiming the amortization as discussed above and attaching a statement to a timely filed return (presumably, including extensions but the regulations do not specifically say this).

Amortizable Bond Premium at Date of Death

The amount of amortizable bond premium attributable to the period ending with the date of an individual's death is a deduction on the individual's final Form 1040, in accordance with the rules previously discussed, and does not carry over to the estate.

SELF-STUDY QUIZ

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

7. Which of the following is **not** allowed when reporting interest earned on U.S. savings bonds?

    a. Taxpayers can elect to report interest earned from U.S. savings bonds on the accrual method, as the interest is earned.

    b. A taxpayer is allowed to change their election of how to report their savings bonds each tax year.

    c. The tax year that the taxpayer makes their election of how to treat U.S. savings bonds, the taxpayer reports all income accrued on the bonds from the date of acquisition.

8. If a Series EE U.S. savings bond is transferred to fund a trust, which of the following is true?

    a. If the bonds are a gift, the trust has to recognize the unreported interest income in the year the bonds are gifted.

    b. If the trust is a grantor trust, any increase in value on the bonds is taxable to the grantor, the grantor must pay the tax in the year transferred.

    c. If the bonds are transferred to an irrevocable trust, all interest accrued as of the date of transfer is recognized by the transferor.

9. Tim passes away in 2010. In his will, it is indicated that his daughter, Maren, should be distributed $30,000. The executor of the will distributed Maren a Series EE bond with a face value of $35,000 to satisfy the bequest indicated in the will. Tim's original purchase price of the bond was $20,000. The bond had accrued $5,000 of unrecognized interest at the time of the distribution to Maren. Which of the following is true?

    a. If no Section 454 election is made on Tim's final return, the interest should be included in Tim's final return.

    b. Tim's estate should recognize the $5,000 of interest on the Series EE bond as IRD.

    c. Maren would be responsible for reporting the unrecognized interest associated with the bequest.

    d. If a Section 454 election was made on Tim's final return, Maren will be responsible for reporting the unrecognized interest.

10. Aubrey discovers a corporate bond that was issued on July 1, 1981 in her grandmother's records after her grandmother passed away. How would the original issue discount (OID) of the bond be treated?

    a. Recognized as ordinary income in the year of maturity.

    b. Calculated using a constant interest rate method with semiannual compounding.

    c. Recognized using a constant interest rate method over the life of the bond with annual compounding.

    d. Over the life of the bond on a straight-line basis.

11. When debt instruments are acquired at a price in excess of its face value, the excess is referred to as a bond premium. Which of the following is correct regarding the bond premium?

    a. If an estate or trust chooses to amortize the premium of a taxable bond over its life, the election applies to all taxable bonds purchased at a premium thereafter.

    b. If an estate or trust purchases a taxable bond at a premium, the premium must be reported on its tax return in the year of purchase.

    c. Any taxable bond with a premium that is acquired in the current year by an entity and amortized, it is treated as investment interest expense in the financial statements.

    d. For taxable bonds with a premium to be amortized over the life of the loan, the election must have been made by the decedent if included in an estate or trust.

SELF-STUDY ANSWERS

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

7. Which of the following is **not** allowed when reporting interest earned on U.S. savings bonds? **(Page 16)**

    a. Taxpayers can elect to report interest earned from U.S. savings bonds on the accrual method, as the interest is earned. [This answer is incorrect. Taxpayers are allowed to elect to report interest from U.S. savings bonds on the accrual method (i.e., as earned) according to IRC Sec. 454(a).]

    b. A taxpayer is allowed to change their election of how to report their savings bonds each tax year. [This answer is correct. Once the taxpayer makes the election on how they are going to report their savings bonds, the election applies to all U.S. savings bonds owned currently (year of election) and subsequently acquired. The taxpayer is not allowed to change their election each year.]

    c. The tax year that the taxpayer makes their election of how to treat U.S. savings bonds, the taxpayer reports all income accrued on the bonds from the date of acquisition. [This answer is incorrect. According to IRS law, in the year the taxpayer makes their election on how to treat U.S. savings bonds, the taxpayer should report all income accrued on the bonds from the date of acquisition.]

8. If a Series EE U.S. savings bond is transferred to fund a trust, which of the following is true? **(Page 16)**

    a. If the bonds are a gift, the trust has to recognize the unreported interest income in the year the bonds are gifted. [This answer is incorrect. In the case of an outright gift of the U.S. Savings bonds, previously unreported interest income is recognized by the donor, not the trust, in the year of the gift.]

    b. If the trust is a grantor trust, any increase in value on the bonds is taxable to the grantor, the grantor must pay the tax in the year transferred. [This answer is incorrect. If the trust is a grantor trust, and the increase in value of the bonds (i.e., the interest) continues to be taxable to the grantor, the grantor may continue to defer reporting the interest earned each year.]

    c. If the bonds are transferred to an irrevocable trust, all interest accrued as of the date of transfer is recognized by the transferor. [This answer is correct. When Series E or EE bonds are transferred to an irrevocable trust, the transferor is required to recognize all interest accrued to the date of transfer, to the extent not previously recognized.]

9. Tim passes away in 2010. In his will, it is indicated that his daughter, Maren, should be distributed $30,000. The executor of the will distributed Maren a Series EE bond with a face value of $35,000 to satisfy the bequest indicated in the will. Tim's original purchase price of the bond was $20,000. The bond had accrued $5,000 of unrecognized interest at the time of the distribution to Maren. Which of the following is true? **(Page 16)**

    a. If no Section 454 election is made on Tim's final return, the interest should be included in Tim's final return. [This answer is incorrect. According to Rev. Rul. 64-104, if no Section 454 election is made on the Tim's final return, interest earned up to the date of death is income in respect of the decedent, which should not be included in Tim's final return.]

    b. Tim's estate should recognize the $5,000 of interest on the Series EE bond as IRD. [This answer is correct. If an estate distributes Series E, EE, H, HH, or I bonds in satisfaction of a pecuniary (fixed-dollar) bequest, the interest accrued to the date of the decedent's death, plus any additional interest accrued to the date of distribution is income reportable by the estate.]

    c. Maren would be responsible for reporting the unrecognized interest associated with the bequest. [This answer is incorrect. When a person inherits a pecuniary bequest that is satisfied with US savings bonds, the recipient is only responsible for reporting the interest earned after the transfer per Reg. 1.1014-4(a)(3).]

    d. If a Section 454 election was made on Tim's final return, Maren will be responsible for reporting the unrecognized interest. [This answer is incorrect. Per Rev. Rul. 68-148, an election under IRC Sec. 454 may

be made on the decedent's final income tax return to include all of the interest earned on the bonds from their acquisition date to the decedent's date of death.]

10. Aubrey discovers a corporate bond that was issued on July 1, 1981 in her grandmother's records after her grandmother passed away. How would the original issue discount (OID) of the bond be treated? **(Page 19)**

    a. Recognized as ordinary income in the year of maturity. [This answer is incorrect. As indicated in Reg. 1.1272-1(b), for government bonds issued before July 2, 1982, OID is recognized as ordinary income in the year of maturity. This does not apply to the corporate bond that Aubrey found.]

    b. Calculated using a constant interest rate method with semiannual compounding. [This answer is incorrect. For government and corporate bonds issued after December 31, 1984 and before April 4, 1994, OID is calculated using a constant interest rate method assuming semiannual compounding as detailed in Reg. 1.1272-1(b).]

    c. Recognized using a constant interest rate method over the life of the bond with annual compounding. [This answer is incorrect. With government and corporate bonds issued after July 1, 1982 and before January 1, 1985, OID is recognized using a constant interest rate method over the life of the bond assuming annual compounding, based on the bond's anniversary date.]

    d. Over the life of the bond on a straight-line basis. [This answer is correct. For corporate bonds issued after May 27, 1969 and before July 2, 1982, OID is recognized over the life of the bond on a straight-line basis based on Reg. 1.1272-1(b).]

11. When debt instruments are acquired at a price in excess of its face value, the excess is referred to as a bond premium. Which of the following is correct regarding the bond premium? **(Page 19)**

    a. If an estate or trust chooses to amortize the premium of a taxable bond over its life, the election applies to all taxable bonds purchased at a premium thereafter. [This answer is correct. If the election to amortize the premium of a taxable bond over its life is made by an estate or trust, the election applies to all taxable bonds purchased at a premium and held at the beginning of the year or purchased thereafter. As the premium is amortized, the basis of the bond is reduced correspondingly. Thus, the election has the effect of converting a capital deduction into an ordinary income deduction.]

    b. If an estate or trust purchases a taxable bond at a premium, the premium must be reported on its tax return in the year of purchase. [This answer is incorrect. When an estate or trust purchases a taxable bond at a premium, the fiduciary can elect to amortize the premium over the life of the bond according to IRC Sec. 171(c).]

    c. Any taxable bond with a premium that is acquired in the current year by an entity and amortized, it is treated as investment interest expense in the financial statements. [This answer is incorrect. How bond premium amortization is reported depends on when the bond was acquired. For bonds acquired after 1987, the amortization is a reduction of interest income. For bonds acquired after October 22, 1986, but before 1988, the amortization is treated either as investment interest expense or, if elected, as a reduction of interest income. For bonds acquired before October 23, 1986, the amortization is treated as "Other deductions not subject to the 2% floor."]

    d. For taxable bonds with a premium to be amortized over the life of the loan, the election must have been made by the decedent if included in an estate or trust. [This answer is incorrect. The election to amortize the premium over the life of the bond is made on the return for the first tax year the fiduciary desires it to be effective, without regard to such an election made by the decedent or grantor.]

Postmortem Retirement Plan Distributions—Qualified Plans and Traditional IRAs

General Rules

When a decedent owned a retirement plan account at the date of death and an estate or trust was named as the designated beneficiary, the return preparer faces three primary income tax considerations: (1) how distributions from the plan are to be taxed, (2) when distributions are required to be made, and (3) how income tax can be minimized.

Taxable distributions from a decedent's individual retirement account (IRA) and nonlump-sum distributions from qualified retirement plans are generally ordinary income to a recipient, whether distributed to a surviving spouse, a nonspouse individual, a trust, or the decedent's estate. Although favorable tax treatment (10-year forward averaging and capital gain rates) is available for certain distributions from qualified plans, it is not available for IRA distributions.

Income earned within a qualified retirement plan or IRA (internal income) is not subject to income taxation by either the participant or the beneficiary prior to being distributed.

When a retirement plan or traditional IRA account owner dies, the distribution requirements and related tax effects primarily depend on: (1) whether the deceased individual had reached his or her required beginning date prior to death and (2) who the decedent had designated as beneficiary. For a summary of these rules in the form of decision tree flowcharts, see *PPC's Guide to Practical Estate Planning*.

The required beginning date (RBD) is generally April 1 of the year following the year in which the account owner attained age 70$^1/_2$. For participants of qualified plans (not IRAs) owning no more than 5% of the stock in the employer sponsoring the plan or participants of an employer funded 403(b) plan, the RBD may be extended beyond age 70$^1/_2$ until April 1 of the year after the participant retires.

If an IRA participant/owner had reached the required beginning date by the date of death but had not received the minimum required distribution (MRD) for that year, the MRD must be paid to the IRA's designated beneficiary to the extent it was not distributed to the participant/owner.

If an estate or trust is the beneficiary of a qualified plan or IRA, the proceeds it receives from the plan are included in distributable net income (DNI). However, the estate or trust is entitled to an income distribution deduction (as limited by DNI) under IRC Sec. 661 for income distributions it makes to a beneficiary (other than those in satisfaction of a pecuniary bequest).

If the estate or trust does not distribute the IRA or retirement plan proceeds to a beneficiary, the proceeds are taxed at the estate or trust level, which will typically result in a greater tax burden than if the proceeds were distributed to an individual beneficiary. Thus, it will generally be preferable for the estate or trust to distribute the proceeds (and thus, shift the income tax burden) to the beneficiary. However, the executor or trustee must look to the governing instrument and/or local law to determine what can be distributed to a beneficiary and what is considered income and principal. A distribution from an IRA or qualified plan may consist of both income and principal. For example, if the trustee only has the authority to distribute trust income to the beneficiary, and if, as is often the case, the governing instrument is silent as to income classification, local law must be consulted. Most states have adopted one of the Uniform Principal and Income Acts with various modifications. Typically, the retirement plan proceeds are considered primarily principal, and thus, the trust will not be able to shift much, if any, of the income tax burden to the beneficiary if the trustee is not authorized to make distributions of principal. (If the trustee is not able to determine what is income vs. principal, and the Uniform Principal and Income Act of 1997 applies, 90% of required distributions are allocable to principal; payments made that are not required under the minimum distribution rules are allocable entirely to principal.

Determining the Designated Beneficiary

The designated beneficiary of an account is determined based on the beneficiary designated as of the participant's date of death and who remains a beneficiary on September 30 of the year following the year of the participant's

death. A beneficiary will be disregarded for determining the distribution period for MRDs after the participant's death if, by September 30 of the year following the participant's death, the beneficiary has received distribution of the entire benefit or made a qualified disclaimer.

In general, only an individual can be a designated beneficiary for the minimum required distribution rules. However, if certain criteria are met, as described in the following discussion, a trust may be considered a designated beneficiary.

To be treated as a beneficiary, the individual must be designated as a beneficiary, rather than using a distribution, disclaimer, or account division to create a new beneficiary who did not exist at the date of death. Having rights to the benefits under the decedent's will or state law (e.g., by being the sole beneficiary of the estate or by inheriting the benefits under state intestacy laws) does not make that individual a designated beneficiary.

Trust Named as Beneficiary

The beneficiary of a trust may be a designated beneficiary if the trust is considered a *qualified trust*. A trust is considered qualified if, as of the later of the date on which the trust is named as a beneficiary or the owner/participant's required beginning date, the following requirements are met (and continue to be met)

1. the trust is a valid trust under state law, or would be but for the fact that there is no principal;

2. the trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee;

3. the trust beneficiaries are properly identifiable from the trust document; and

4. proper documentation has been provided to the administrator of the plan or IRA by October 31 after the year of the participant's death.

If the trust meets these criteria, the trust beneficiaries are considered the designated plan beneficiaries for computing the required minimum distributions. Therefore, the oldest trust beneficiary's life expectancy is used to compute the required distributions. Furthermore, if one of the trust beneficiaries is not an individual (e.g., a charity), the plan participant is treated as not having a designated beneficiary for purposes of computing the required distributions. In that case, distributions must be based on the participant's single life expectancy.

If a qualified terminable interest (QTIP) trust is a beneficiary of a retirement plan or IRA and the qualified trust requirements are met, distributions to the QTIP trust will be treated as paid directly to the surviving spouse. The account balance will qualify for the estate tax marital deduction, even though the remainder interest is payable to nonspouse beneficiaries.

Example 1F-1 QTIP trust named as beneficiary of IRA.

Bill Martin died in 2010. He had directed that his IRA balance be distributed in annual installments over the life expectancy of his wife, Pat, to a testamentary QTIP trust. The income earned on the undistributed balance of the IRA is also to be distributed annually to the trust. Under applicable state law, the installments of the IRA balance become trust principal. All trust income, including the amount earned on the undistributed (as well as the distributed) portion of the IRA, is payable to Pat. Upon Pat's death, any undistributed balance in the IRA is to be distributed to the trust, and the children are the remainder beneficiaries of the trust.

Since the trust operates as a mere conduit for payment of the annual income earned in the IRA to Pat, the trust satisfies the QTIP requirements that all income be payable to the surviving spouse at least annually.

For tax reporting purposes, all taxable amounts distributed from the IRA to a trust are included in gross income of the trust. The trust then claims an income distribution deduction for amounts distributed to Pat.

For a detailed discussion of naming a trust as beneficiary of a qualified plan or IRA, see *PPC's Guide to Practical Estate Planning*.

A designated beneficiary can be determined as late as September 30 following the year of the participant's death. Thus, if an otherwise nonqualified trust is named as a beneficiary of an IRA or qualified plan, it may be possible to correct the problem of having a nonindividual beneficiary (e.g., a charity) by distributing that beneficiary's entire interest by September 30 of the year following the participant's death. Because that nonindividual is no longer a potential designated beneficiary, required minimum distributions may generally be made over the life expectancy of the oldest remaining beneficiary who is an individual.

Estate Named as Beneficiary

If an estate (or other non-individual or trust not considered a qualified trust) is named as the beneficiary of a qualified plan or IRA, post-death minimum required distributions (MRDs) may be greatly accelerated since they will be computed as if there is no designated beneficiary.

Death before the Owner's Required Beginning Date. If the participant/owner dies before his or her required beginning date, distributions must be totally distributed by December 31 of the fifth year following the year the participant/owner died. However, a spouse who is the only beneficiary of the estate and has total control of the plan assets may be able to roll over the balance into his or her own IRA.

Death after the Owner's Required Beginning Date. If the participant/owner dies after his or her required beginning date, the required minimum distributions must continue at least as rapidly as during the participant/owner's life. Thus, minimum required distributions must be calculated using the participant/owner's remaining single life expectancy. The spousal rollover option may be available if the spouse is the only beneficiary of the estate and has total control of the plan assets.

However, if the spouse is the beneficiary of the estate and has the authority to direct distributions to him or herself, a spousal rollover still may be allowed even if the estate, rather than the spouse, is named as the beneficiary of the retirement plan.

Funding Pecuniary Bequest with Retirement Plan Benefits May Accelerate Income

A pecuniary formula bequest to a surviving spouse (or to a marital trust) is a bequest of a fixed-dollar amount determined by a formula. If assets classified as IRD (income accrued but not recognized at the date of death by a cash basis taxpayer and includable in the gross estate) are transferred from the estate or trust to a beneficiary in satisfaction of a pecuniary bequest, income recognition to the recipient may be accelerated. The income may be recognized even though the right to receive the IRD has not been converted to cash.

Benefits payable from a qualified plan or IRA are IRD to the extent the benefits exceed the aggregate amount of the owner's nondeductible contributions. For example, if an IRA were transferred by the estate to a marital trust in satisfaction of a pecuniary bequest, the entire date-of-death value of the IRA less the owner's nondeductible contributions may be recognized as ordinary income by the estate in the year of transfer, even if the IRA balance was to be distributed over a number of years as an annuity. However, the estate may claim a deduction for estate tax paid on IRD included in the decedent's estate.

It is unclear whether funding a pecuniary bequest (other than one using the fairly representative method) with retirement plan assets will cause immediate gain recognition according to the IRD transfer rules.

Reporting Retirement Plan Distributions to an Estate or Trust

The treatment of retirement plan distributions to an estate or trust as income or principal for fiduciary accounting purposes depends on the terms of the will or trust document. If the governing instrument is silent, local law controls. Under the general rule, the value of the qualified plan or IRA at the date the trust or estate becomes the IRA beneficiary is treated as principal for fiduciary accounting purposes. Most states have adopted one of the Uniform Principal and Income Acts with various modifications. A distribution from an IRA or qualified plan may consist of both income and principal. For example, if the trustee cannot otherwise determine what is income or principal and the Uniform Principal and Income Act of 1997 applies, 10% of distributions *required* to be made [e.g., a required minimum distribution under IRC Sec. 401(a)(9) or a distribution amount required by the retirement plan] is allocated to income and 90% to principal. *Nonrequired* payments are allocated entirely to principal.

Example 1F-2 IRA distributions considered primarily principal for fiduciary accounting purposes made to a simple trust.

Henry Olds died on September 3, 2009, owning a traditional (non-Roth) IRA valued at $700,000 (basis of $0). He died after his required beginning date and had already taken his required minimum distribution for 2009. The IRA documents Henry had executed years earlier named a trust, created under the law of his home state, as the designated beneficiary of his IRA. The trust document also named Henry's spouse, Mary, should she survive him, as the sole income beneficiary of the trust and required all the trust's income to be distributed to her each year. The trust requires principal to be distributed equally between their two children upon Mary's death.

Although the trust instrument is silent about whether the IRA distributions are to be classified as income or principal for fiduciary accounting purposes, applicable state law follows the Uniform Principal and Income Act of 1997, which allocates 10% of required distributions to fiduciary income and 90% to principal. (All nonrequired IRA and retirement plan distributions are allocated to principal.) Thus, the trustee is only permitted to make distributions to Mary of 10% of *required* minimum distributions that the trust receives from the IRA, despite the fact that Mary is the sole "income" beneficiary of the trust. On November 15, 2010, the IRA custodian distributed $100,000, of which $8,000 was a required minimum distribution (based on Mary's life expectancy), to the trust according to the trustee's instructions. The trustee immediately invested these funds, generating earnings of $1,500 in taxable interest income by the trust's December 31 year-end. The trust had no expenses for the period ending December 31, 2010.

The trustee distributed the $1,500 in taxable interest income and $800 ($8,000 x 10% allocated to fiduciary income) to Mary in February 2011 since, according to the trust terms, all fiduciary accounting income must be distributed to the surviving spouse. For tax purposes, the trust will report adjusted total income (all ordinary income) of $101,500 ($100,000 IRA distribution + $1,500 interest income) but is only entitled to a distribution deduction for the $2,300 ($1,500 + $800) distributed to Henry's widow.

On Schedule K-1, the IRA distribution of $800 is classified as IRD as a memo item, which alerts Mary of a potential Section 691(c) deduction.

A different income tax result would occur if the executor or trustee were authorized to make discretionary distributions of principal to the income beneficiary and actually did so. (The Uniform Principal and Income Act of 1997 authorizes a trustee to make discretionary adjustments between principal and income to provide an equitable total investment return among the income and remainder beneficiaries.) In that case, the trust would obtain a deduction by distributing some or all of the IRA income to the income beneficiary, even though the estate or trust may treat the retirement funds received as principal for fiduciary accounting purposes. The distribution would reduce the combined income tax burden of the estate or trust and the individual to the extent it equalized the marginal income tax rates of the Form 1041 for the fiduciary and Form 1040 for the income beneficiary.

Example 1F-3 IRA distributions considered primarily principal, but distributions of principal allowable to trust beneficiary.

Assume the same facts as in Example 1F-2, except that the trustee was authorized, according to the trust instrument, to make discretionary distributions of principal to Mary. The trustee determined that minimizing the combined income tax burden for both the trust and Mary was the proper objective. Thus, she distributed the minimum amount required to prevent the trust from paying income tax at the rate of 35% while also preventing Mary's marginal tax rate from reaching 35%. Because Mary's projected marginal tax rate would likely be less than 35% even with the additional distribution of income, the trustee distributed $90,700 ($1,500 interest income + $800 IRA proceeds allocable to income + $88,400 IRA proceeds allocable to principal) to Mary in February 2011 [for 2010, due to the 65-day election made by the trustee under Section 663(b)], leaving the trust with a taxable income of $10,500. (The 35% trust income tax rate for 2010 begins at $11,201 for trusts and estates.)

Note that although this is technically a complex trust because distributions of principal were made, an exemption of $300 is still allowed. A trust required to distribute all of its income currently is entitled to a deduction of $300 even in a year when it distributes principal and, therefore, is not a "simple trust."

Retirement Plan Balance Is Income in Respect of a Decedent

A decedent's balance in a traditional (non-Roth) IRA or retirement plan at the date of death, including unrealized appreciation and income accrued to that date, minus the aggregate amount of the owner's nondeductible contributions, is income in respect of a decedent (IRD). IRD is includable in the decedent's gross estate for estate tax purposes and is taxable to its recipient for income tax purposes regardless of the recipient's method of accounting. In addition, IRD does not receive a step-up in basis upon the death of the owner. However, the recipient may claim a deduction for estate tax paid on the IRD.

Postmortem Distributions from Roth IRAs

Roth IRA Defined

The Roth IRA is available for taxpayers to make nondeductible contributions and if certain conditions are met, to receive tax-free distributions. A Roth IRA is simply an IRA designated as a Roth IRA when it is established. Except as provided by IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs.

Application of Minimum Distribution Rule

Post-death Distributions. Roth IRA owners are under no obligation to take lifetime distributions from their Roth IRAs because the normal distribution rules do not apply prior to their death. However, at their death, the distribution rules that apply to Roth IRAs are the same as those that apply to a traditional IRA when the account owner dies prior to his or her required beginning date. Thus, nonspouse beneficiaries normally must receive the entire balance in the account within five years of the year of the owner's death, or if properly elected, over their life expectancy. Spouse beneficiaries can elect to treat the Roth IRA as their own or roll it into their own Roth IRAs. Alternatively, a surviving spouse can also choose to delay distributions until the decedent would have attained age 70 1/2.

Taxation of Distributions

Taxation of a Roth IRA distribution generally depends on whether it is a "qualified" or "nonqualified" distribution.

Qualified Distributions from Roth IRAs Are Nontaxable. "Qualified distributions" from Roth IRAs are not taxable (and not subject to the 10% penalty tax on early withdrawals). A qualified distribution is one that is received after the five-tax-year period beginning with the first tax year for which a contribution is made to a Roth IRA and is:

1. made on or after the date the account owner turns age 59 1/2,
2. made to the account owner's beneficiary (or estate) due to his death,
3. attributable to the account owner's being disabled, or
4. made to pay first-time home purchase expenses.

The five-year waiting period does not always mean that the funds must remain in a Roth IRA for five full years before they can be withdrawn tax-free.

Example 1G-1 Determining five-year period for qualified distributions.

Karen, age 57, made her first $2,000 contribution to her Roth IRA in March 2011 for the 2010 tax year. One month prior to her death in April 2012, she made another $2,000 contribution to the same IRA. Karen had named a trust, which met the requirements of a qualified trust, as the designated beneficiary of her IRA. On January 2, 2015, the trustee withdrew the entire $7,400 balance (representing two contributions of $2,000 each plus $3,400 of earnings). The distribution to the trust is entirely free from federal income tax because it was received after the five-tax-year period beginning with the first tax year (2010) for which a contribution was made. The 10% penalty did not apply since the distributions were made on account of Karen's death.

Nonqualified Roth IRA Distributions. Withdrawals from a Roth IRA that are not qualified distributions are includable in income to the extent attributable to earnings. However, distributions are treated first as a return of contributions,

and all of an individual's Roth IRAs are treated as a single Roth IRA for this purpose. Contributions include amounts converted (rolled over) from traditional IRAs, but these contributions are considered only after regular Roth IRA contributions. Further, converted amounts are considered on a FIFO basis.

Example 1G-2 Tax-free withdrawal of principal from a Roth IRA.

Prior to his death in 2010, George (age 50) set up two Roth IRA accounts in 2007. He contributed $1,000 to each account that year and $1,000 to each in 2008 and 2009, for total contributions to each account of $3,000. A qualified trust was the designated beneficiary of the IRAs. On July 10, 2010, there was a balance of $4,500 in Account One and $4,000 in Account Two. The trustee withdrew all $4,500 from Account One. The distribution is not a qualified distribution because the five-year waiting period has not ended. However, although the distribution is composed of $3,000 principal and $1,500 earnings from Account One, the withdrawal is considered to come first from George's $6,000 of total Roth IRA contributions. Thus, the entire withdrawal is tax-free and penalty-free.

Proceeds from Life Insurance

An estate receives insurance proceeds when it is named as the beneficiary or when no beneficiary has been named upon the insured's death. Most insurance contracts contain a default clause naming the beneficiary if none have been named at the insured's death. If the beneficiary is still living at the time of the insured's death, the proceeds are paid to him or her. When the beneficiary is not living at the time of the insured's death, the proceeds are payable to the owner's probate estate. A trust would only receive insurance proceeds when it has been named as the beneficiary of the insurance proceeds.

Life insurance proceeds paid on account of the insured's death are not included in gross income. This exclusion applies whether the proceeds are paid in a lump sum, installments, or under some other payment method. The exclusion only applies to the policy proceeds and only if paid on account of the insured's death.

A different situation exists when the executor surrenders a policy on a living insured. The deceased may have owned a policy in which another person is the insured. Upon the decedent's death, the policy becomes a probate estate asset (since the deceased was the owner) but no proceeds are payable because the insured is still alive. The executor might surrender the policy to convert the policy into cash instead of distributing the policy to an estate beneficiary. This would give the beneficiary an immediate source of cash instead of having to wait until the death of the insured. On surrender, the proceeds of a life insurance policy would be taxable to the extent the proceeds exceeded the estate's basis. The estate's basis would equal the premiums paid by the deceased as well as those paid by the executor before surrender. No basis adjustment for the value of the policy at the deceased's death is allowed under the IRD rules.

Most insurance companies will pay interest on proceeds between the date of death and actual payment of the proceeds. While the proceeds are not taxable, any interest payments are included in gross income. The difference between the payment and the policy proceeds is interest. When the proceeds are paid in installments, they are prorated over the payment period. As payments are made, the portion of each payment that represents interest is included in gross income, while the portion that represents proceeds is excluded.

SELF-STUDY QUIZ

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

12. Wilson passed away on July 15, after turning 71 on March 1. At the date of his death, Wilson had not received his minimum required distribution (MRD) for the year from his IRA. The primary beneficiary of the IRA is the estate. The proceeds from the IRA were distributed from the estate to Wilson's niece. Which of the following is correct?

    a. Wilson's estate will not be entitled to an income distribution deduction.

    b. The tax burden of Wilson's estate will be lower since it is making a distribution to a beneficiary.

    c. Since Wilson did not receive his MRD before his death, no distribution is required.

    d. As of the date of his death, Wilson had not reached his required beginning date for his IRA.

13. If an estate is named the beneficiary of a qualified plan or IRA, which of the following is true regarding the minimum required distributions (MRDs) of the qualified plan or IRA?

    a. If the participant/owner passes away before their required beginning date, the estate must take distribution of the whole plan immediately.

    b. If the participant/owner passes away after their required beginning date, the required minimum distributions cease and the estate can hold the qualified plan or IRA without taking distributions.

    c. There will not be any minimum required distributions since the estate does not have a required beginning date.

    d. If a spouse is the only beneficiary of an estate, the IRA can be rolled into the spouse's existing IRA plan.

14. Which of the following is true for distributions from a Roth IRA after the account holder's death?

    a. A surviving spouse is required to take distributions from a Roth IRA when the spouse reaches the age of 70½.

    b. Nonspouse beneficiaries can elect to roll over the entire balance of an inherited Roth IRA to their own Roth account.

    c. The same rules that apply to a traditional IRA when the account holder passes prior to their required beginning date apply to Roth IRAs.

15. Ed purchased separate life insurance policies on himself and his wife, Lynn, 25 years ago, naming each other their beneficiaries. Ed passes away on May 25, but Lynn chooses not take payment on the policy until the next year. Which of the following is true?

    a. Lynn must include any interest paid by the insurance company on the life insurance proceeds as part of her gross income.

    b. Lynn must include the amount received as part of her gross income for the tax year.

    c. If Lynn had passed away before Ed and Ed had not named another beneficiary, the life insurance proceeds would be set up in a trust.

    d. If Lynn decided to receive her life insurance proceeds in installments, all principal and interest would be included in gross income.

SELF-STUDY ANSWERS

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

12. Wilson passed away on July 15, after turning 71 on March 1. At the date of his death, Wilson had not received his minimum required distribution (MRD) for the year from his IRA. The primary beneficiary of the IRA is the estate. The proceeds from the IRA were distributed from the estate to Wilson's niece. Which of the following is correct? **(Page 29)**

    a. Wilson's estate will not be entitled to an income distribution deduction. [This answer is incorrect. If an estate or trust is the beneficiary of a qualified plan or IRA, the proceeds it receives from the plan are included in distributable net income (DNI). The estate or trust is entitled to an income distribution deduction (as limited by DNI) under IRC Sec. 661 for income distributions it makes to a beneficiary, as long as it is not a pecuniary bequest, which Wilson's niece is not.]

    b. The tax burden of Wilson's estate will be lower since it is making a distribution to a beneficiary. [This answer is correct. If the estate or trust does not distribute the IRA or retirement plan proceeds to a beneficiary, the proceeds are taxed at the estate or trust level, which will typically result in a greater tax burden than if the proceeds were distributed to an individual beneficiary. Since Wilson's estate is distributing the proceeds to his niece, the tax burden should be lessened.]

    c. Since Wilson did not receive his MRD before his death, no distribution is required. [This answer is incorrect. If an IRA participant/owner had reached the required beginning date by the date of death but had not received the MRD for that year, the MRD must be paid to the IRA's designated beneficiary to the extent it was not distributed to the participant/owner according to Reg. 1.401(a)(9)-5.]

    d. As of the date of his death, Wilson had not reached his required beginning date for his IRA. [This answer is incorrect. The required beginning date (RBD) is generally April 1 of the year following the year in which the owner attained age 70½ per Reg. 1.408-8. Since Wilson turned 71 on March 1 of the year of his death, he would have turned 70½ before the year began and means that his RDB would have been April 1 in the year of his death.]

13. If an estate is named the beneficiary of a qualified plan or IRA, which of the following is true regarding the minimum required distributions (MRDs) of the qualified plan or IRA? **(Page 29)**

    a. If the participant/owner passes away before their required beginning date, the estate must take distribution of the whole plan immediately. [This answer is incorrect. If the participant/owner dies before his or her required beginning date, distributions must be totally distributed by December 31 of the fifth year following the year the participant/owner died according to the IRS.]

    b. If the participant/owner passes away after their required beginning date, the required minimum distributions cease and the estate can hold the qualified plan or IRA without taking distributions. [This answer is incorrect. If the participant/owner dies after his or her required beginning date, the required minimum distributions must continue at least as rapidly as during the participant/owner's life. Thus, minimum required distributions must be calculated using the participant/owner's remaining single life expectancy.]

    c. There will not be any minimum required distributions since the estate does not have a required beginning date. [This answer is incorrect. If an estate is named as the beneficiary of a qualified plan or IRA, post-death minimum required distributions are not only required by the IRS, but may be greater accelerated since they will be computed as if there is no designated beneficiary.]

    d. If a spouse is the only beneficiary of an estate, the IRA can be rolled into the spouse's existing IRA plan. [This answer is correct. According to IRS rules, if a spouse is the only beneficiary of the estate and has total control of the plan assets, they may be able to roll over the balance into their own IRA plan.]

14. Which of the following is true for distributions from a Roth IRA after the account holder's death? **(Page 33)**

    a. A surviving spouse is required to take distributions from a Roth IRA when the spouse reaches the age of 70 ½. [This answer is incorrect. One option to the surviving spouse is that they can choose to delay distributions from a decedent's Roth IRA account until the decedent, not the surviving spouse, would have attained age 70 ½.]

    b. Nonspouse beneficiaries can elect to roll over the entire balance of an inherited Roth IRA to their own Roth account. [This answer is incorrect. Nonspouse beneficiaries normally must receive the entire balance in the Roth IRA account within five years of the year of the owner's death, of if properly elected, over their life expectancy. Spouse beneficiaries can elect to treat the Roth IRA as their own or roll it into their own Roth IRAs.]

    c. The same rules that apply to a traditional IRA when the account holder passes prior to their required beginning date apply to Roth IRAs. [This answer is correct. IRC Sec. 408A(c)(5) stated that the distribution rules that apply to Roth IRAs are the same as those that apply to a traditional IRA when the account owner dies prior to his or her required beginning date.]

15. Ed purchased separate life insurance policies on himself and his wife, Lynn, 25 years ago, naming each other their beneficiaries. Ed passes away on May 25, but Lynn chooses not take payment on the policy until the next year. Which of the following is true? **(Page 34)**

    a. Lynn must include any interest paid by the insurance company on the life insurance proceeds as part of her gross income. [This answer is correct. Most insurance companies will pay interest on proceeds between the date of death and actual payment of the proceeds. While the proceeds are not taxable, any interest payments are included in gross income. The difference between the payment and the policy proceeds is interest.]

    b. Lynn must include the amount received as part of her gross income for the tax year. [This answer is incorrect. Life insurance proceeds paid on account of the insured's death are not included in gross income per IRC Sec. 101(a). This exclusion applies whether the proceeds are paid in a lump sum, installments, or under some other payments method.]

    c. If Lynn had passed away before Ed and Ed had not named another beneficiary, the life insurance proceeds would be set up in a trust. [This answer is incorrect. When the beneficiary of a life insurance policy is not living at the time of the insured's death, the proceeds are payable to the owner's probate estate. A trust would only receive insurance proceeds when it has been named as the beneficiary of the insurance proceeds.]

    d. If Lynn decided to receive her life insurance proceeds in installments, all principal and interest would be included in gross income. [This answer is incorrect. When the proceeds of a life insurance policy are paid in installments, they are prorated over the payment period. As payments are made, the portion of each payment that represents interest is included in gross income, while the portion that represents proceeds is excluded.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T41TG101)

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

1. Sam died on April 3, 2010. When he passed away, he owned $3,500 of interest coupons on corporate bonds that were payable on March 31, 2010. His family gave the bonds to the executor at the reading of the will. The executor redeemed the coupons on May 1, 2010 for $3,500. Which of the following is correct for the interest income on the bonds?

   a. The interest income should be reported on Form 1041 by the estate.

   b. The IRD rules will apply to the estate for the interest income.

   c. The interest income should be included on Sam's final return.

   d. Do not select this answer choice.

2. When determining how interest and dividends should be reported on Form 1041, which of the following is an appropriate guideline for a taxpayer to follow?

   a. Income from thrift money market accounts should be reported as interest income by the taxpayer.

   b. Dividends paid on accounts in savings and loan associations are reported as dividend income on Form 1041.

   c. Income from money market mutual funds should be reported as interest income by the taxpayer.

   d. Foreign taxes withheld should be decreased by the amount of foreign tax credit taken on Form 1041.

3. The estate of Michael Redmon has the following income in 2010:

Taxable interest	$8,000
Tax-exempt interest	$2,000

   The estate paid trustee fees of $2,000 in 2010. What portion of the trustee fees would be deductible on Page 1 of Form 1041 for the year?

   a. $0.

   b. $400.

   c. $1,600.

   d. $2,000.

4. Which of the following is correct for the distributable net income (DNI) of an estate or trust?

   a. An estate or trust is allowed a deduction for any component of DNI not included in gross income.

   b. Net tax-exempt interest is subtracted from total income to determine DNI and then added back for the distribution deduction.

   c. DNI is usually the lower limit of the entity's distribution deduction or the lowest amount that a beneficiary would include in gross income.

   d. When determining DNI of an estate or trust, tax-exempt interest income should be added back to taxable income.

5. The 2003 Jobs and Growth Tax Relief Reconciliation Act created a dividend income category called qualified dividend income. Which of the following would be considered a qualified dividend?

   a. Any dividend income considered by the taxpayer as investment income.

   b. A property dividend received by a noncorporate taxpayer from a qualified foreign corporation.

   c. A dividend received on stock that the taxpayer is obligated to make payments with respect to positions in related property.

   d. A dividend paid by a mutual savings bank and considered a dividends paid deduction under IRC Sec. 591.

6. Which of the following would always be included when computing distributable net income for a simple trust?

   a. Extraordinary cash dividends.

   b. Taxable stock dividends.

   c. Tax-exempt interest income.

   d. Extraordinary property dividends.

7. Which of the following U.S. savings bonds are 30-year instruments that feature a deferment of taxes on the interest earned until maturity of the bond with an inflation protected growth?

   a. Series I U.S. savings bonds.

   b. Series E U.S. savings bonds.

   c. Series EE U.S. savings bonds.

   d. Series H U.S. savings bonds.

8. If an IRC Sec. 454 election is made on a decedent's final income tax return to include the interest earned on bonds from their acquisition date until to the decedent's date of death, which of the following is true?

   a. Only the income on bonds that have matured are included in the decedent's final tax return.

   b. All interest included in the return is treated as income in respect of the decedent.

   c. Only the interest on bonds sold as a result of the death is included on the decedent's final tax return.

   d. The estate of the decedent will only include the interest earned after the date of death.

9. A bond, redeemable for $150,000, was issued on January 1, 2010 and is redeemable on January 1, 2012. The OID on the bond is $1,100. Is the OID considered de minimis?

   a. Yes.

   b. No.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

10. Which of the following would the market discount rule possibly apply to?

    a. U. S. Savings bonds.

    b. A bond purchased in the secondary market at a discount.

    c. A fixed maturity date short-term obligation settling within one year from the issue date.

    d. Tax-free obligations that were acquired before May 1, 1993.

11. The Frank Wines Trust purchased a $20,000 20-year U. S. Treasure bond yielding 6% interest on August 1 for $20,700. The $700 is accrued interest related to the bond. For the entire year, the trust received $1,200 in interest. Which of the following is true regarding this bond?

    a. The trust will not need to report any interest in its financial records for the year, since a portion of it was accrued at purchase.

    b. The trust will need report the $700 of interest received at purchase as income for the year.

    c. The trust will need to include the full $1,200 of interest received as taxable income on Form 1041 for the year.

    d. The trust will report a gross amount of $1,200 of interest less $700 purchased on Form 1041 for the year.

12. Michael passes away on January 15. The beneficiaries of his IRA are Linda, Todd, and his estate. The estate distributes its share of the proceeds to Sid. Linda writes a new will after Michael's passing and leaves everything in her estate to her grandson, Liam. Linda passes away on September 1 of the same year. As of September 30th of the year following Michael's death, which of the following individuals is considered a designated beneficiary of Michael's IRA account?

    a. Sid.

    b. Liam.

    c. Todd.

    d. Do not select this answer choice.

13. Which of the following is **not** a requirement for a trust to be considered qualified?

    a. Proper documentation has been provided to the administrator of the plan or IRA within a specified time period.

    b. The trust has provisions for making changes to its beneficiaries based on conditional factors.

    c. Under state law, the trust is considered a valid trust.

    d. Within the trust documents, the beneficiaries of the trust are properly identified.

14. If the trust document is silent about how IRA distributions should be classified and applicable state law follows the Uniform Principal and Income Act of 1997, which of the following classifications would be correct?

    a. Nonrequired payments would be allocated entirely to income.

    b. 10% of required distributions would be allocated to principal.

    c. 90% of required distributions would be allocated to income.

    d. Nonrequired payments would be allocated entirely to principal.

15. Erica began making Roth IRA contributions ten years ago. Which of the following distributions from her Roth IRA would be considered taxable?

    a. A distribution to Erica to pay for the purchase of a first home.

    b. A distribution to Erica to close the Roth IRA account.

    c. A distribution to Erica's beneficiary due to Erica's death.

    d. A distribution made to pay medical expenses after Erica became disabled.

Lesson 2: Income from Rents, Royalties, and Pass-through Entities

INTRODUCTION

Fiduciaries use Schedule E of Form 1040, Supplemental Income and Loss, to report the fiduciary's share of income or loss from rents, royalties, partnerships, S corporations, and other fiduciaries.

The reporting of a fiduciary's share of income, deductions, losses and credits from pass-through entities has become a complex area of tax law. A practitioner cannot merely transfer amounts from a Schedule K-1 to a partner's, S shareholder's, or beneficiary's Form 1041 without considering factors such as the at-risk limitations, basis limitations, passive activity loss rules, and loan repayments. Furthermore, critical information is often disclosed on the supplemental information section of Schedule K-1 or as a separate attachment. Therefore, it is important for the practitioner to request and examine all available information.

The partnership year terminates with respect to a deceased partner. Thus, partnership income through death will be included on the decedent's final individual income tax return (Form 1040), while partnership income after death will be reported by the estate or other successor in interest. Partnership items are discussed later in this lesson.

When a partner dies, there is a special election under IRC Sec. 754 available at the partnership level to step up the "inside basis" of the partnership assets. Limited liability companies are generally treated as partnerships for income tax purposes. Additional information about the Section 754 election is discussed later in this lesson.

S corporations generally pass through items of income or loss based on a per-share, per-day allocation method. However, when a shareholder dies, if all shareholders consent, the corporation can elect an interim closing of the books for tax purposes. Only certain types of trusts are eligible to be shareholders of S corporations, including voting trusts and certain testamentary and grantor trusts. By meeting certain criteria, a trust owning S corporation stock can elect to be a qualified subchapter S trust (QSST), to ensure the corporation's S status is preserved. In addition, an electing small business trust (ESBT) can be an S corporation shareholder. Unlike other trusts that can qualify as S corporation shareholders, ESBTs can have multiple beneficiaries and accumulate income. S corporation items are discussed later in this lesson.

There are special considerations for charitable remainder trusts that own S corporation stock or partnership interests. For example, charitable remainder trusts cannot be ESBTs. Additionally, partnership income is often unrelated business taxable income (UBTI), causing a 100% excise tax for all UBTI.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify how specific items reported on a partnership K-1 will affect the income tax reporting of the deceased or fiduciary partner, and if estates and various types of trusts are permitted S corporation shareholders.
- Determine the requirements for reporting pass-through income or loss from S corporations, pass-through income from other fiduciaries and rental and royalty income.

Partnership Schedule K-1 and How to Interpret It

Practitioners must be able to identify the tax consequences of items and amounts reported to the fiduciary partner on Schedule K-1 (Form 1065) and also to correctly track the partner's adjusted tax basis in the partnership. Tracking a partner's tax basis is important for a number of reasons, including the determination of (1) gain or loss if the partnership interest is sold or abandoned, (2) gain resulting from excess cash distributions, (3) basis in property received in partnership distributions or liquidation, and (4) limitations on recognizing losses passed through to a partner. Unfortunately, items on the Schedule K-1 are often reported inconsistently, and the confusing IRS rules on reporting of partners' capital accounts makes this a complicated task.

Partner's Capital Account

The analysis of the partner's capital account (Item L of Schedule K-1 in Form 1065) can be a helpful exercise in interpreting the income and deduction items on Schedule K-1, and in calculating the changes to the partner's tax basis. If a partnership maintains its books on the tax basis, the capital account reconciliation will provide information useful in verifying the tax impact of items reported on the Schedule K-1 and in calculating the partner's basis adjustments. However, partnerships that maintain their books using GAAP, the Section 704(b) safe harbor rules, or an "other" basis will report amounts that make reconciliation to Form 1041 complicated. In these situations, practitioners must often take extra steps to determine partner basis adjustments and may need to contact the managing general partner to obtain sufficient information.

Example 2A-1 Using capital accounts to monitor Schedule K-1 data.

The Robertson Family Trust is a 5% limited partner in a restaurant activity. The trust's Schedule K-1 from the partnership has the following entries:

Line	Description	Amount
1	Ordinary (loss) from business	$ 4,881
5	Portfolio income: interest	1,216
10	Net gain (loss) under Section 1231	154
13	Charitable contributions	194
13	Deductions related to portfolio income	500
13	Interest expense on investment debts	238
17	AMT depreciation adjustment	310
18	Tax-exempt interest income	42
20	Supplemental information:	
	Disallowed travel and entertainment	110
	Specially allocated depreciation	(762)
	Investment income	1,216

The capital account information reported to the trust on its Schedule K-1 (per line L) is as follows:

(a) Capital Account at Beginning of Year	(c) Partner's Share of Current Year Increase (Decrease)	(d) Withdrawals and Distributions	(e) Capital Account at End of Year
$ 18,408	$ 4,489	$ 4,000	$ 18,897

The practitioner reconciles the trust's share of book income (from its Schedule K-1 capital account allocation) as follows:

Line	Schedule K-1 Items	
1	Ordinary income	$ 4,881
5	Portfolio interest	1,216
10	Net Section 1231 gain	154
13	Charitable contribution	(194)
13	Deductions related to portfolio income	(500)
13	Investment interest expense	(238)
18	Tax-exempt interest income	42
20	Supplemental information:	
	Disallowed travel and entertainment	(110)
	Specially allocated depreciation	(762)
	Partner's share of book income	$ 4,489

The practitioner confirmed that the $762 specially allocated depreciation is an additional deduction to be claimed (i.e., the $762 was not deducted in reaching the $4,881 ordinary income amount). Also, the trust's

basis adjustments have been confirmed as an overall increase of $489 ($4,489 increase above, less the $4,000 distribution). The partnership books appear to be maintained on the tax basis, thus the increase and decrease items reported to the trust in its Schedule K-1 capital account reconciliation for 2010 also reflect its partnership basis adjustments (although this may not always be the case in every year).

A partner reports capital gain to the extent a distribution of money exceeds the partner's basis in the partnership interest immediately before the distribution. For this purpose, distributions are treated as made on the last day of the tax year if they are draws against the partner's distributive share of partnership income. Similarly, Rev. Rul. 94-4 provides that a deemed distribution resulting from a partner's reduced share of partnership liabilities is treated as an advance or draw taken into account on the last day of the tax year. Thus, a partner increases his basis in the partnership interest by his allocable share of partnership income items, capital contributions, and his share of increases in partnership liabilities before accounting for the distributions received during the year. Conversely, a partner with an allocable loss from a partnership must reduce basis for distributions before considering allocable loss items. The ordering of these adjustments is significant because basis increases may shelter distributions from taxation and basis reductions attributable to distributions can limit a partner's ability to deduct partnership losses or cause gain recognition.

Limitations on Losses Passed through to Partner

When a partnership passes a loss through to a fiduciary partner, it is the fiduciary partner's, not the partnership's, responsibility to determine if there is any limitation on the amount of loss the partner can claim. The deductibility of a loss must be considered in view of three possible limitations, considered in the following order: (1) tax basis, (2) at-risk, and (3) passive loss. The sequence is important because a loss disallowed by one of the limitations is not eligible for deduction under a successive limitation. When interpreting the Schedule K-1 from a partnership, the tax return preparer must be alert to a combination of various factors to determine whether these limitations apply at the partner level.

Example 2A-2 Determining if the deduction for a partnership loss is limited.

The REO Trust's Schedule K-1 from Benson Realty Partners, a limited partnership, reports a loss of $3,850 and a deficit in REO Trust's ending capital account of $600. REO acquired its partnership interest in 1985. Tax basis, at-risk, and passive activity loss limits must all be considered, since they may restrict REO's loss in the current year.

The $600 deficit in ending capital indicates that pass-through losses to the partner have exceeded the partner's capital investment. However, a partner's proportionate allocation of partnership liabilities may generate additional basis in the partnership interest and at-risk basis. Item K on the Schedule K-1 discloses that the trust's share of liabilities is $22,410, of which $19,010 are qualified nonrecourse liabilities. A partner's share of partnership debt increases the basis in the partnership interest. The recourse or nonrecourse status of partnership debt has significance for the at-risk limits but does not affect a partner's basis in the partnership interest. Therefore, the trust is not limited by tax basis.

While nonrecourse liabilities generally do not provide at-risk basis, pre-1987 real estate activities are not subject to at-risk limitations. Since the trust acquired its interest in 1985, the preparer assumes it to be at risk for its share of all partnership nonrecourse debt and thus has no at-risk restriction on its current loss. (See discussion below of the at-risk limitation.)

The final hurdle in deducting the loss is the passive loss limitation. Passive activity losses are reported on Form 8582, Worksheet 3, column b. Amounts reported on Form 8582, Worksheet 3, will be combined with all passive activities owned by the trust to determine the deductible passive activity loss (rather than at-risk limitations, which is determined on an activity-by-activity basis). Note that trusts are not eligible for the $25,000 rental real estate exemption unless the Section 645 election to treat a revocable trust as part of the estate for income tax purposes has been made.

At-risk Limitations

The at-risk rules of IRC Sec. 465 limit the losses generated by various business and investment activities to the amount that the taxpayer is "at risk economically." These rules apply at the fiduciary taxpayer level, whether the

at-risk activity is held directly (reported on Schedule C, C-EZ, or F) or through an interest in a pass-through entity such as a partnership or S corporation. The effect of the at-risk limitation is to limit the deductible loss from an at-risk activity. It has no effect in a taxable year the activity is profitable.

Initially, the at-risk rules were designed to curb tax shelter losses in certain specified activities, including farming, oil and gas exploration, equipment leasing, and movie production. Subsequently, the at-risk rules were extended to all trade or business activities, to the holding of real property (other than mineral property) placed in service after 1986, and to ownership in a pass-through entity holding realty. However, a special exception (discussed below) allows a taxpayer holding realty to still be considered at risk for "qualified nonrecourse financing" secured by the realty.

Amounts Considered at Risk. A trust or estate's amount at risk in an activity is the sum of:

1. Cash contributed to the activity.

2. The adjusted basis of other property contributed.

3. Amounts borrowed for use in the activity if the fiduciary is liable for the repayment of the debt.

4. Amounts borrowed for use in the activity, to the extent of the fair market value (FMV) of the fiduciary's property (other than the property used in the activity) that is pledged as security.

This amount is reduced by the fiduciary's cumulative allocation of taxable losses and deductions. Although not specifically stated in IRC Sec. 465, the regulations provide that a partner's amount at-risk should also be increased by his or her cumulative share of partnership income and gains and reduced by his or her cumulative distributions.

Certain types of investments in or loans to an activity may not qualify (in whole or in part) as at-risk amounts. A trust or estate is not at risk for a loss that is incurred (either directly or through a partnership or S corporation) in a business or production-of-income activity for investments made in the form of:

1. nonrecourse loans (either within the activity or to acquire an interest in the activity) that are not secured by the taxpayer's own property (i.e., property not used in the activity);

2. amounts contributed to or used in the activity that are protected against loss by guarantee, stop-loss agreement, or similar arrangement; or

3. amounts borrowed, whether recourse or nonrecourse, for use in, or contribution to, the activity from a person who has an interest in the capital or profits of the activity (other than as a creditor) or who is related to a person (other than the taxpayer) who has such an interest in the activity.

Qualified Nonrecourse Financing. Although nonrecourse loans secured by property used in the activity are generally not considered for at-risk purposes, a special exception applies for realty. When holding real property, a taxpayer is considered at risk for his share of "qualified nonrecourse financing" secured by property used in the activity. Qualified nonrecourse financing must meet all of the following requirements:

1. borrowed for the holding of real property;

2. borrowed from or guaranteed by a federal, state, or local governmental entity, or borrowed from a person or entity regularly engaged in the business of lending money (e.g., a bank or savings and loan), other than a person related to the taxpayer, a person or entity from which the taxpayer acquired the property, a person who receives a fee from the taxpayer's investment, or someone related to any such person;

3. debt for which, except as provided in regulations, no one is personally liable for repayment; and

4. not convertible to equity.

Limited Partners. The status of being a limited partner in a partnership generally increases the likelihood of encountering an at-risk limitation because limited partners generally are at risk only for their direct capital invest-

ment in the partnership. However, in some cases, the partnership agreement may require capital calls for additional funds from limited partners. This adds to their at-risk basis, but not until the capital contributions are actually made. Also, limited partners may have guaranteed nonrecourse debts of the partnership, which also generate at-risk basis. While guarantees alone generally do not provide at-risk basis, a limited partner who guarantees a partnership nonrecourse note may be able to achieve at-risk basis if he establishes ultimate economic responsibility for the debt (the limited partner has no right of action against the general partner if required to perform on the guarantee, and the debt is nonrecourse to the extent the general partner is not liable).

Computing At-risk Amount. Form 6198 (At-Risk Limitations) must be completed and filed with the tax return for any year a trust's at-risk activity (whether conducted as a sole proprietorship or through a pass-through entity) incurs a loss if the activity includes invested or borrowed amounts that are excluded from basis for at-risk purposes (e.g., nonrecourse financing). If the activity is also subject to the passive loss rules, Form 6198 is completed first, and any allowable loss is then carried to Form 8582 (Passive Activity Loss Limitations).

Example 2A-3 Determining amount at risk via Form 6198.

In 2009, Trust A and an individual, Bud Bush, formed a 50/50 partnership (the A&B Partnership) that acquired a small apartment building. Each contributed $5,000 cash, which the partnership used as a down payment on the building. In addition, the partnership took out a nonrecourse mortgage note in the amount of $150,000. This rental property was purchased from, and the mortgage note issued to, a savings and loan association that had acquired the building on a foreclosure a year earlier. Because the lender is also the seller of the property, the note does not meet the special "qualified nonrecourse financing" exception to the at-risk rules. Trust A was allocated a loss of $5,000 in 2009. Although the loss did not exceed its at-risk limit, it is restricted by the Section 469 passive loss rules.

Trust A's adjusted basis in its partnership interest as of January 1, 2010, is $75,000 ($5,000 cash contribution plus $75,000 allocable share of partnership debt less the 2009 loss of $5,000). In 2010, Trust A and Bud each contributed $3,000 to the partnership. The partnership, in turn, used $4,000 to pay down the principal on the partnership debt and the other $2,000 for other partnership expenses. For 2010, the partnership incurred a loss of $14,000, of which Trust A was allocated $7,000. Trust A's allowable at-risk loss of $3,000 for 2010 is computed using Form 6198. However, the passive loss limitations must be considered next.

When calculating the amount at risk on Form 6198, Part II of the form allows a simplified computation that refers to adjusted basis in the activity as of the beginning of the tax year. Conversely, Part III contains a detailed computation of at-risk basis commencing from the acquisition of the activity or, if later, the effective date of the activity becoming subject to the at-risk rules.

In many cases, particularly for investments in pass-through entities such as partnerships and S corporations, the adjusted basis in the activity for the Part II computation and the detailed computation for Part III will result in the same limitation (assuming the activity has been subject to the at-risk limits since its acquisition by the taxpayer). However, in other cases, a higher at-risk basis results from the detailed computation in Part III. In this example, Trust A's at-risk amount in Part III equals the simplified Part II amount. It should be noted that there is no requirement to complete Part II. Since it is possible that this simplified computation will not produce the correct at-risk basis, the authors recommend bypassing Part II and completing only Part III.

A loss that is limited because of the at-risk rules is treated as a "deduction allocable to such activity" in the first succeeding year. This carried-over loss is used as a deduction against the following year's income from the same activity. If the carryover deduction creates or increases a loss, the loss is deductible only if it is at risk. Unused losses may be carried forward indefinitely to be used in later years. Unlike passive losses, suspended at-risk losses are not triggered in the year the activity is terminated.

Section 179 Expense

Section 179 expense may not be allocated to trusts or estates. Therefore, a trust or estate that is a partner in a partnership cannot deduct its prorata share of the partnership Section 179 deduction. However, the partnership is not required to reduce the basis of the Section 179 property for any amount that the trust or estate is not allowed to

deduct. Instead, the partnership is allowed to depreciate the additional basis of the Section 179 property attributable to the trust or estate's disallowed portion of the Section 179 deduction.

How to Report Partnership Income or Loss for a Deceased Partner

Income in Respect of a Decedent from a Partnership

When a partner dies, the value of the partnership interest must normally be included on Form 706 (if filing is required) as part of the partner's gross estate for estate tax purposes. (Because the estate tax is repealed in 2010, the filing of Form 706 is not required for decedents dying in 2010, however.) The partnership year terminates with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise. Thus, partnership income through date of death will be included on the decedent's final Form 1040, while partnership income after death will be reported by the estate or other successor in interest. The taxable year of the partnership itself does not close merely due to the death of a partner.

Income in the Year of Death. The partnership year terminates with respect to a partner whose entire interest in the partnership terminates because of death. Therefore, partnership income earned in the year of death is reported on the decedent's final Form 1040 and will not be considered income in respect of a decedent (IRD). However, other income that was earned by the partnership but not taxed as of the date of the partner's death because of the partnership's accounting methods (e.g., installment sale income and cash method receivables), is IRD regardless of whether it was earned in the year of the partner's death.

IRD is an asset for estate tax purposes and is reported on Form 706 (if filing is required). IRD is also subject to income tax in the return of the estate or other successor-in-interest in the year the income is received. Thus, IRD is subject to both income and estate tax for decedents dying in a year other than 2010. However, when the estate or beneficiary collects and reports IRD, an income tax deduction is allowed under IRC Sec. 691(c) for the federal estate tax attributable to the inclusion of the value on Form 706.

Example 2B-1 Partnership income through date of death is not IRD.

Rick Wright was a 40% partner in the accounting firm of Wright and Associates. Wright and Associates uses a calendar year. Rick died on August 4, 2010. Rick had received distributions of current year partnership earnings of $30,000 through the date of death. His share of 2010 partnership income as of that date was $40,000, and was $100,000 for the entire year. Rick's partnership interest was owned by his estate at December 31, 2010.

For income tax purposes, Rick is taxed on the $40,000 of partnership income through the date of death. The $40,000 earned before Rick died is not IRD since the partnership terminated with respect to Rick on his date of death and the income through that date is reported on his final Form 1040. The remaining $60,000 of income for calendar 2010 is reported by the estate.

Liquidation of a Deceased Partner's Interest. When a deceased partner's interest in the partnership is liquidated via a distribution or series of distributions, IRD treatment depends on whether the distributions are:

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

If payments are considered Section 736(a) payments (i.e., a distributive share of partnership income or guaranteed payments), they are IRD. A review of the partnership agreement will be necessary to determine how a deceased partner's interest is liquidated. Generally, if the distributions are made in exchange for the decedent's interest in partnership property, they are Section 736(b) payments and are not IRD.

However, for general partners in partnerships where capital is not a material income-producing factor (i.e., service partnerships) and for all partners if the deceased partner died before January 5, 1993, amounts attributable to

unrealized receivables of the partnership or goodwill (unless the partnership agreement calls for payment of goodwill to a deceased partner) are treated as Section 736(a) payments and thus IRD.

When liquidating payments are not fixed in total, payments received by a successor in interest are treated first as Section 736(b). Any payments in excess of the value of the successor's interest in partnership property are Section 736(a) payments and thus IRD.

Example 2B-2 Deceased partner receives distributive share of partnership income.

Bob was a 20% general partner in a local accounting firm. Bob died on June 30, 2008. In liquidation of Bob's interest, Bob's estate is to receive 20% of the partnership's net taxable income for the next five years. The partnership uses the cash method for tax reporting purposes. The partnership's balance sheet at June 30, 2008 is as follows:

Asset	Tax Basis	FMV
Cash	$ 85,000	$ 85,000
Accounts Receivable	—	415,000
Office Building	80,000	100,000
Land	70,000	125,000
Total Assets	$ 235,000	$ 725,000
Capital:		
Bob (20%)	$ 47,000	$ 145,000
Other Partners (80%)	188,000	580,000
Total Capital	$ 235,000	$ 725,000

The first $62,000 (20% of $85,000 cash + $100,000 office building + $125,000 land) paid to Bob's estate is a Section 736(b) payment, since payments from the partnership are treated first as Section 736(b) payments. The remaining payments are treated as Section 736(a) payments.

Assume Bob's estate receives $35,000 in 2008, $42,000 in 2009, and $38,000 in 2010 as liquidation payments. The 2008 payment is a Section 736(b) payment. The 2009 payment is:

Section 736(b) payment ($62,000 − $35,000)	$ 27,000
Section 736(a) payment ($42,000 − $27,000)	15,000
	$ 42,000

Therefore, the estate has IRD of $15,000 in 2009 for the liquidation payments received from the partnership. The entire $38,000 in 2010 is a Section 736(a) payment and is IRD in 2010.

Buy-Sell Agreement. A buy-sell agreement may require a deceased partner's entire interest to be sold to the remaining partners immediately after the decedent's death. The partnership's tax year is deemed to close with respect to the decedent as of the date of death. The distributive share of partnership income earned by the decedent through the date of death is reported on the decedent's final income tax return. An interim closing of the books is used to determine the amount of such income required to be reported on the decedent's final tax return.

Example 2B-3 Closing the partnership tax year when a buy-sell agreement is in effect.

Gail, who was a minority partner in Queen Partnership, a cash-method, calendar-year partnership, died on September 1, 2010. Gail's share of partnership income through date of death was $80,000; for the entire year, it was $120,000. Gail had withdrawn $72,000 prior to her death. In addition, the partners of Queen have signed separate buy-sell agreements among themselves. The agreements provide that in the case of the death of a partner, the other partners, in their individual capacities and not as partners of Queen, agree to buy the interest of the deceased partner. The purchase price of the interest is based upon a formula stated in the agreements.

The partnership year closes with respect to Gail's interest, on the date of death. Accordingly, $80,000 of income is included in Gail's final tax return, and the remaining $40,000 of income for the year is reported by the purchasers of Gail's partnership interest. As long as Gail was not a 50%-or-more partner, the sale of the interest to the other partners would have no tax effect upon the partnership (other than a possible Section 754 partnership basis adjustment). None of the $120,000 is IRD.

Adjustments to Inside Basis of Partnership Assets upon Partner's Death

A partnership is allowed to make an election under IRC Sec. 754 to adjust the "inside" basis of partnership assets upon the transfer of a partnership interest resulting from the death of a partner. This basis adjustment benefits only the deceased partner's successor-in-interest.

The basis of property acquired from a decedent who died in 2010 will generally be the modified carryover basis (the decedent's adjusted tax basis + the amount of basis increase elected by the executor) at the date of death. However, this rule does not apply to property that is considered a right to receive IRD. In applying IRC Sec. 754, it is important to note that the same rules preventing the estate's "outside" basis of the partnership interest from being stepped up to FMV for items of IRD also prevent a step-up in the "inside" bases of the partnership assets. Therefore, because of the IRD rules, installment notes and certain other partnership receivables cannot be stepped up to FMV even if a Section 754 election is in effect.

For decedents dying in a year other than 2010, the traditional step-up (or step-down) to FMV rules apply under IRC Sec. 1014(a). However, IRD assets are not eligible for the step-up to FMV.

Basis Adjustment Recordkeeping

The key requirements of the Section 754 election are:

- it must be made by the partnership;
- in the case of a transfer upon death, the transferee partner has one year from the date of death to notify the partnership in writing of the transfer; and
- the partnership is required to reflect the effect of the basis adjustments on the partnership return.

Once notice has been made, the partnership keeps track of the basis adjustment calculations. The partnership then reports the necessary annual information to the estate on its Schedule K-1. Typically, the "Other Deductions" line or the "Other Information" line of the partner's Schedule K-1 is used to report Section 754 basis adjustment information. For a detailed discussion of the inside and outside basis adjustments upon a partner's death, see *PPC's 1065 Deskbook*.

Example 2B-4 Successor's basis adjustment for partnership assets when the partnership has IRD.

Lindsay Lopez, who died March 31, 2010, was a 50% partner in the ABC Partnership. The partnership's balance sheet at the time of Lindsay's death was as follows:

Assets			Liabilities		
	Tax Basis	FMV		Tax Basis	FMV
Cash	$20,000	$20,000	Accounts payable	$20,000	$20,000
Installment note	10,000	20,000	Capital	30,000	60,000
Equipment	20,000	40,000			
Total	$50,000	$80,000	Total liabilities and equity	$50,000	$80,000

The fair market value of Lindsay's interest in the partnership at the time of death is $30,000, including $5,000 of IRD (from her share of the installment note receivable). The executor of Lindsay's interest elects to allocate

$25,000 of the $1.3 million aggregate basis increase to the partnership interest. The estate's outside and inside basis of the partnership interest are calculated as follows:

	Estate's Outside Basis	Estate's Inside Basis
Capital Account	$ 30,000	$ 15,000
Less: IRD	(5,000)	N/A
Plus:		
Carryover basis of IRD (note)		N/A
Partnership debt	10,000	10,000
	$ 35,000	$ 25,000

Assuming the partnership makes a valid Section 754 election, Lindsay's estate is entitled to adjust the basis of the partnership's assets by $10,000 (the estate's share of the difference in the outside and inside basis). Items of IRD are not entitled to a basis adjustment. Thus, the installment note will not be stepped up, and it will generate IRD when it is collected. The inside basis of the equipment is stepped up by $10,000 to reflect the full FMV of Lindsay's interest in that property. Thus, the inside basis of Lindsay's interest is stepped up from $25,000 to $35,000, and the basis of the equipment is stepped up from $10,000 to $20,000 (with respect to Lindsay's interest only).

Example 2B-5 Sale of decedent's partnership interest.

Assume the same facts as in Example 2B-4, except that Lindsay's estate sold its interest in ABC to an unrelated party for $30,000 cash and the assumption of the estate's $10,000 share of the partnership's accounts payable, effective as of the opening of business on April 1, 2010 (the day after Lindsay's death. Since the estate does not receive a basis in IRD, its outside basis in the partnership interest is $35,000, as calculated in Example 2B-4, and the estate must recognize a $5,000 gain on the sale.

Estates and Trusts as S Corporation Shareholders.

Death of an S Corporation Shareholder

The shareholder eligibility rules of Subchapter S are very explicit, and the presence of an ineligible shareholder can terminate the corporation's S election. The *estate* of a deceased shareholder is a permitted shareholder of an S corporation. During the period of administration when S corporation shares are held by the estate, there is no S corporation eligibility problem as long as the administration is not unduly prolonged. The estate is treated as the shareholder for purposes of the 100 shareholder limitation for S corporations. Furthermore, for purposes of determining the total number of shareholders, a husband and wife (and their estates), and all members of a family (and their estates) will automatically be treated as one shareholder.

Testamentary trusts receiving S corporation stock pursuant to the terms of a will are eligible S corporation shareholders only for a two-year period beginning on the date the stock is transferred to the trust. A testamentary trust will remain an eligible shareholder beyond the two year period if the trust qualifies as either a qualified Subchapter S trust (QSST) or an electing small business trust (ESBT) and makes the appropriate election. If the trustee and beneficiaries want the trust to retain ownership of the stock without causing a revocation of the S election, and if the trust can qualify as either a QSST or ESBT, the necessary election needs to be made before the two-year period expires. These trusts are covered later in this lesson.

After the death of the deemed owner of a grantor trust, the trust may continue as the S corporation shareholder for a period of two years beginning with the deemed owner's death. During the two-year periods, the grantor trust (or testamentary trust) recognizes its share of the S corporation income, losses, and credits and makes adjustments to its stock basis.

Disposition of Stock While Held by an Estate

For various reasons, the estate may decide to dispose of the stock instead of distributing it to the estate's beneficiaries. Some corporations have buy-sell agreements requiring the estate to sell the stock, or the executor

may need to generate cash to pay debts and expenses. Whether the estate can sell the stock will depend on securities laws and the existence of any shareholder agreements. The executor should confirm the ability to sell the stock before the sale.

Stock Is Sold to Party Other Than a Corporation. If the stock is sold, the estate will recognize a long-term capital gain or loss based on the difference between the amount realized and the estate's basis. The estate's basis will be the estate tax value adjusted by any IRD items and for any income or losses allocated to the estate while the estate owned the stock.

Stock Is Redeemed by the S Corporation. When a corporation acquires its stock from its shareholders (a redemption), the transaction can be classified as either a (a) sale or exchange or (b) dividend. To qualify as a sale or exchange and be eligible for long-term capital gain treatment, the redemption of S corporation stock must qualify under IRC Sec. 302 or IRC Sec. 303.

If a redemption does not meet the qualifications of a sale or exchange, it will be characterized as a distribution under IRC Sec. 301 and for the purposes of IRC Sec. 1368(a). The manner in which the estate will be taxed on this distribution will vary depending on whether the S corporation was a prior C corporation with accumulated earnings and profits (AE&P).

1. *No AE&P exists.* The amount received by the estate will be a tax-free distribution to the extent that it does not exceed the adjusted basis of the stock. Once the distribution exceeds the adjusted basis, the excess will be treated as a gain from the sale or exchange of property. Depending on the circumstances, the estate may have little or no gain because of the basis increase under IRC Sec. 1022 (for decedents dying in 2010) or the step-up in basis under IRC Sec. 1014 (for decedents dying in a year other than 2010).

2. *AE&P exists.* The amount received by the estate will be a tax-free distribution to the extent that it does not exceed the corporation's accumulated adjustment account (AAA). After the AAA is exhausted, the amount received will be a taxable dividend to the extent of the S corporation's AE&P. Once all of the AE&P is distributed, any amount received will be a return of basis. Any amount remaining after the adjusted basis is depleted will be a long-term capital gain.

Trusts as S Corporation Shareholders

The following types of trusts are generally allowed to be S corporation shareholders:

1. A trust that is treated as owned by one individual (whether or not the grantor) who is a U.S. citizen or resident. For example, a trust qualifying for annual exclusion gifts that was created for estate planning purposes may qualify under this requirement.

2. A trust (described in item 1) that continues in existence following the death of the deemed owner but limited to the two-year period following the date of death.

3. A testamentary trust created under a will, but only for a two-year period following the transfer of the S corporation stock to the trust.

4. Voting trusts that are created primarily to exercise the voting power of the S corporation stock. The beneficial owners of the trust must be treated as the owners of their portion of the trust. The beneficial owners must be citizens or residents of the United States. In addition, a written trust agreement entered into by the shareholders must:

    a. delegate the right to vote to one or more trustees;

    b. require all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of the stock;

    c. require title and possession of the stock to be delivered to the beneficial owners upon termination of the trust; and

d. terminate, under its terms or by state law, on or before a specific date or event.

5. An electing qualified Subchapter S trust (QSST). This allows a trust with successive beneficiaries (e.g., separate income beneficiaries and remainder beneficiaries) to hold S corporation stock if specific criteria are met. This criteria is discussed later in this lesson under the subheading "Qualified Subchapter S Trusts (QSSTs)."

6. An electing small business trust (ESBT). An ESBT can be an S corporation shareholder. ESBTs are discussed in detail later in this lesson under the subheading "Electing Small Business Trusts (ESBTs)."

7. Tax-exempt qualified plan trusts under IRC Sec. 401(a) [i.e., an employee stock option plan (ESOP)]. For coverage of these trusts, see *PPC's 5500 Deskbook*.

Qualified Subchapter S Trusts (QSSTs)

If the following specific criteria are met, a trust will be allowed to hold S corporation stock as a qualified Subchapter S trust (QSST):

1. The trust has only one income beneficiary during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident. A husband and a wife are treated as one beneficiary if they file a joint return, are both U.S. citizens or residents, and are both designated beneficiaries of the trust.

2. All of the fiduciary accounting income is, or is required to be, distributed currently to the one income beneficiary. Since a simple trust is required by the terms of the document to distribute all of its accounting income, it will qualify as a QSST. A complex trust can qualify as a QSST, if the trustee, although not required to do so by the terms of the trust instrument, actually does distribute all the trust's fiduciary accounting income currently. A trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST.

3. Any principal distributions, including a termination distribution, must go to the income beneficiary if made during the beneficiary's lifetime.

4. The income beneficiary's interest must terminate on the earlier of the beneficiary's death or the trust's termination.

5. The trust's income beneficiary must make a QSST election related to the stock of each S corporation held by the trust.

6. No distribution (income or principal) by the trust can satisfy the grantor's legal obligation to support the income beneficiary.

When a grantor (Subpart E) trust or a testamentary trust continues to own S corporation stock after the two-year period specified in IRC Sec. 1361(c)(2)(A), the trust is not a permitted S corporation shareholder unless it continues to qualify as a grantor trust, QSST, or an ESBT. A QSST or an ESBT election may be made for a former grantor trust or testamentary trust that qualifies as a QSST (or ESBT). A testamentary trust includes a trust that receives S corporation stock from a trust that elects to be treated as part of an estate under IRC Sec. 645.

In addition to the above requirements, an electing small business trust (ESBT) can convert to a QSST if certain requirements are met, as discussed in this lesson under the subheading "Converting from a QSST to an ESBT or from an ESBT to a QSST."

Example 2C-1 Making the QSST election.

Andy Baer is a shareholder in Alamo Corp., a successful manufacturing firm that has been an S corporation for several years. His mother, Doris, is an elderly widow who requires expensive nursing care. Andy has been providing this support for his mother, but his only tax benefit is an extra personal exemption. Andy is considering creating a trust to hold 20% of his Alamo stock in order to deflect a stream of income to support

Doris. Upon Doris's eventual death, Andy would like to designate his two minor children as successor income beneficiaries, with the trust terminating and the stock being distributed to the children when they reach age 25.

Andy's objectives can be met through the use of a Qualified Subchapter S Trust. However, it will be necessary to have two trusts, because at Doris's death, Andy's two minor children would become income beneficiaries, and a QSST is permitted to only have a single income beneficiary. Each trust would be drafted to provide income to Doris during her lifetime, income to a successor minor child of Andy's following Doris's death, and eventual principal distribution of the stock to the child at the specified age.

For each QSST to be treated as an eligible S corporation shareholder, a special election must be made and signed by the current income beneficiary of the trust (Doris) or her legal representative. This election must be filed within the 16-day-and-2-month period beginning on the date on which the stock of the S corporation is initially transferred to the trust. If the S corporation were a newly electing entity, the separate QSST election could be made as part of the election of S status on IRS Form 2553 (Election by a Small Business Corporation). In that case, the QSST election can be made on Part III of Form 2553 if the stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. Also, the QSST's deemed owner must consent to the S corporation election on Part I, column K of Form 2553.

As discussed later in this lesson, an electing small business trust (ESBT) can also hold S corporation stock. In this example, an ESBT would not meet Andy's tax-saving objective because an ESBT is taxed at the highest individual rate on its share of the corporation's pass-through income.

Once the QSST election is made, it can only be revoked with the consent of the IRS Commissioner, unless the QSST becomes an ESBT. These provisions are discussed later in this lesson under the subheading "Converting from a QSST to an ESBT or from an ESBT to a QSST." IRS consent will not be given if one of the purposes is avoidance of income taxes or if the tax year is closed.

If under local law, a distribution to the income beneficiary is to satisfy the grantor's legal obligation to support the income beneficiary, the trust will not qualify as a QSST as of the date of such distribution.

A QSST election can be made within two years, two months and 16 days of the death of the deemed owner (for grantor trusts) or of the stock transfer from the estate to the trust (for testamentary trusts).

A new (successive) income beneficiary is not required to file an election to continue QSST status, just as a new shareholder in an existing S corporation is not required to consent to the S status. However, a new QSST beneficiary may affirmatively refuse to consent to the QSST election within the 15-day-and-2-month period after the date of becoming the successor income beneficiary, thereby revoking the S election of the entire corporation. This capability of a new beneficiary of a QSST that may hold only a small amount of stock can be contrasted with the IRC Sec. 1362(d)(1)(B) general revocation procedures for S corporations, which require shareholders owning more than 50% of the stock to consent to a termination of S status.

Example 2C-2 Beneficiary's refusal to consent to QSST election.

Continuing with the facts in Example 2C-1, assume that Doris Baer, as income beneficiary of Doris Baer Trust A (a QSST) died on August 18, 2010. Under the terms of this trust, Doris's granddaughter, Susie, becomes the successor and sole income beneficiary of the Doris Baer Trust A. For the 15-day-and-2-month period following this change in the QSST income beneficiary, Susie (or her parent acting on her behalf, if she is still a minor) can file an affirmative refusal to consent to the QSST election. The refusal to consent becomes effective on the day Susie becomes the income beneficiary of the QSST. By breaking QSST status, the trust will generally become an ineligible shareholder, causing termination of the corporation's S election.

Electing Small Business Trusts (ESBTs)

Previously, only grantor trusts, voting trusts, certain testamentary trusts, and qualified Subchapter S trusts (QSSTs) could be S corporation shareholders. None of these trusts, however, are allowed to have more than one current beneficiary or to accumulate income. Congress felt that a trust allowing multiple beneficiaries and the accumulation of income would facilitate family financial planning and provided an electing small business trust (ESBT) as an S corporation shareholder if all of the following criteria are met:

1. All trust beneficiaries must be individuals, estates eligible to be S corporation shareholders, or certain charitable organizations. (A beneficiary generally includes any person who has a present, remainder, or reversionary interest in the trust.) However, charitable remainder trusts are not eligible ESBT shareholders. Further, nonresident alien beneficiaries are allowed as beneficiaries but they cannot be potential current beneficiaries.

2. No interest (including the payment of gift tax by a donee) in the trust can be acquired by purchase. However, the trust can purchase S corporation shares to hold in the trust.

3. A proper ESBT election is made by the trust.

An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries. Thus, an individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries. The price paid for this flexibility is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest trust rate (35% for 2010), unless the income qualifies as long-term capital gains, in which case a capital gain rate applies.

Although a QSST cannot be an ESBT, it can convert to an ESBT if certain requirements are met. These requirements are discussed later in this lesson under the subheading "Converting from a QSST to an ESBT or from an ESBT to a QSST."

In an ESBT, each potential current beneficiary of the trust is counted as a shareholder for purposes of the 100 shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder. A *potential current beneficiary* generally is any person or charity who is entitled to, or at the discretion of the trustee may receive, a distribution from the principal or income of the trust. A person entitled to receive a distribution only after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment) is not a potential current beneficiary until the time arrives or event occurs.

Current powers of appointment can cause an inadvertent termination of S status. For example, if any person (e.g., the trustee or the beneficiary) has a general lifetime power of appointment over the trust, the corporation's S election will terminate if the number of potential current beneficiaries will exceed the 100-shareholder limit. However, unexercised powers of appointment are disregarded in determining who are considered potential current beneficiaries of an ESBT. All members of a class of charities allowed to receive distributions will be treated as a single potential current beneficiary until the power of appointment is exercised. Once a power of appointment is exercised and a distribution is made, each charity in receipt of a distribution will be considered a separate potential current beneficiary of the trust.

An attempt to temporarily waive, release, or limit a currently exercisable power of appointment will be ignored in determining who is a potential current beneficiary. However, if the holder of a power of appointment permanently releases the power in a manner that is valid under applicable local law, the persons who would be potential current beneficiaries solely because of the power will not be considered potential current beneficiaries after the date of the release.

Trusts entitled to receive distributions from an ESBT (via the exercise of a power of appointment or by a trustee's act) must be a QSST or an ESBT. In that case, the potential current beneficiaries of the distributing ESBT include the QSST's life income beneficiary and the potential current beneficiaries of the ESBT that received the distribution.

The taxable income of an ESBT consisting solely of stock in one or more S corporations includes:

1. The S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder.

2. Gain or loss from the sale of the S corporation stock.

3. To the extent provided in regulations, any state or local income taxes and administrative expenses.

In addition, capital losses are allowed only to the extent of capital gains. The income distribution deduction and the personal exemption cannot reduce taxable income of an ESBT consisting solely of stock in an S corporation.

The IRS has indicated that an ESBT cannot deduct any portion of a net operating loss carryover for the S corporation portion of the ESBT that the trust acquired from the residuary testamentary trust.

An ESBT is permitted to deduct interest expense on debt incurred to purchase S corporation stock for taxable years beginning after 2006. The interest expense will directly reduce the taxable income passed through from the S corporation, thus resulting in the reduction of total income automatically taxed to the trust at the highest individual rate (35% for 2010). This is a favorable provision because it reduces the overall income subject to the 35% trust-level tax.

Only the non-S corporation portion of capital gains will be reported on page 1 of Form 1041 and on Schedule D. The S corporation portion of any items of income, deduction, gains or losses will be calculated separately, and the related tax is included on Schedule G, line 7. See Example 2D-9 for an example of this reporting. If the ESBT has capital gains, the preferential rates will apply to the ESBT's capital gain. The ESBT is generally subject to the same estimated tax payment rules as individuals.

If the trust terminates before the end of the S corporation's tax year, the trust takes into account its prorata share of S corporation items for its final year.

When an ESBT holds other property in addition to S corporation stock, the portion of the trust consisting of stock in one or more S corporations is treated as a separate trust when figuring income tax attributable to the S corporation stock. The taxable income attributable to this portion includes items 1, 2, and 3 above. Thus, the trust consists of two portions, the "S" portion and the "Other" (non-S) portion. The S portion items are disregarded when figuring the tax liability of the "Other" portion, which is taxed under the normal trust taxation rules. Distributions from the "Other" portion and the "S" portion are deductible (limited to the DNI of the "Other" portion) in computing the taxable income of the "Other" portion. However, no distribution deduction is allowed in arriving at the S portion's taxable income. See Example 2D-9 for an example of an ESBT which holds S corporation stock in addition to other assets.

A grantor trust may elect to be an ESBT. All (or part) of the "S" portion or the "Other" portion of an ESBT may be treated as owned by the grantor or owner under IRC Sec. 671 (i.e., treated as a grantor trust). When all (or part) of the ESBT is treated as a grantor trust, the items of income, deduction and credits attributable to the grantor portion are taxed to the deemed owner under the regular grantor trust rules. In that case, an ESBT can have three portions, the grantor portion and the parts of the "S" and "Other" portions that are not treated as grantor trusts.

Charitable contributions paid from the S corporation's income are treated as paid by the S portion pursuant to the trust's governing instrument. Such charitable contributions are deducted by the S portion only in the year they are required to be taken into account by the trust under IRC Sec. 1366. Trustees cannot elect to treat charitable contributions paid by an S corporation after the close of the tax year as made during the tax year. That election is available only for charitable contributions actually paid by the trust.

SELF-STUDY QUIZ

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

16. Under which of the following circumstance would a practitioner find the analysis of the partner's capital account useful in understanding the Schedule K-1 income and deduction items, and in calculating the changes to the partner's tax basis?

    a. When the partnership maintains its books according to generally accepted accounting principles (GAAP).

    b. When the partnership maintains its books using the Section 704(b) safe harbor rules.

    c. When the partnership maintains its books on the tax basis.

    d. When the partnership maintains its books using an "other" basis.

17. Which of the following is an accurate statement regarding at-risk limitations?

    a. At-risk limitation rules are applicable at the fiduciary taxpayer level only if the at-risk activity is reported on Schedule C.

    b. At-risk limitations are effective in the taxable year of profitable activity.

    c. Trusts that incur a loss in a business activity where the investment is in the form of nonrecourse loans not secured by the taxpayer's own property are not considered at risk.

    d. Generally, an estate's sum of cash contributed to the activity is not considered at risk.

18. Sarah Connor, a 30% general partner in Glass Partnership, died on April 1, 2009. For tax purposes as part of Sarah's gross estate, the value of the partnership must be included on which of the following forms?

    a. Form 706.

    b. Form 1040.

    c. Form 1041.

    d. Form 8582.

19. Leann Harris was a partner in the accounting firm of Harris and Autumn Associates (HAA). Leann died July 2, 2010, and her interest in the partnership was liquidated through a series of distributions. Under which of the following circumstance would Leann's distributions **not** be considered IRD?

    a. If Leann's distributions were a distributive share of HAA's income.

    b. If Leann's distributions were guaranteed payments.

    c. If HAA made distributions in exchange for Leann's interest in partnership property.

20. Which of the following scenarios complies with the shareholder eligibility rules of Subchapter S?

    a. Shareholder A died March 20, 2010. Her estate is considered an eligible shareholder of the S corporation.

    b. Shareholder A, her husband, and twin daughters would each be treated as separate shareholders.

    c. The twin daughters are beneficiaries of a testamentary trust; the trust is an eligible S corporation shareholder for three years.

    d. The testamentary trust cannot recognizes its share of the S corporation income and credits.

21. There are certain criteria that must be met for a trust to be allowed to hold S corporation stock as a qualified Subchapter S trust (QSST). Which of the following does **not** meet that criterion?

    a. A QSST may have only one income beneficiary while that beneficiary is living.

    b. Any principal distributions must go only to the income beneficiary while living.

    c. A trust income beneficiary must make a QSST election related to the stock of each corporation held by the trust.

    d. An income beneficiary's interest must be terminated on the earlier of his death or the trust's termination.

22. Which of the following statements regarding QSSTs is most accurate?

    a. Once a QSST election is made by a former grantor trust, it cannot be revoked.

    b. A trust cannot qualify as a QSST if the distribution to the income beneficiary is to fulfill the grantor's legal responsibility to support the income beneficiary under local law.

    c. Generally, a QSST election must occur within two years, two months and 14 days of death of the deemed owner.

    d. New income beneficiaries are required to file an election to maintain QSST status.

23. Which of the following statement most accurately explains an aspect of ESBTs?

    a. Charitable remainder trusts can be ESBT shareholders.

    b. Interest in the trust can be purchased.

    c. Charitable organizations are not eligible for trust beneficiary status.

    d. An ESBT can hold S corporation stock and divide the income among family members.

24. What is an ESBT permitted to do?

    a. It can deduct interest expense on debt incurred to purchase S corporation stock.

    b. It can deduct a part of a net operating loss carryover that the trust obtained from the residuary testamentary trust.

25. What should be reported on Form 1041, Page 1 and on Schedule D?

    a. The deemed owner's consent to the S corporation election.

    b. Non-S corporation part of capital gains.

    c. Nonseparately stated ordinary items.

    d. Interest income.

SELF-STUDY ANSWERS

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

16. Under which of the following circumstance would a practitioner find the analysis of the partner's capital account useful in understanding the Schedule K-1 income and deduction items, and in calculating the changes to the partner's tax basis? **(Page 43)**

    a. When the partnership maintains its books according to generally accepted accounting principles (GAAP). [This answer is incorrect. If a partnership maintains its books according to GAAP, practitioners must often take extra steps to determine partner basis adjustments and may need to contact the managing general partner to obtain sufficient information per the IRC Sec. 731(a)(1).]

    b. When the partnership maintains its books using the Section 704(b) safe harbor rules. [This answer is incorrect. Partnerships that maintain their books using the Section 704(b) safe harbor rules make analyzing the partner's capital account more difficult for the practitioner because it can force the practitioner to take additional steps to determine partner basis adjustments. It may also make reconciliation to Form 1041 complicated.]

    c. When the partnership maintains its books on the tax basis. [This answer is correct. If a participant maintains its books on the tax basis, the capital account reconciliation will provide information useful in verifying the tax impact of items reported on the Schedule K-1 and in calculating the partner's basis adjustments. The practitioner will find the capital account allocation in Item L of Schedule K-1 of Form 1065.]

    d. When the partnership maintains its books using an "other" basis. [This answer is incorrect. If a partnership maintains its books on an "other" basis, their books will report amounts that make reconciliation to Form 1041 complicated. In these situations, practitioners must often take extra steps to determine partner basis adjustments and may need to contact the managing general partner to obtain sufficient information.]

17. Which of the following is an accurate statement regarding at-risk limitations? **(Page 43)**

    a. At-risk limitation rules are applicable at the fiduciary taxpayer level only if the at-risk activity is reported on Schedule C. [This answer is incorrect. According to IRC Sec. 465, the at-risk limitation rules apply at the fiduciary taxpayer level, even if the at-risk activity is held directly (reported on Schedule C, C-EZ, or F) or through an interest in a pass-through entity such as a partnership or S corporation.]

    b. At-risk limitations are effective in the taxable year of profitable activity. [This answer is incorrect. At-risk limitations have no effect in a taxable year when the activity is profitable. Thus, the effect of the limitation is to limit the deductible loss from an at-risk activity according to IRC Sec. 465.]

    c. Trusts that incur a loss in a business activity where the investment is in the form of nonrecourse loans not secured by the taxpayer's own property are not considered at risk. [This answer is correct. According to Prop. Reg. 1.465-25(a), a trust or estate is not at risk for a loss that is incurred (either directly or through a partnership or S corporation) in a business or production-of-income activity for investments made in the form of nonrecourse loans (either within the activity or to acquire an interest in the activity) that are not secured by the taxpayer's own property (i.e., property not used in the activity).]

    d. Generally, an estate's sum of cash contributed to the activity is not considered at risk. [This answer is incorrect. According to IRC Sec. 465(b)(1)(A), Prop. Reg. 1.465-22(a), a trust or estate's amount at risk in an activity includes the sum of cash contributed to the activity. Also included are the adjusted basis of other property contributed and amounts borrowed for use in the activity if the fiduciary is liable for the repayment of the debt.]

18. Sarah Connor, a 30% general partner in Glass Partnership, died on April 1, 2009. For tax purposes as part of Sarah's gross estate, the value of the partnership must be included on which of the following forms? **(Page 48)**

a. Form 706. [This answer is correct. If filling is required, when a partner dies, the value of the partnership interest normally must be included on Form 706 as part of the partner's gross estate for estate tax purposes. The partnership year terminates with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise per IRC Sec. 706(c)(2)(A).]

b. Form 1040. [This answer is incorrect. The value of the partnership interest is not included on Form 1040. However, the partnership income through date of death is included on the decedent's final federal income tax return.]

c. Form 1041. [This answer is incorrect. The value of the partnership interest is not included on Form 1041. However, partnership income after death is included on the estate's Form 1040 or by a successor in interest.]

d. Form 8582. [This answer is incorrect. According to the Internal Revenue Code, passive activity losses are reported on Form 8582, Worksheet 3, column b. The value of the partnership interest is not included on this form.]

19. Leann Harris was a partner in the accounting firm of Harris and Autumn Associates (HAA). Leann died July 2, 2010, and her interest in the partnership was liquidated through a series of distributions. Under which of the following circumstance would Leann's distributions **not** be considered IRD? **(Page 48)**

a. If Leann's distributions were a distributive share of HAA's income. [This answer is incorrect. When a deceased partner's interest in the partnership is liquidated via a distribution or series of distributions, IRD treatment depends on the character of the distribution. According to IRC Sec. 753, a distributive share of the partnership's income is IRD.]

b. If Leann's distributions were guaranteed payments. [This answer is incorrect. When a deceased partner's interest in the partnership is liquidated via a distribution or series of distributions, guaranteed payments to a partner are IRD as stated in IRC Sec. 753.]

c. If HAA made distributions in exchange for Leann's interest in partnership property. [This answer is correct. Generally, if the distributions are made in exchange for the decedent's interest in partnership property, they are Section 736(b) payments which are not IRD.]

20. Which of the following scenarios complies with the shareholder eligibility rules of Subchapter S? **(Page 51)**

a. Shareholder A died March 20, 2010. Her estate is considered an eligible shareholder of the S corporation. [This answer is correct. According to IRC Sec. 1361(b)(1)(B), the estate of a deceased shareholder is a permitted shareholder of an S corporation.]

b. Shareholder A, her husband, and twin daughters would each be treated as separate shareholders. [This answer is incorrect. As stated in IRC Sec. 1361(c)(1)(A), for purposes of determining the total number of shareholders, a husband and wife (and their estates), and all members of a family (and their estates) will automatically be treated as one shareholder.]

c. The twin daughters are beneficiaries of a testamentary trust; the trust is an eligible S corporation shareholder for three years. [This answer is incorrect. Testamentary trusts receiving S corporation stock pursuant to the terms of a will are eligible S corporation shareholders only for a two-year period beginning on the date the stock is transferred to the trust as stated in IRC Sec. 1361(c)(2)(A)(iii).]

d. The testamentary trust cannot recognizes its share of the S corporation income and credits. [This answer is incorrect. According to the IRS, during the two-year periods, the testamentary trust recognizes its share of the S corporation income, losses, and credits and makes adjustments to its stock basis.]

21. There are certain criteria that must be met for a trust to be allowed to hold S corporation stock as a qualified Subchapter S trust (QSST). Which of the following does **not** meet that criterion? **(Page 51)**

a. A QSST may have only one income beneficiary while that beneficiary is living. [This answer is incorrect. A trust will be allowed to hold S corporation stock as a qualified Subchapter S trust (QSST) if all of the criterion are met. One requirement is that the trust has only one income beneficiary during the life of the current income beneficiary per Reg. 1.1361-1(j)(2).]

b. Any principal distributions must go only to the income beneficiary while living. [This answer is incorrect. As stated in the regulations, any principal distributions, including a termination distribution, must go to the income beneficiary if made during the beneficiary's lifetime. Therefore, this is a specific requirement.]

c. A trust income beneficiary must make a QSST election related to the stock of each corporation held by the trust. [This answer is correct. According to IRS Regulations, the trust's income beneficiary must make a QSST election related to the stock of each S corporation held by the trust.]

d. An income beneficiary's interest must be terminated on the earlier of his death or the trust's termination. [This answer is incorrect. The income beneficiary's interest must terminate on the earlier of the beneficiary's death or the trust's termination per IRS Regulations. Therefore, this is a specific requirement.]

22. Which of the following statements regarding QSSTs is most accurate? **(Page 51)**

a. Once a QSST election is made by a former grantor trust, it cannot be revoked. [This answer is incorrect. Once the QSST election is made, it can only be revoked with the consent of the IRS Commissioner, or the QSST becomes an ESBT. IRS consent will not be given if one of the purposes is avoidance of income taxes or if the tax year is closed per Reg. 1.1361-1(j)(11).]

b. A trust cannot qualify as a QSST if the distribution to the income beneficiary is to fulfill the grantor's legal responsibility to support the income beneficiary under local law. [This answer is correct. As stated in Reg. 1.1361-1(j)(2)(ii)(B), if under local law, a distribution to the income beneficiary is to satisfy the grantor's legal obligation to support the income beneficiary, the trust will not qualify as a QSST as of the date of such distribution.]

c. Generally, a QSST election must occur within two years, two months and 14 days of death of the deemed owner. [This answer is incorrect. A QSST election can be made within two years, two months and 16 days of the death of the deemed owner (for grantor trusts) or of the stock transfer from the estate to the trust (for testamentary trusts) according to Reg. 1.1361-1(j)(6)(iii) and (h)(3)(i)(B).]

d. New income beneficiaries are required to file an election to maintain QSST status. [This answer is incorrect. A new (successive) income beneficiary is not required to file an election to continue QSST status, just as a new shareholder in an existing S corporation is not required to consent to the S status per Reg. 1.1361-1(j)(10).]

23. Which of the following statement most accurately explains an aspect of ESBTs? **(Page 51)**

a. Charitable remainder trusts can be ESBT shareholders. [This answer is incorrect. Charitable remainder trusts are not eligible ESBT shareholders per IRC Sec. 1361(e)(1)(B)(iii).]

b. Interest in the trust can be purchased. [This answer is incorrect. As stated in IRC Sec. 1361(e)(1)(A)(ii) and Reg. 1.1361-1(m)(1)(iii), no interest (including the payment of gift tax by a donee) in the trust can be acquired by purchase.]

c. Charitable organizations are not eligible for trust beneficiary status. [This answer is incorrect. All trust beneficiaries must be individuals, estates eligible to be S corporation shareholders, or certain charitable organizations per IRC Sec. 1361(e)(1)(B)(iii).]

d. An ESBT can hold S corporation stock and divide the income among family members. [This answer is correct. An individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries per the Internal Revenue Code.]

24. What is an ESBT permitted to do? **(Page 51)**

    a. It can deduct interest expense on debt incurred to purchase S corporation stock. [This answer is correct. According to IRC Sec. 641(c)(2)(C)(iv), an ESBT is permitted to deduct interest expense on debt incurred to purchase S corporation stock for taxable years beginning after 2006. The interest expense will directly reduce the taxable income passed through from the S corporation, thus resulting in the reduction of total income automatically taxed to the trust at the highest individual rate.]

    b. It can deduct a part of a net operating loss carryover that the trust obtained from the residuary testamentary trust. [This answer is incorrect. According to the IRS, an ESBT cannot deduct any portion of a net operating loss carryover for the S corporation portion of the ESBT that the trust acquired from the residuary testamentary trust.]

25. What should be reported on Form 1041, Page 1 and on Schedule D? **(Page 51)**

    a. The deemed owner's consent to the S corporation election. [This answer is incorrect. The QSST's deemed owner must consent to the S corporation election on Part I, column K of Form 2553.]

    b. Non-S corporation part of capital gains. [This answer is correct. Only the non-S corporation portion of capital gains will be reported on page 1 of Form 1041 and on Schedule D per the Internal Revenue Code.]

    c. Nonseparately stated ordinary items. [This answer is incorrect. Estates should report nonseparately stated ordinary income on Schedule E of Form 1040, Part II.]

    d. Interest income. [This answer is incorrect. The interest income is reported in the income section on Page 1 of Form 1041.]

Reporting Pass-through Income or Loss from S Corporations

Practitioners need to identify the tax consequences of items and amounts reported to the S corporation shareholder on Schedule K-1 and also to correctly track the shareholder's adjusted tax basis in the stock and debt. Tracking a shareholder's tax basis is important for a number of reasons, including the determination of (1) gain or loss if the stock is sold, (2) potential gain resulting from distributions, and (3) limitations on recognizing losses passed through to a shareholder.

Not all trusts are permissible S corporation shareholders. Certain trusts owning S corporation stock are treated as grantor trusts for purposes of reporting their share of income or loss from an S corporation. Such information must be shown on a separate schedule attached to Form 1041. In addition, an ESBT may hold S corporation stock and its tax calculations and presentations are different than those for other trusts permitted to be S corporation shareholders.

A practitioner cannot transfer amounts from an S corporation Schedule K-1 to the Form 1041 without first considering factors such as basis limitations, at-risk limitations, and the passive loss rules. The S corporation shareholder's basis calculation is discussed below. The at-risk limitations, which are the same as for partnerships, were discussed earlier in this lesson.

Basis Limitations for S Shareholders

The net income or net loss from an S corporation passes through to the stockholder on Schedule K-1 of Form 1120S. Income increases the stockholder's basis while losses decrease the stockholder's basis. IRC Sec. 1366(d) states that S corporation losses claimed as a deduction by the shareholder cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the adjusted basis of any indebtedness of the S corporation owed *directly* to the shareholder.

It is the shareholder's responsibility, rather than the corporation's, to determine the proper stock or debt basis. The information necessary to determine basis adjustments should be disclosed on each shareholder's Schedule K-1. Depending on the type of trust in which the S corporation is held, the stock basis must be calculated each year by either the trust, the grantor, or the income beneficiary. For an estate, a testamentary trust, a grantor trust that continues after the death of the grantor (or deemed owner), and an ESBT, the executor or fiduciary must keep up with the stock basis. For a grantor trust and a voting trust, the stock basis must be maintained by the grantor (or deemed owner). For a QSST, both the fiduciary and the income beneficiary should monitor the stock basis because the items of income and deduction flow to the income beneficiary but the actual sale of the S corporation stock is reported by the trust.

Computing Basis in Stock. A stockholder's basis in the S corporation stock normally starts with the initial cost of acquiring the shares. In some instances, original basis may be determined by other methods, as follows:

1. Subject to certain tests pertaining to stock ownership, the basis of stock issued at incorporation is equal to the adjusted basis of assets contributed by the shareholder, plus any gain recognized on the transfer.

2. Basis of stock acquired by gift is generally the transferor's basis. Transfers to trusts often occur as a gift from the grantor.

3. Stock acquired by inheritance is generally valued at the FMV of the shares at the date of death.

Stock basis is adjusted when, for example, the shareholder buys or sells stock in the corporation or contributes capital to the corporation. Also, at each year-end, the shareholder's stock basis must be redetermined under IRC Sec. 1367, with the beginning-of-the-year basis as the starting point as follows:

1. Basis is increased by the stockholder's share of:

    a. nonseparately stated income;

    b. separately stated items of income, including tax-exempt income;

c. excess of the shareholder's deduction for depletion over the basis of the property subject to depletion (not applicable to oil and gas depletion that is determined at the shareholder level); and

d. recapture of general business credits under IRC Sec. 50(a)(1) to the extent such recapture causes an increase to an asset's basis.

2. Basis is decreased by the stockholder's share of:

a. nonseparately stated loss;

b. separately stated items of deduction or loss including charitable contributions;

c. any corporate expenses not deductible in computing its taxable income and not chargeable to a capital account (e.g., the nondeductible portion of business meals);

d. the amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed the shareholder's proportionate share of the corporation's basis in the property; and

e. the reduction in an asset's basis when the general business credit caused such a reduction under IRC Sec. 50(c)(1).

3. Basis is also decreased by nontaxable distributions (i.e., distributions treated as a tax-free return of stock basis). Distributions from the corporation to the shareholder reduce stock basis but do not reduce debt basis (i.e., debt basis is reduced by corporate repayments of the shareholder debt rather than general distributions to shareholders).

Adjustments are made to stock basis in the following order:

1. increases for income and gain items;

2. decreases for nontaxable distributions received by the shareholder;

3. decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions; and

4. decreases for items of loss and deduction.

A shareholder may elect to reduce basis by items of loss or deduction before reducing basis by nondeductible, noncapital expenses and certain oil and gas depletion deduction. The election is made by attaching to a timely filed original or amended return a statement that the shareholder agrees to carry over to the succeeding tax year the nondeductible, noncapital expenses (and certain oil and gas depletion deductions) in excess of stock and debt basis. The election applies for the year of the election and for all future years.

The adjustments made to stock basis are allocated to each share owned by the shareholder. When a shareholder has a different basis in different lots of stock, pass-through adjustments are generally allocated prorata to all shares, rather than more to the shares with the larger basis. Tax credits generally do not affect basis.

Example 2D-1 Using Schedule K-1 to determine S shareholder's stock basis.

The Lyle Trust (a testamentary trust created in 2008) has beginning 2010 stock basis in LL Company stock of $49,000. The corporation distributes $75,000 to the Lyle Trust during the year and at year-end passes through the following items to it via Schedule K-1:

Line	Schedule K-1 Items	
1	Nonseparately stated ordinary business income	$ 25,000
2	Loss from rental real estate	(3,500)
4	Interest income	4,000
8a	Long-term capital gain	5,000
12	Charitable contributions	2,000
13	Work opportunity tax credit	6,000
16	Tax-exempt interest income	2,500
16	Interest expense on loan used to purchase tax-exempt bonds	900
16	Nondeductible portion of meals and entertainment expense	5,000
16	Nondeductible wages (due to work opportunity tax credit)	6,000
16	Distribution	75,000
17	Investment income	4,000

The Lyle Trust does not have enough stock basis to deduct its items of loss or deduction as shown in the following calculation:

Basis, beginning of year	$ 49,000
Income and gain items:	
Nonseparately stated income	25,000
Interest income	4,000
Net long-term capital gain	5,000
Tax-exempt interest income	2,500
Stock basis before distributions	85,500
Distributions	(75,000)
Basis before loss and deduction items	10,500
Nondeductible and noncapital expenses:	
Interest expense on loan used to purchase tax-exempt bonds	(900)
Nondeductible portion of meals and entertainment expense	(5,000)
Nondeductible wages (due to work opportunity tax credit)	(6,000)
Basis, end of year	$ -0-

Because the basis must be reduced for nondeductible, noncapital expenses and certain oil and gas depletion deductions before items of loss or deduction, in this example, the Lyle Trust will not have any basis with which to take a loss. If the Lyle Trust made the election to reduce basis by items of loss or deduction before reducing basis by nondeductible and noncapital expenses, the trust would have basis in the stock for taking the deductible losses (see Example 2D-2).

Example 2D-2 Electing to reduce basis by items of loss or deduction.

Assume the same facts as in Example 2D-1, except the Lyle Trust elected to reduce basis by items of loss or deduction before reducing basis by nondeductible, noncapital expenses.

Stock basis before loss and deduction items (from Example 2D-1)	$ 10,500
Loss and deduction items:	
Loss from rental real estate	(3,500)
Charitable contributions	(2,000)
Stock basis before nondeductible and noncapital expenses	$ 5,000

Establishing Debt Basis. Once losses have reduced a shareholder's stock basis to zero, additional losses are generally suspended (not currently deductible) until the shareholder acquires additional stock basis. However, such losses are currently deductible to the extent the shareholder has debt basis. An S corporation shareholder receives basis for debt only when it is owed directly to the shareholder by the corporation. A shareholder's guarantee of a loan made to the corporation by a third party (e.g., a bank) does not provide basis. However, if a shareholder-guarantor actually satisfies the debt of the corporation or gives a note to the bank in full satisfaction of the S corporation liability, additional basis is created.

In *Selfe*, the appeals court suggested that a shareholder-guarantor might be able to increase basis if the lender had looked primarily to the shareholder for repayment. The Tax Court (and all other subsequent court decisions) disagreed with the *Selfe* case and declined to allow basis to a shareholder beyond the original investment even though the bank loan to the corporation was made possible because of a shareholder's guarantee. The courts consistently require an economic outlay on the part of the shareholder to allow basis associated with debt; the mere guarantee of corporate debt is insufficient.

At-risk Limitations

The at-risk limitations apply to S corporation shareholders in the same way they apply to partners. The IRS has not issued any guidance on the transfer at death of S corporation losses that were suspended by at-risk limitations. It is believed that such suspended losses do not carry over to the estate or an heir.

Claiming Losses and Reporting Distributions

While a shareholder's basis in stock is important for determining gain or loss when the stock is disposed of or redeemed, a primary reason for tracking the basis is to determine the extent to which the shareholder can claim pass-through losses as well as the proper treatment of distributions. The following examples illustrate the treatment for losses and distributions.

Example 2D-3 Application of loss to stock and debt basis.

Ed Gram died in 2009. The estate is the sole stockholder in AD Company (an S corporation). The estate's basis is $10,000. There were no distributions from the corporation in 2010. The corporation also owes the estate $15,000 from loans Ed made during his lifetime. During 2010, the corporation incurred a $30,000 loss. The Estate of Ed Gram's deductible loss is computed as follows:

Basis in stock	$ 10,000
Loan to corporation	15,000
Total basis (maximum loss deduction)	25,000
Actual loss for 2010	(30,000)
Excess loss carryover to 2011	$ (5,000)

The loss for 2010, which was allocated to the Estate of Ed Gram as an S shareholder, first reduced his basis in stock to zero, and then reduced the basis in his debt to the corporation.

Example 2D-4 Effect of distributions on basis.

Assume the same facts as Example 2D-3, except that during 2010 the corporation incurred a $20,000 loss and distributed $10,000 to the estate. The following computation shows the estate's basis and taxable income:

	Stock Basis	Debt Basis	Total
Basis in stock	$ 10,000	$ —	$ 10,000
Loan to corporation	—	15,000	15,000
Total	10,000	15,000	25,000
Distribution	(10,000)	—	(10,000)
Balance	—	15,000	15,000
Loss for 2010	—	(20,000)	(20,000)
Excess loss carryover to 2011	$ -0-	$ (5,000)	$ (5,000)

The order of basis adjustments is important. The distributions to shareholders reduce the basis in stock before any losses. Therefore, the stock basis is reduced to zero because of the distribution. The loss reduced the debt basis to zero and there is a carryover to 2011 of $5,000.

When basis in stock or shareholder debt has been reduced by losses occurring in years after 1982, it will be restored with subsequent income. In this situation, the ordering rules first restore basis in shareholder debt to the

extent of prior basis reductions from post-1982 losses, and basis in stock is increased only after debt basis has been restored.

Example 2D-5 Restoration of basis with income.

Assume the same facts as in Example 2D-4 (i.e., the estate has zero basis in its stock and zero basis in its debt as of the end of 2010). If the S corporation passes through $18,000 of income to the estate for 2011, the basis in the estate's debt will first be increased by $15,000 to the original amount. The remaining $3,000 will then be added to the estate's stock basis, which will provide basis for claiming a deduction in 2011 for the $5,000 carryforward loss from 2010.

Losses that are currently nondeductible because of insufficient basis carry forward indefinitely. When sufficient stock or debt basis is acquired through subsequent corporate profits, shareholder contributions to the capital account, or shareholder loans to the corporation, the carryover losses become deductible. Carryover losses are personal to the shareholder (i.e., they do not transfer with stock). In general, the shareholder forfeits the carryover losses and they disappear when one of the following events occurs:

1. The S corporation election is terminated [although the special one-year "post-termination transition period" rule of IRC Sec. 1377(b) allows the shareholder to restore stock basis to allow loss recovery].

2. The shareholder disposes of the stock.

Passive losses can be deducted when the activity is sold or disposed of in a taxable transaction. Normally, the distribution of a passive activity to a beneficiary is not a sale. Any suspended loss incurred while the activity is owned by the estate passes to the beneficiary, but may only be recognized by the beneficiary when the activity is sold. For a discussion of the passive loss limitations, see lesson 3.

Reporting Income in the Year of an S Corporation Shareholder's Death

S corporations typically pass through items of income or loss based on a per-share, per-day allocation method. In the year of a shareholder's death, the decedent is normally allocated a prorata share of the corporation's pass-through items on Schedule K-1 for the portion of the corporation's tax year through the date of death, to be reported on the decedent's final Form 1040. For the prorata share of income for the remainder of the corporation's tax year, a Schedule K-1 will be prepared for the successor shareholder(s), which may be the estate of the decedent.

Example 2D-6 Allocating income between the decedent and estate.

Brett and Emily each owned one-half of Ross Corporation, a calendar-year, cash-basis S Corporation. Brett died on October 31. That year, the corporation had $150,000 in income. Ten months of income will be shown on Brett's final tax return and two months of income will be shown on the estate's tax return. The 1120S tax preparer allocates the income as follows:

Brett's final Form 1040	[50% × ($150,000 × 10/12)]	$62,500
Estate's Form 1041	[50% × ($150,000 × 2/12)]	$12,500

However, since death is a complete termination of a shareholder's interest, the corporation can elect to determine a decedent's prorata share of pass-through items by an interim closing of the books, if all shareholders consent. Regardless of the allocation method used, a deceased shareholder's share of the corporation's income or loss for the period ending with the date of death is included on the decedent's final Form 1040. The basis of inherited S corporation stock must be reduced by any S corporation income items that are IRD, such as accrued S corporation income that is not a part of decedent's prorata share of income. The election to determine a decedent's prorata share of pass-through items by an interim closing of the books is made by the corporation. See *PPC's 1120S Deskbook* for additional discussion of this election.

Example 2D-7 Interim closing of the books upon death of a shareholder.

Frank and George each own 50% of the shares of FG Corp, an S corporation. George died on June 30. If the books were closed on June 30, FG would pass through a total operating loss of $20,000 to its two sharehold-

ers. During the remainder of the year, the corporation earns $50,000 of net income, resulting in $30,000 of ordinary income for the entire year. The income is FG's only pass-through item.

George's death is a complete termination of his interest. FG Corp elects to treat the tax year as if it consisted of two tax years, so that the pass-through to George's final Form 1040 is based on the income or loss through June 30. The income for the year is allocated in the following manner:

	January 1 through June 30	July 1 through December 31	Total
Frank	$ (10,000)	$ 25,000	$ 15,000
George's final 1040	(10,000)	—	(10,000)
George's estate	—	25,000	25,000
Totals	$ (20,000)	$ 50,000	$ 30,000

Frank, who held his shares all year, receives the same amount of pass-through regardless of which method is used. The election affects only shareholders whose interests in the corporation change during the year. All shareholders, however, must consent to the election.

If the election is not made, the amount that passes through to George's final Form 1040 is $7,438 (181/365 × $15,000) and the pass-through to George's estate is $7,562.

George's estate reports the $25,000 on Schedule E (Form 1040), Part II.

Reporting S Corporation Items for an Estate

An estate is a qualified S corporation shareholder. While there is no statutory limit to the length of time an estate can be an eligible S shareholder, the estate administration cannot be unduly prolonged. If the IRS terminates the estate because it is unduly prolonged, the S corporation stock is treated as owned by the estate's successor in interest. This successor must also be a qualified S corporation shareholder or the S corporation election will be terminated.

When an estate receives a Schedule K-1 from an S corporation, it must report the income on Form 1041.

Example 2D-8 Reporting S corporation income on an estate's Form 1041.

The Frank Thompson Estate received a K-1 from FG Corporation which reported the following items:

Line	Description	Amount
1	Nonseparately stated ordinary income	$ 25,000
4	Interest income	2,500

The estate reports the nonseparately stated ordinary income on Schedule E of Form 1040, Part II. The interest income is reported in the income section on Page 1 of Form 1041.

If an estate has a fiscal year, its share of the S corporation's income does not have to be included in its income until the estate's taxable year that includes the end of the corporation's taxable year. Depending on the fiscal year selected, an 11-month deferral is possible. However, a shareholder must report any S corporation distributions in the tax year received. When the corporation's tax year ends after the estate's year, the estate may not be able to make any adjustments to basis and its AAA until the end of the corporation's tax year. Until the estate can accurately compute its basis and AAA, the estate will not be able to determine how the distribution is taxed. A large distribution received upon the shareholder's death may alleviate basis problems, but it may also prompt the need for an extension until complete basis and AAA information can be obtained.

Reporting S Corporation Items for a Trust

A trust's reporting of items from an S corporation K-1 will depend on the type of trust. Not all trusts are eligible S corporation shareholders. See previously in this lesson for a discussion of the types of trust that can hold S corporation stock. The discussion below assumes the trust qualifies as an S corporation shareholder.

A trust that is deemed to be owned by one individual and voting trusts are treated as grantor trusts for income tax purposes. Therefore, when such a trust receives a Schedule K-1 from an S corporation, it is reported on a statement attached to Form 1041.

A testamentary trust and a trust that continues after the death of the grantor or deemed owner (i.e., when a trust is treated as owned by one individual and that individual dies) report their S corporation items directly on Form 1041.

Reporting Items from an ESBT. An ESBT is taxed differently than any other trust eligible to hold S corporation stock. The primary benefit of this entity is its ability to accumulate income from the S corporation. The cost of this benefit is that the income from the S corporation will generally be taxed at 35% for 2010. However, being taxed at the highest individual tax rate may not be a significant issue because "ordinary" trust income is taxed at 35% once taxable income is over $11,200 (for 2010). A distribution deduction is allowed in the normal way for non-S corporation income, and capital gain income qualifies for preferential income tax treatment.

Example 2D-9 ESBT owns S corporation stock and other assets.

The Barbara B. Langford Trust is an ESBT. Olivia Langford, Barbara's daughter is the sole beneficiary of the ESBT. She will receive the trust principal and any undistributed income when she reaches age 40. Distributions from the ESBT are at the discretion of the trustee, Olivia's uncle, and subject to an "ascertainable standard" provision in the trust instrument.

The major asset of the trust is 100% of the stock of an S corporation, BBL, Inc., but the trust also holds taxable bonds that generated $40,000 of interest income in the current year. The ESBT's Schedule K-1 from BBL shows $250,000 of ordinary income and $125,000 of net (15%) long-term capital gain. Olivia's uncle did not charge a trustee fee for the year and the ESBT had no other expenses. The trustee made a discretionary distribution of $25,000 in cash to Olivia.

The ESBT is allowed the usual $25,000 distribution deduction in calculating the income from the non-S corporation income of the trust on Schedule B of its Form 1041. The taxable income of the non-S portion of the ESBT is $14,900 ($40,000 less the $25,000 distribution deduction and $100 exemption). Olivia will include $25,000 in her current year gross income from the Schedule K-1 she received from the ESBT.

The ESBT itself will be taxed separately on the "S" corporation items: the $250,000 of ordinary income (all taxed at 35%) and the $125,000 of long-term capital gain (taxed at 15% in 2010). Therefore, the trust would pay a total of $110,424 in income tax. The ESBT's income from the S corporation is not a component of the trust's DNI.

Distributions from an ESBT are first considered to be distributions of DNI to the extent of DNI. Since the trust pays taxes on the S corporation stock income at the trust level, if the trustee decided in his discretion that the income beneficiary should receive cash in excess of DNI, the S corporation income could be distributed to the beneficiary as well. Since the trust would have already paid tax on the "S" portion of its income, the distribution would produce no distribution deduction to the trust and no income inclusion by the beneficiary.

When all (or part) of an ESBT is treated as a grantor trust, the items of income, deduction and credits attributable to the deemed owner are reported on a statement attached to Form 1041. Thus, an ESBT can have three portions, the grantor portion and the parts of the "S" and "Other" portions that are not treated as grantor trusts.

Reporting Items from a QSST. In a QSST, the income beneficiary is treated under IRC Sec. 678(a) as the owner of the portion of the trust that consists of S corporation stock. Thus, with respect to the S corporation stock, the trust will be treated as a grantor trust. The income beneficiary is not taxed on the gain or loss upon disposition of the S corporation stock. See the discussion later in this lesson under the subheading "Disposition of S Corporation

Stock by a QSST." If the QSST also owns other assets, income and loss from such assets may be reported on Form 1041 (i.e., they are not automatically subject to the grantor trust provisions). However, all of the income of the trust, including the income from other assets as well as from the S corporation, must actually be distributed or required to be distributed in order to qualify as a QSST.

Example 2D-10 QSST owns S corporation stock and other assets.

The Barbara B. Langford Trust is a QSST. Olivia Langford, Barbara' daughter, is the sole beneficiary of the trust.

The major asset of the trust is 100% of the stock of an S corporation, BBL, Inc., but the trust also holds taxable bonds that generated $40,000 of interest income. The trust's Schedule K-1 from BBL shows $250,000 of ordinary income and $125,000 of net long-term capital gain. BBL distributed $375,000 to the trust. Olivia's uncle did not charge a trustee fee and the trust had no other expenses for the year.

Since the trust is a QSST, Olivia is treated as the owner under IRC Sec. 678(a) of that portion of the trust which consists of the BBL, Inc. stock. Therefore, she is taxed under the grantor trust rules on the $250,000 of BBL's ordinary income and the $125,000 of BBL's long-term capital gain. The QSST Form 1041 does not include the S corporation income. The beneficiary's income information should be reported to Olivia on a statement of income, deductions, and credits attributed to a grantor.

In addition, since the trust is a QSST holding S corporation stock, the trustee is required to distribute all income currently. "Income" refers to fiduciary accounting income. The $40,000 bond interest is included on Form 1041 and the trust will get an income distribution deduction for $40,000.

The accounting income of the QSST generally is the amount of the S corporation's current distribution to the QSST, which often differs from the amount of the taxable income reported on the Form 1120S, Schedule K-1, to the QSST. Furthermore, there is no requirement that the S corporation make any cash distribution of its earnings. If no distribution from the S corporation is received, no accounting income is distributed by the trust, even though there is taxable income from the S corporation that is taxable to the QSST beneficiary. The potential problem faced by all S corporation shareholders is that the cash distributed from the S corporation, if any, may not be sufficient to pay the income tax on the shareholder's portion of S corporation earnings.

Disposition of S Corporation Stock by a QSST

Although the income beneficiary is treated as the owner of the portion of the trust that consists of the S corporation stock, the trust recognizes gain or loss upon disposition of the S corporation stock. A beneficiary of a QSST is allowed to deduct the QSST's share of S corporation losses that have been suspended under the at-risk or passive loss rules when the QSST disposes of the related S corporation stock. See lesson 3 for a discussion of passive activity losses.

Because the trust recognizes gain or loss upon disposition of S corporation stock, the trustee (as well as the income beneficiary) must track the adjusted basis of the stock. S corporation stock basis is discussed earlier in this lesson.

Example 2D-11 Disposition of S corporation stock by a QSST.

Assume the same facts as in Example 2D-10 except the Barbara B. Langford Trust sells the BBL, Inc. stock on December 24 of the current year for $4 million. Also assume the stock's basis on January 1 was $3,945,000.

The trust's basis in the stock is computed as:

Basis, beginning of the year	$ 3,945,000
Income items:	
Ordinary income	250,000
Capital gain	125,000
Less: Distributions	(375,000)
Basis at time of sale	$ 3,945,000

Therefore, the gain recognized by the trust is $55,000 ($4,000,000 − $3,945,000). The gain is reported on Schedule D of Form 1041. Olivia will report the $250,000 of ordinary income and $125,000 of capital gain on her personal return.

Converting from a QSST to an ESBT or from an ESBT to a QSST

The IRS provides guidance for converting a QSST to an ESBT or converting an ESBT to a QSST under Regs. 1.1361-1(j)(12) and (m)(7).

Converting a QSST into an ESBT. A trust is eligible to convert from a QSST to an ESBT if it meets the following requirements:

1. The trust meets all of the requirements described in the previous section under the subheading "Electing Small Business Trusts (ESBTs)," except for the requirement that the trust not have a QSST election in place under IRC Sec. 1361(d)(2).

2. The trustee and the current trust income beneficiary make the ESBT election (as described later in this section) with respect to the S corporation stock held by the trust.

3. The trust has not converted from an ESBT to a QSST in the last 36 months (from the date of the new ESBT election).

4. The ESBT election is to be effective not more than 15 days and 2 months prior to the date the election is filed and cannot be more than 12 months after the date the election is filed. If an election specifies an effective date more than 15 days and 2 months prior to the date on which the election is filed, it will be effective 15 days and 2 months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it was filed.

Once a QSST election is made, it is revocable only with the consent of the IRS. IRS consent to revoke a QSST election as of the effective date of the ESBT election is automatically granted to any QSST that satisfies the requirements of Reg. 1.1361-1(j). Thus, separate IRS permission to revoke the QSST election is not required when converting a QSST to an ESBT under Reg. 1.1361-1(j).

The conversion of a QSST to an EBST generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). [When a QSST that is limited to a two-year existence (because it is a testamentary trust or it is treated as owned by an individual that continued in existence after the death of the deemed owner) converts to an ESBT, the QSST terminates its entire interest in the S corporation.] Thus, the S corporation cannot elect to terminate its tax year. However, for purposes of the S corporation pass-through rules, the QSST will be treated as terminating its interest in the S corporation and the ESBT will be treated as a new shareholder. The last day the QSST will be a shareholder is the day before the effective date of the ESBT election, and the new ESBT will be a shareholder beginning on the effective date of the ESBT election. If the QSST has suspended losses upon conversion to an ESBT, neither the code nor the regulations indicate whether those losses carryover to the ESBT.

Converting from an ESBT to a QSST. A trust is eligible to convert from an ESBT to a QSST if it meets the following requirements:

1. The trust meets the requirements of a QSST as described earlier in this lesson under the subheading "Qualified Subchapter S Trusts (QSSTs)."

2. The trustee and the current income beneficiary make the QSST election with respect to the stock of each S corporation held by the trust.

3. The trust has not converted from a QSST to an ESBT in the 36-month period preceding the effective date of the new QSST election.

4. The effective date of the new QSST election is not more than 15 days and 2 months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and 2 months prior to the date on which the election is filed, it will be effective 15 days and 2 months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it was filed.

Once an ESBT election is made, it is revocable only with the consent of the IRS. IRS consent to revoke an ESBT election is automatically granted to any ESBT that satisfies the requirements of Reg. 1.1361-1(m)(7). Thus, separate IRS permission to revoke the ESBT election is not required when converting an ESBT to a QSST under Reg. 1.1361-1(m)(7).

The conversion of an ESBT to a QSST generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). [When an ESBT that is limited to a two-year existence (because it is a testamentary trust or it is treated as owned by an individual that continued in existence after the death of the deemed owner) converts to a QSST, the ESBT terminates its entire interest in the S corporation.] Thus, the S corporation cannot elect to terminate its tax year. However, for purposes of the S corporation pass-through rules, the ESBT will be treated as terminating its interest in the S corporation and the QSST will be treated as a new shareholder. The last day the ESBT will be a shareholder is the day before the effective date of the QSST election, and the new QSST will be a shareholder beginning on the effective date of the QSST election. If the ESBT has suspended losses upon conversion to a QSST, neither the code nor the regulations indicate whether those losses carryover to the QSST (and then to the income beneficiary).

Section 179 Expense

Section 179 expense may not be allocated to trusts or estates. Therefore, a trust or estate that is a shareholder in an S corporation cannot deduct its prorata share of the S corporation's Section 179 deduction. However, the S corporation is not required to reduce the basis of the Section 179 property for any amount that the trust or estate is not allowed to deduct. Instead, the S corporation is allowed to depreciate the additional basis of the Section 179 property attributable to the trust or estate's disallowed portion of the Section 179 deduction.

Pass-through Income from Other Fiduciaries

A trust or estate generally reports the trade or business income and expense amounts from a Schedule K-1 received from other fiduciaries on Schedule E of Form 1040, Supplemental Income and Loss. However, if the Schedule K-1 reports nonbusiness income items such as interest, dividends, and capital gains, the trust or estate reports these items on the corresponding lines or schedules of Form 1041 instead of Schedule E. Thus, interest income passed through on a Schedule K-1 of Form 1041 is reported on the "Interest income" line on page 1 of Form 1041, dividends passed through are reported on the "Dividend income" line and pass-through capital gains and losses are reported on Schedule D.

If the other fiduciary passes through passive activity items, these amounts must first be posted to Form 8582, Worksheet 3. These amounts will be combined with all passive activity items of the trust or estate. Passive income is reported on Schedule E of Form 1040, Part III, column (d). Generally, passive losses will not pass from another fiduciary. However, if depreciation is allocated to the beneficiary (in this case, the beneficiary is a trust or estate), the depreciation may be passive. Passive losses (after first being calculated on Form 8582) are reported on Schedule E of Form 1040, Part III, column (c).

Upon the death of a cash-basis individual beneficiary of an estate or trust, gross income from the fiduciary on the final Form 1040 includes only income actually distributed before death. Income required to be distributed as of the date of death, but distributed after the decedent's death, is taxable to either the estate or the successor-in-interest to the deceased beneficiary's interest in the estate or estate, depending on the provisions of the trust instrument and/or local law (e.g., Uniform Principal and Income Act).

Rental and Royalty Income

General Rules

A trust or estate reports rental and royalty income and expense amounts on Schedule E of Form 1040, Supplemental Income and Loss. Gross income, depreciation, depletion, and operating expenses, as applicable, should be listed for each of the rental and royalty properties. An estate or trust's net farm rental income (loss) based on crops or livestock produced by a tenant should be reported from Part I of Schedule E (Form 1040) on the line for rental income (line 5), rather than the line for farm income (line 6). The line for farm income (Line 6) is to report the profit or loss generated from a farm operated by the estate or trust, calculated on Schedule F.

Rental and royalty income often represents IRD to the extent accrued rental or royalty payments were not received until after the date of death.

The passive activity rules must be considered when a fiduciary has rental activity to report on Schedule E.

The deductions for depletion and depreciation are claimed at the fiduciary level only to the extent not allocated to current income beneficiaries. Deductions for depletion and depreciation allocated to the current income beneficiaries are reported directly on Schedules K-1 to the respective beneficiaries.

Decedent's Former Residence

A decedent's former residence can raise significant tax issues. The tax reporting depends on how the property is used *after* the owner's death. The way in which the residence was used by the decedent prior to his or her death does not automatically carry over to the beneficiaries.

A dwelling unit is considered a residence if it is used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year it is rented at a fair market rent. A dwelling unit used for personal purposes by the estate's or trust's beneficiaries will be treated as personal use property unless the beneficiaries pay the entity a fair rent. If the beneficiaries do not pay a fair rent, the dwelling unit will be taxed as a mixed-use vacation home. The fiduciary reports fair rental payments according to the passive activity rules.

If there is no personal use of the property by the beneficiaries, and the property is held for the production of income, any loss on the sale should be deductible by the beneficiaries.

SELF-STUDY QUIZ

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

26. Basis is decreased by the stockholder's share of which of the following?

    a. Nondeductible portion of meals.

    b. Tax-exempt income.

    c. Nonseparately stated income.

    d. Investment tax credit.

27. In regards to claiming losses, what is the primary reason for tracking the basis?

    a. To determine gain or loss when stock is disposed of.

    b. To determine the extent to which the shareholder can claim pass-through losses.

28. What determines a trust's reporting of items from an S corporation K-1?

    a. Shareholder agreements.

    b. Type of trust.

    c. Whether the S corporation was a prior C corporation.

29. A trust is eligible to convert from a QSST to an ESBT if it meets all of the following requirements **except**:

    a. The trust must wait at least 24 months before converting from an ESBT to a QSST from the date of the new ESBT election.

    b. The ESBT election is not effective more than twelve months after filing.

    c. The ESBT election must be made by the trustee and the current trust income beneficiary.

30. Which of the following statements most accurately describes the guidance for converting a QSST to an ESBT?

    a. Once a QSST election is made, it cannot be revoked.

    b. When converting a QSST to an ESBT under Reg. 1.1361-1(j), separate IRS permission is not required to revoke the QSST election.

    c. Once a QSST is converted to an ESBT, the entire trust interest in an S corporation must be terminated.

    d. If suspended losses occur prior to a QSST converting to an ESBT, the regulations indicate if those losses carryover to the ESBT.

31. Which of the following statements most accurately describes the guidance for converting an ESBT to a QSST?

    a. If suspended losses exist in an ESBT that is converting to an QSST, the code indicates whether those losses carryover to the QSST.

    b. Once a ESBT is converted to an QSST, the entire trust interest in an S corporation must be terminated.

    c. When converting an ESBT to a QSST under Reg. 1.1361-1(j), separate IRS permission is not required to revoke the election.

    d. Once a ESBT election is made, it cannot be revoked.

32. In regards to pass-through income from other fiduciaries, which of the following should be reported on Form 8582, Worksheet 3?

    a. Passive activity items passed through from another fiduciary.

    b. Pass-through dividend income.

    c. Interest income that is passed through on a Schedule K-1, Form 1041.

    d. Pass-through capital gains and losses.

SELF-STUDY ANSWERS

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

26. Basis is decreased by the stockholder's share of which of the following? **(Page 63)**

    a. Nondeductible portion of meals. [This answer is correct. As stated in IRC Sec. 1367, basis is decreased by the stockholder's share of any corporate expenses not deductible in computing its taxable income and not chargeable to a capital account (e.g., the nondeductible portion of business meals).]

    b. Tax-exempt income. [This answer is incorrect. Basis is increased by the stockholder's share of separately stated items of income, including tax-exempt income according to IRC Sec. 1367.]

    c. Nonseparately stated income. [This answer is incorrect. Basis is increased by the stockholder's share of nonseparately stated income.]

    d. Investment tax credit. [This answer is incorrect. Basis is increased by the stockholder's share of recapture of general business credits under IRC Sec. 50(a)(1) to the extent such recapture causes an increase to an asset's basis.]

27. In regards to claiming losses, what is the primary reason for tracking the basis? **(Page 63)**

    a. To determine gain or loss when stock is disposed of. [This answer is incorrect. A shareholder's basis in stock is important for determining gain or loss when the stock is disposed of or redeemed. However, there is another, more common reason, for determining basis.]

    b. To determine the extent to which the shareholder can claim pass-through losses. [This answer is correct. The primary reason for tracking the basis is to determine the extent to which the shareholder can claim pass-through losses as well as the proper treatment of distributions.]

28. What determines a trust's reporting of items from an S corporation K-1? **(Page 63)**

    a. Shareholder agreements. [This answer is incorrect. Whether the estate can sell the stock will depend on securities laws and the existence of any shareholder agreements. Shareholder agreements do not determine how a trust reports items from an S corporation K-1.]

    b. Type of trust. [This answer is correct. According to the IRS, a trust's reporting of items from an S corporation K-1 will depend on the type of trust. Some trusts report their S corporation items directly on Form 1041, while others report it on a statement attached to Form 1041.]

    c. Whether the S corporation was a prior C corporation. [This answer is incorrect. The manner in which the estate will be taxed on a redemption of stock will vary depending on whether the S corporation was a prior C corporation with accumulated earnings and profits (AE&P). However, it does not affect how K-1 items are reported on Form 1041.]

29. A trust is eligible to convert from a QSST to an ESBT if it meets all of the following requirements **except**: **(Page 63)**

    a. The trust must wait at least 24 months before converting from an ESBT to a QSST from the date of the new ESBT election. [This answer is correct. According to Reg. 1.1361-1(j)(12), a trust must not have converted from an ESBT to a QSST in the last 36 months (from the date of the new ESBT election), not 24 months.]

    b. The ESBT election is not effective more than twelve months after filing. [This answer is incorrect. The ESBT election is to be effective not more than 15 days and 2 months prior to the date the election is filed and cannot be more than 12 months after the date the election is filed.]

c. The ESBT election must be made by the trustee and the current trust income beneficiary. [This answer is incorrect. The trustee and the current trust income beneficiary make the ESBT election with respect to the S corporation stock held by the trust per Reg. 1.1361-1(j)(12).]

30. Which of the following statements most accurately describes the guidance for converting a QSST to an ESBT? **(Page 63)**

a. Once a QSST election is made, it cannot be revoked. [This answer is incorrect. Once a QSST election is made, it is revocable with the consent of the IRS according to IRC Sec. 1361(d)(2)(C).]

b. When converting a QSST to an ESBT under Reg. 1.1361-1(j), separate IRS permission is not required to revoke the QSST election. [This answer is correct. Separate IRS permission to revoke the QSST election is not required when converting a QSST to an ESBT under Reg. 1.1361-1(j).]

c. Once a QSST is converted to an ESBT, the entire trust interest in an S corporation must be terminated. [This answer is incorrect. The conversion of a QSST to an EBST generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). The last day the QSST will be a shareholder is the day before the effective date of the ESBT election, and the new ESBT will be a shareholder beginning on the effective date of the ESBT election.]

d. If suspended losses occur prior to a QSST converting to an ESBT, the regulations indicate if those losses carryover to the ESBT. [This answer is incorrect. If the QSST has suspended losses before conversion to an ESBT, neither the code nor the regulations indicate whether those losses carryover to the ESBT.]

31. Which of the following statements most accurately describes the guidance for converting an ESBT to a QSST? **(Page 63)**

a. If suspended losses exist in an ESBT that is converting to an QSST, the code indicates whether those losses carryover to the QSST. [This answer is incorrect. If the EBST has suspended losses upon conversion to an QSST, neither the code nor the regulations indicate whether those losses carryover to the QSST.]

b. Once a ESBT is converted to an QSST, the entire trust interest in an S corporation must be terminated. [This answer is incorrect. The conversion of a ESBT to an QSST generally does not result in the trust terminating its entire interest in an S corporation under IRC Sec. 1377(a)(2). For purposes of the S corporation pass-through rules, the ESBT will be treated as terminating its interest in the S corporation and the QSST will be treated as a new shareholder.]

c. When converting an ESBT to a QSST under Reg. 1.1361-1(j), separate IRS permission is not required to revoke the election. [This answer is correct. Separate IRS permission to revoke the ESBT election is not required when converting a ESBT to an QSST under Reg. 1.1361-1(j).]

d. Once a ESBT election is made, it cannot be revoked. [This answer is incorrect. Once a ESBT election is made, it is revocable with the consent of the IRS according to IRC Sec. 1361(e)(3).]

32. In regards to pass-through income from other fiduciaries, which of the following should be reported on Form 8582, Worksheet 3? **(Page 72)**

a. Passive activity items passed through from another fiduciary. [This answer is correct. If the other fiduciary passes through passive activity items, these amounts must first be posted to Form 8582, Worksheet 3. These amounts will be combined with all passive activity items of the trust or estate.]

b. Pass-through dividend income. [This answer is incorrect. Dividends passed through are reported on the "Dividend income" line on page 1 of Form 1041.]

c. Interest income that is passed through on a Schedule K-1, Form 1041. [This answer is incorrect. Interest income passed through on a Schedule K-1 of Form 1041 is reported on the "Interest income" line on page 1 of Form 1041.]

d. Pass-through capital gains and losses. [This answer is incorrect. Pass-through capital gains and losses are reported on Schedule D.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T41TG101)

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

16. How should a partner's reduced share of partnership liabilities be treated?

    a. As accrued S corporation income.

    b. As a sale or exchange and be eligible for long-term capital gain treatment.

    c. A miscellaneous itemized deduction for purpose of the alternative minimum tax (AMT).

    d. An advance recorded on the last day of the tax year.

17. Who is responsible for determining the limitation on the amount of loss a partner can claim when a partnership passes a loss through to a fiduciary partner?

    a. The fiduciary partner.

    b. The partnership.

    c. The IRS.

    d. Do not select this answer choice.

18. Qualified nonrecourse financing is financing for which no one is personally liable for repayment and entails all of the following **except**:

    a. Borrowed in connection with holding real property.

    b. Loaned by the federal government.

    c. Secured in connection with holding real property.

    d. Borrowed from the seller of the property.

19. Which of the following is correct regarding income in respect of a decedent (IRD)?

    a. It is an asset reported on Form 1041 (if filing is required).

    b. It is partnership income earned through the date of death.

    c. It is subject to income and estate tax for decedents dying in a year other than 2010.

    d. It is a deduction allowed on the estate tax return, Form 706 (if filing is required).

20. Ted Johnson was a 40% partner in the accounting firm of Johnson and Associates. Johnson and Associates uses a calendar year. Ted died on July 4, 2010. Ted had received distributions of current year partnership earnings of $15,000 through the date of death. His share of 2010 partnership income as of that date was $30,000, and was $60,000 for the entire year. Ted's partnership interest was owned by his estate at December 31, 2010.

    Which of the following statements is correct regarding the example above?

    a. Ted is taxed on $15,000 of partnership income through his date of death.

    b. The $30,000 earned before Ted died is considered IRD.

    c. The $30,000 of income earned after death is reported by the estate.

    d. Do not select this answer choice.

21. April was a minority partner in Seasonal Partnership, a cash-method, calendar-year partnership. On May 1, 2010, April passed away. April's share of partnership income through date of death was $70,000; for the entire year, it was $120,000. April had withdrawn $62,000 prior to her death. In addition, the partners of Seasonal have signed separate buy-sell agreements among themselves. The agreements provide that in the case of the death of a partner, the other partners, in their individual capacities and not as partners of Seasonal, agree to buy the interest of the deceased partner. The purchase price of the interest is based upon a formula stated in the agreements.

    Which of the following statements is correct regarding the example above?

    a. None of the $120,000 is considered IRD.

    b. The sale of the interest to other partners will have a significant tax effect upon the partnership.

    c. April's final tax return will include $60,000 of income.

    d. Seasonal Partnership's year closes with respect to April's interest at the end of the calendar year.

22. When can a grantor trust that continues to own stock after the two-year specified period, become a permitted S corporation shareholder?

    a. When it continues to qualify as a testamentary trust, electing small business trust (ESBT), or a voting trust.

    b. When it continues to qualify as a voting trust, QSST, or a tax-exempt qualified trust under IRC Sec. 401(a).

    c. When it continues to qualify as a QSST, grantor trust, or an ESBT.

    d. When it continues to qualify as a tax-exempt qualified trust under IRC Sec. 401(a), grantor trust, or voting trust.

23. Ted Dillon is a shareholder in Crowley Corp., a successful manufacturing firm that has been an S corporation for several years. His mother, Lena, is an elderly widow who requires expensive nursing care. Ted has been providing this support for his mother, but his only tax benefit is an extra personal exemption. Ted is considering creating a trust to hold 25% of his Crowley stock in order to deflect a stream of income to support Lena. Upon Lena's eventual death, Ted would like to designate his minor child as successor income beneficiary, with the trust terminating and the stock being distributed to the child at age 25.

    Which of the following trusts would be preferable in this situation?

    a. ESBT.

    b. QSST.

    c. Testamentary.

    d. Grantor.

24. In the example in question 23, for the trust to be treated as an eligible shareholder, a special election must be made and then signed by whom?

    a. Lena.

    b. Ted.

    c. Ted's legal representative.

    d. A Crowley Corp. representative.

25. How is a trust treated regarding the S corporation shareholder limit if there is no potential current beneficiary?

    a. As a trustee.

    b. As a shareholder.

    c. As a distributee.

    d. As an agent.

26. Who is responsible for determining the stock or debt basis for S corporation stock owned by an estate?

    a. Grantor.

    b. Corporation.

    c. Income beneficiary.

    d. Executor.

27. When computing basis in stock, adjustments must be made to stock basis in a specific order. Choose the one that is in the correct order?

    a. Decreases for items of loss and deduction; decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions; decreases for nontaxable distributions received by the shareholder, and increases for income and gain items.

    b. Increases for income and gain items; decreases for nontaxable distributions received by the shareholder; decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions; and decreases for items of loss and deduction.

    c. Decreases for nontaxable distributions received by the shareholder; increases for income and gain items; decreases for items of loss and deduction; and decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions.

    d. Decreases for nondeductible, noncapital expenses and certain oil and gas depletion deductions; decreases for items of loss and deduction; increases for income and gain items; and decreases for nontaxable distributions received by the shareholder.

28. What happens when losses in an S corporation reduce a shareholder's stock basis to zero and the shareholder does not have any debt basis?

    a. The losses are reported on Form 8582.

    b. The losses are not currently deductible.

    c. The losses are reported on Schedule D.

    d. The losses are allowed only to the extent of capital gains.

29. Which of the following trusts is taxed differently from any other trust qualified to hold S corporation stock and is used for its ability to accrue income from the S corporation?

    a. Voting trust.

    b. ESBT.

    c. QSST.

    d. Grantor trust.

30. An income beneficiary is treated under IRC Sec. 678(a) in a QSST as the owner of the part of the trust that consists of S corporation stock. With respect to the S corporation stock, how will the trust be treated?

    a. Grantor trust.

    b. Testamentary trust.

    c. Voting trust.

    d. ESBT.

31. Which of the following statements is most accurate?

    a. The QSST accounting income generally is the amount of the taxable income reported on Form 1120S, Schedule K-1, to the QSST.

    b. S corporations are not required to make any cash distributions of its earnings.

    c. It is not necessary for all of the income of the trust to be distributed to qualify as a QSST.

    d. If no distribution from the S corporation is received, the accounting income will be distributed by the trust as long as there is taxable income from the S corporation that is taxable to the QSST beneficiary.

32. Where should a trust or estate report rental and royalty income and expense amounts?

    a. Form 1040, Schedule E.

    b. Form 1065, Schedule K-1.

    c. Form 1040, Schedule C.

    d. Form 1041, Schedule D.

Lesson 3: Passive Activity Loss Rules

INTRODUCTION

The passive activity loss (PAL) rules appear straightforward. A taxpayer cannot offset active trade or business income or portfolio income with a loss from a passive activity. A passive activity is (1) any rental activity (except those of certain real estate professionals) or (2) a business activity in which the taxpayer does not materially participate. Unused losses and credits from passive activities become suspended and carryforward indefinitely to offset future passive activity income or to be recognized upon a taxable disposition of 100% of the passive activity. Unfortunately, implementing the rules can be complicated. Form 8582 (Passive Activity Loss Limitations) is used to combine and net the various passive activities of a taxpayer and to determine the current deductible and the carryforward portion of passive activity losses.

Although the passive loss rules apply to estates and trusts under IRC Sec. 469(a)(2)(A), there is no authoritative guidance on how the PAL rules apply to fiduciaries. Reg. 1.469-8 has been reserved to cover the application of the PAL rules to trusts, estates, and their beneficiaries, but thus far, the IRS has not issued passive loss regulations relating to estates and trusts. Practitioners should be alert to developments in this area.

The guidance provided in this lesson is the generally accepted treatment of passive activity losses incurred by estates and trusts. The authors have based the conclusions reached in this chapter on tax return forms, IRS return instructions, Subchapter J of the Internal Revenue Code, and informal discussions with the Treasury Department. While the authors believe the positions taken in this chapter are reasonable, future IRS regulations may invalidate some of the conclusions presented herein.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the generally accepted treatment of passive activity losses incurred by estates and trusts, including loss limitations determined at the entity level and reporting to a beneficiary.

Overview of Passive Activity Loss Rules

The passive activity loss (PAL) rules were enacted to prevent taxpayers, including estates and trusts, from sheltering compensation, business, and investment income with losses from tax shelters. To accomplish this, Congress created three classes of income: nonpassive trade or business income, portfolio (investment) income, and passive activity income. A taxpayer's income and losses from various activities are segregated into these three classes. A net loss from passive activities cannot be used to offset nonpassive income or portfolio income. Additionally, tax credits from passive activities can only be used to offset the tax liability attributable to income from passive activities. Disallowed passive losses are suspended until they can be used to offset passive income. Any remaining suspended losses generally will be deductible when the entire interest in the passive activity is disposed of in a taxable transaction. See later in this lesson for information regarding unused passive losses upon the distribution of a passive activity to a beneficiary.

Although the PAL rules were primarily targeted to prevent tax shelter abuses, the result of this effort reaches far beyond the true tax shelter and taxpayers may have nondeductible losses even when no tax shelter activity is involved. Generally, a passive "activity" involves the conduct of a trade or business in which the taxpayer does not "materially participate." A rental activity is generally considered a passive activity. Likewise, crop share income is passive. Crop share income results from rental arrangements where landowners agree to be paid in crop shares or livestock for the use of their land.

Taxpayers materially participating in rental real estate activities may escape application of the passive loss rules if certain requirements are met.

If a decedent has unused PALs at the time of death, the losses cannot pass through to the decedent's estate or trust. However, such losses may be deductible on the decedent's final Form 1040. Passive activity losses that would

otherwise be suspended if this were not the decedent's final return are deductible to the extent they exceed the modified carryover basis under IRC Sec. 1022 (for decedents dying in 2010) basis step-up under IRC Sec. 1014 (for decedents dying before 2010). Any remaining PALs expire unused at the date of death.

Definition of "Activity"

The definition of an activity has great importance because an "activity" is the unit of measure for several important determinations under the passive loss rules. The taxpayer's material participation in a business is determined at the "activity" level. Also, suspended losses may be deducted when the taxpayer's entire interest in the passive "activity" is disposed of in a fully taxable transaction.

One or more activities are treated as a single activity if the activities are an appropriate economic unit for the measurement of gain or loss. A "facts and circumstances" test (see the following paragraph) is provided by the IRS to determine if activities are an appropriate economic unit for measuring gain or loss.

"Facts and Circumstances" Test

Under the regulations, a facts and circumstances test is used to determine which activities are an appropriate economic unit for the measurement of gain or loss upon disposition of the activity in a fully taxable transaction. Any reasonable method may be used to apply the relevant facts and circumstances. The factors listed below (not all of which need to be present to treat multiple activities as a single activity) are given the greatest weight in making this determination:

1. Similarities and differences in types of business.

2. The extent of common control and ownership.

3. Geographical location.

4. The degree of interdependence between the activities.

An important consequence of the facts and circumstances test is that apparently it is no longer necessary to file a formal election statement to combine or fragment rental real estate undertakings that would otherwise be aggregated into a single activity (under prior regulations).

Typically, the fiduciary will want to segregate rental real estate undertakings into as many separate activities as possible. This allows the trust or estate to deduct suspended passive losses relating to an activity upon its disposition in a fully taxable transaction. See later in this lesson for information regarding unused passive losses upon the distribution of a passive activity to a beneficiary.

Rental Activities

A rental activity may not be grouped with a trade or business activity unless either activity is insubstantial in relation to the other. Unfortunately, no definition of "insubstantial" is provided in the regulation. However, the regulation clarifies that rental activities involving real estate may not be grouped with activities involving the rental of personal property (except to the extent personal property is provided in connection with the real property, such as in a furnished apartment).

Tax Shelter Activities

An anti-abuse rule is provided to prevent the inappropriate grouping of traditional tax-shelter activities with other activities in the same type of business. A taxpayer who is a limited partner or a limited entrepreneur in such an activity may only group that activity with:

1. another activity in the same type of business if the taxpayer is a limited partner or limited entrepreneur in the activity, or

2. another activity in which the taxpayer is not a limited partner or limited entrepreneur if the activity is in the same type of business and the grouping is appropriate under the facts and circumstances.

A limited entrepreneur includes a person who does not actively participate in the management of the enterprise. Determining whether a person actively participates depends on the facts and circumstances.

Consistency Requirements

Once a taxpayer has grouped activities under the regulations, they may not be regrouped unless the original grouping was clearly inappropriate or there has been a material change in facts and circumstances making the original grouping clearly inappropriate. If the activities must be regrouped, the taxpayer must comply with the disclosure requirements to be determined by the Commissioner. As an anti-abuse measure, the IRS may regroup the activities of a taxpayer who attempts to circumvent the passive activity limitations.

For tax years beginning on or after January 25, 2010, taxpayers must report certain changes in groupings of activities. Taxpayers must file a statement with their annual tax returns for any tax year there is (1) a new grouping of activities, (2) an addition of new activities to existing groupings, or (3) regroupings resulting from an inappropriate grouping or a material change in facts or circumstances. Generally, a taxpayer engaged in two or more passive activities who fails to report whether the activities have been grouped as a single activity in accordance with these new rules must treat each activity as a separate activity for the PAL rules. However, a taxpayer who fails to report a grouping or regrouping in the first required tax year will be deemed to have properly reported if all returns are filed consistently with such groupings and the required disclosure is made on the return for the year in which the failure is first discovered by the taxpayer. Exceptions from the new reporting rules include (1) pre-existing groupings (i.e., those made in tax years beginning before January 25, 2010) and (2) rental real estate activities of qualified real estate professionals under the PAL rules.

Material Participation Determination

The classification of a trade or business activity as either active or passive is based on whether the taxpayer "materially participates" in the activity. A taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. Although this sounds simple, a question arises as to whose activities are tested for material participation in the case of an estate or nongrantor trust—the settlor, the decedent, the fiduciary, or the beneficiaries. Unfortunately, there is no authoritative guidance from the IRS to answer this question. However, the Senate Finance Committee report for the Tax Reform Act of 1986 stated that an estate or trust materially participates if its fiduciary, acting in a fiduciary capacity, materially participates.

In a ruling involving a testamentary trust, the IRS indicated that it looks only to the activities of the trustee when determining whether the trust has materially participated in a business activity. In this case, a testamentary trust held an interest in an LLC (treated as a partnership for Federal tax purposes) that operated a business. The trustees provided services to the LLC encompassing various administrative and operational activities relating to the business, including direct participation in operations, oversight of bond financings and borrowing activities, and approval of operating budgets. To satisfy the material participation standard, the trustees appointed "special trustees" to carry out the administrative and operational activities of the trust's interest in the partnership. However, these "special trustees" were not authorized to legally bind or commit the trust to any transaction or activity without approval; all decision-making responsibilities were retained by the "regular" trustees.

The passive loss rules do not apply to grantor trusts; instead, the rules apply at the grantor level. For a qualified Subchapter S trust (QSST), participation is measured by the participation of the deemed owner of the trust. Under the QSST rules, the beneficiary of a QSST is deemed to be the owner of the trust. There is no guidance on how to measure participation in electing small business trusts (ESBTs), which were not qualified S corporation shareholders when TRA '86 was enacted.

Seven Material Participation Tests

There are seven separate tests for determining material participation, which is determined separately for each tax year. The first four tests are quantitative and based on a fiduciary's hours of participation during the tax year. The

next two tests are based on the fiduciary's participation in prior tax years. If the fiduciary has withdrawn earnings or retired from a business, these two tests prevent the conversion of otherwise nonpassive income to passive income simply because of the present inactivity in the business. The final test is a facts and circumstances test based on the statutory definition of material participation. Although these regulations apply to individuals, this course substitutes the word "fiduciary" for "individual" in the tests enumerated below, since there are no regulations applying material participation to fiduciaries.

A fiduciary materially participates in an activity if any one of the following seven tests is satisfied:

Quantitative Tests

1. The fiduciary participates in the activity for more than 500 hours during the current year.

2. The fiduciary's participation is substantially all of the participation in the activity of all individuals (including nonowners) for the current year.

3. The fiduciary's participation in the activity exceeds 100 hours for the current year and is not less than the participation in the activity of any other individual (including nonowners).

4. The activity is a significant participation passive activity (SPPA) for the tax year, and the fiduciary's aggregate participation in all SPPAs during the year exceeds 500 hours. An SPPA is one in which the fiduciary has more than 100 hours of participation during the tax year but fails to satisfy any other test for material participation.

Prior Year Tests

5. The fiduciary materially participated in the activity for any five tax years (whether or not consecutive) of the 10 tax years immediately preceding the current tax year.

6. The activity is a personal service activity, and the fiduciary materially participated in the activity for any three tax years preceding the current year. A personal service activity is one involving the performance of personal services in the fields of health (including veterinarians), law, engineering, accounting, architecture, actuarial science, performing arts, consulting, or any other trade or business for which capital is not a material income-producing factor.

Statutory Test

7. Based on facts and circumstances, the fiduciary participates in the activity on a regular, continuous, and substantial basis during the current year but does not meet any of the other six tests. A fiduciary must participate in an activity for more than 100 hours during the tax year. The temporary regulations limit the use of this test by requiring that: no person, other than the fiduciary, may be compensated for management services; *and* no other individual may provide more hours of management service than the fiduciary.

Because there are no specific recordkeeping requirements provided in connection with the quantitative tests, fiduciaries have some flexibility in documenting their hours of participation through any reasonable means, including appointment books, calendars, and narrative summaries.

Passive Loss Limitations Generally Determined at the Entity Level

Generally, all PAL limitations are determined at the trust or estate level. However, the passive loss rules do not apply to grantor trusts, but rather to the grantor level. See later in this lesson for a discussion of what happens when depreciation causes a net passive loss.

Example 3D-1 PAL charged to income in a simple trust.

The XYZ Trust is a simple trust, requiring all fiduciary accounting income to be distributed to the sole beneficiary, Tom Jones. The trust earns $30,000 of qualified dividends and incurs a $20,000 passive activity loss for 2010. None of the PAL is attributable to depreciation. Under the terms of the trust instrument, the PAL is chargeable to income.

Fiduciary accounting income for 2010 is $10,000 ($30,000 − $20,000). Distributable net income (DNI) is $30,000. The distribution deduction is the lesser of fiduciary accounting income or DNI. Thus, the distribution deduction is $10,000.

This results in the trust having taxable income of $19,700 [$30,000 dividend income less $10,000 distribution deduction and the $300 exemption]. Thus, the simple trust has taxable income due to the nondeductible PAL, despite the fact all income was required to be distributed. Since the $20,000 PAL cannot offset the dividend income for tax purposes, the PAL will be suspended and carried forward until the trust generates passive income. The PAL can then be used to the extent of passive income.

The trust must complete Schedule I, Alternative Minimum Tax (Form 1041) since it has a distribution deduction. No AMT adjustments appear on Schedule I for the trust or Schedule K-1 for the beneficiary since the only item of income recognized on page 1 of Form 1041 is dividend income, and no PAL could be used to offset the income.

Form 8582 (Passive Activity Loss Limitations) must be completed by the trust and attached to Form 1041.

Example 3D-2 PAL charged to principal in a simple trust.

Assume the same facts as Example 3D-1, except the PAL is charged to principal according to the trust instrument.

With the PAL charged to principal, the fiduciary accounting income for 2010 is the amount of the dividends ($30,000). This is also the amount of DNI. Thus, the distribution deduction is $30,000, resulting in no taxable income for the trust. Since the $20,000 PAL cannot offset the dividend income, the PAL will be suspended and carried forward until the trust generates passive income. At that time the PAL can be used to the extent of any passive income generated.

The trust must complete Schedule I (Form 1041) since it is claiming a distribution deduction. No AMT adjustments appear on Schedule I for the trust or Schedule K-1 for the beneficiary as the only item of income recognized on page 1 of Form 1041 is dividend income, and no PAL could be used to offset the income.

Form 8582 must be completed by the trust and attached to Form 1041.

If the governing instrument is silent with regard to whether a loss is allocable to income or principal, state law controls. Most states have adopted a version of the original or Revised Uniform Principal and Income Acts to determine whether certain receipts and disbursements are income or principal items.

Example 3D-3 PAL in a complex trust with no distributions.

The HS Trust is a complex trust. The trust instrument has no provisions for depreciation reserves. The instrument charges rental losses to income. The HS Trust had the following activity during 2010:

Qualified dividends	$ 25,000
Rental income	10,000
Rental interest expense	(15,000)
Fiduciary accounting income	$ 20,000
Distributions	$ —
Book and tax depreciation expense (no reserve)	(18,000)

Since there are no distributions, all income is taxed to the trust and the PAL is determined at the trust level, resulting in—

Taxable income (before personal exemption)	$ 25,000
Suspended PAL ($10,000 − $15,000 − $18,000)	(23,000)

Example 3D-4 PAL in a complex trust with distributions equal to fiduciary accounting income.

The HS Trust is a complex trust, but it distributed all fiduciary accounting income in 2010. The trust instrument has no provision for depreciation reserves. The instrument charges rental losses to income. The HS trust had the following activity during 2010:

Qualified dividends	$ 25,000
Rental income	10,000
Rental interest expense	(15,000)
Fiduciary accounting income	$ 20,000
Distributions	$ 20,000
Book and tax depreciation expense (no reserve)	(18,000)

Since all fiduciary accounting income is distributed, depreciation is allocated to the beneficiary, resulting in—

Fiduciary (Form 1041)

Qualified dividends	$ 25,000
Distribution deduction	(20,000)
Taxable income (before exemption)	$ 5,000
Suspended PAL ($10,000 − $15,000)	$ (5,000)

Beneficiary (Schedule K-1)

Qualified dividends	$ 20,000
Depreciation expense (passive)	18,000

Example 3D-5 PALs and passive activity gains in the same year.

The SP Trust is a simple trust. Capital gains and losses are allocated to principal by the trust instrument, as are rental losses. The trustee does not maintain a depreciation reserve. Administration expenses are charged to trust income. Depreciation expense is the same for tax as it is for trust accounting purposes.

The trust had the following activity during 2010:

Taxable interest income	$ 20,000
Rental loss (before depreciation expense)	(600)
Depreciation expense on rental property	(3,500)
Installment gain on prior sale of a passive activity	2,000
Long-term capital loss from stock sales	(6,000)
Administration expenses	(2,000)

Distributable net income (DNI) is calculated as—

Interest	$ 20,000
Administration expense	(2,000)
Rental loss	(600)
DNI	$ 17,400

The trust's 2010 fiduciary accounting income (FAI) is $18,000 ($20,000 − $2,000) since the trust agreement allocates the rental loss of $600 to principal. Thus, the beneficiary was allocated $17,400 of DNI, yet received cash distributions for 2010 of $18,000.

Since interest is the only income component of DNI, the beneficiary's Schedule K-1 reports net interest income of $17,400 (equal to DNI). Because this is a simple trust and there is no depreciation reserve, the $3,500 of depreciation expense is reported directly on Schedule K-1.

Since the installment gain recognized in 2010 arose from the sale of another rental property, the $2,000 is passive income. The existence of at least $600 of income from a passive activity is the reason the trust can deduct the 2010 passive loss of $600 (before depreciation expense) from the remaining rental property.

The trust cannot utilize any of its net $4,000 long-term capital loss ($6,000 − $2,000) and, therefore, has a long-term capital loss carryforward to 2011.

If a trust or an estate disposes of 100% of its interest in an activity with suspended losses greater than the gain on disposition in a year in which there is income and loss from other ongoing, passive activities, the current year income and loss from the retained passive activities are netted. Any net passive income from the retained activities is then reduced by the suspended losses. Any suspended losses remaining are treated as nonpassive losses and deducted from the fiduciary's nonpassive income.

Example 3D-6 Passive activity netting rules for dispositions.

The Mira Stevenson Trust is a complex trust with interests in several passive activities. The discretionary income beneficiary received no income distributions for 2010. The trust disposed of 100% of its passive rental real estate activity for a $30,000 gain on January 2, 2010. The net suspended passive losses from the rental real estate activity carried over from 2009 is $90,000. Two other passive activities of the trust produced passive income of $40,000 and passive loss of $30,000 respectively for 2010.

The $40,000 in passive income and the $30,000 of passive loss from the two retained activities are first netted producing $10,000 of passive income. The $90,000 in suspended passive losses from the rental real estate activity are netted against the $30,000 gain, leaving $60,000 in losses. The $10,000 in net passive income from ongoing activities is netted against the $60,000 in losses leaving $50,000 in losses. The $50,000 is no longer a suspended loss since 100% of the trust interest in the rental real estate activity was disposed of in a 2010 taxable transaction, so the $50,000 is available on the Form 1041 for 2010 to offset up to $50,000 of the trust's nonpassive income.

The letter ruling clarifies that suspended losses from the disposition of an activity (net of any gain on disposition of the activity) should not offset current year gross income from activities with passive income without first reducing the gross passive income amount by any gross passive losses from other current year activities. If current year gross passive income from ongoing activities exceeds current year gross passive losses from other ongoing activities, the ruling ensures that the current passive loss amount from ongoing activities is not suspended and therefore can produce a current tax benefit.

Reporting Passive Activity Information to a Beneficiary

A situation may arise when a trust or estate generates passive income along with depreciation deductions associated with the passive activity. This becomes more complicated when the trust or estate distributes the passive income to a beneficiary and the governing instrument does not provide for a depreciation reserve, instead requiring depreciation to be distributed to the beneficiary who receives all the income. Part of the complexity of this scenario is due to the lack of existing authoritative guidance as to how the trust or estate is to report such items in conjunction with the passive activity rules.

Activities with Net Passive Income

When passive income net of tax depreciation results in net passive income, there is no PAL limitation to consider at either the trust or beneficiary level. If the income is distributed to the beneficiary, and the depreciation is also required to be distributed to the beneficiary, such distributions are reported on the beneficiary's Schedule K-1. The beneficiary in turn reports the net passive income on Schedule E of Form 1040.

Example 3E-1 Reporting net passive income to a beneficiary.

The ABC Trust is a simple trust, requiring all fiduciary accounting income to be distributed to the sole beneficiary, Sandra Smith. In 2010, the trust earns $10,000 of qualified dividend income and $15,000 of net

rental income (before depreciation expense). Depreciation expense is $10,000. The trust is not required to maintain a depreciation reserve. Fiduciary accounting income is $25,000. Since all income is required to be distributed, the trust has no taxable income.

The rental income and the depreciation expense are reported separately to the beneficiary in the passive income portion of Schedule K-1. Unless Sandra has other passive activity losses, she will not need to complete Form 8582 since she does not have a passive loss from the rental activity of the trust. Instead, Sandra will report the rental income and depreciation expense directly on Schedule E of Form 1040 as follows:

Rental income from Schedule K-1, ABC Trust	$ 15,000
Less depreciation from Schedule K-1, ABC Trust	(10,000)
Schedule E net income	$ 5,000

Activities in Which Depreciation Creates a Loss

When net passive income less depreciation results in a net passive loss, there is a PAL limitation at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level.

If the PAL limitation is determined at the beneficiary level, the beneficiary must complete Form 8582 and attach it to Form 1040. If the PAL limitation is determined at the trust level, the trust must complete Form 8582 and attach it to Form 1041.

$25,000 Rental Real Estate Exemption

Individual taxpayers who actively participate in a rental real estate activity may deduct up to $25,000 of passive losses attributable to the activity against nonpassive income. This $25,000 rental real estate exemption for active participation is allowed by estates, but not trusts.

Estates. The rental real estate exemption is allowed to estates (and trusts electing to be treated as part of the decedent's estate) for tax years ending less than two years after the decedent's death for rental real estate activities in which the decedent actively participated. Any excess losses are suspended for the year and carried forward.

If the decedent was married, the $25,000 exemption must be shared with the surviving spouse, (i.e., the maximum amount must be reduced by the losses allowed to the spouse in his or her tax year ending with or within the estate fiscal year).

Trusts. The rental real estate exemption for active participation is not allowed to trusts. Furthermore, the exemption does not flow through to a trust beneficiary to enable him or her (who may otherwise actively participate in the activity) to enjoy the benefit of the exemption (e.g., depreciation allocated directly to the beneficiary creates a passive activity loss—see Example 3E-2).

Example 3E-2 Reporting net passive loss from a rental real estate activity to a beneficiary when the trust does not maintain depreciation reserves.

Assume the same facts as in Example 3E-1, except that depreciation expense is $17,000. Since all income is required to be distributed to the beneficiary, the trust has no taxable income.

The rental income and the depreciation are reported separately to the beneficiary in the passive income portion of Schedule K-1. Since depreciation expense is allocated directly to the beneficiary, there is no PAL at the trust level; thus, Form 8582 is not completed by the trust. Instead, the PAL limitation is determined at the beneficiary level. The beneficiary, Sandra, completes Form 8582 and attaches it to her Form 1040. Form 8582 shows the nondeductible PAL of $2,000 ($15,000 rental income less $17,000 depreciation expense). The $2,000 is suspended and carried over by Sandra (assuming that this is her only passive activity for the year).

Example 3E-3 Reporting net passive loss from a rental real estate activity to a beneficiary when the trust maintains depreciation reserves.

Assume the same facts as Example 3E-2, except depreciation reserves are maintained by the trust. Under the terms of the trust instrument, losses from trade or business activities are chargeable to income.

Since the PAL is chargeable to income, the distribution deduction will not completely offset the trust's taxable income. This is because fiduciary accounting income is $8,000 ($10,000 dividend income plus $15,000 rental income less $17,000 depreciation expense). Thus, the trust has taxable income of $1,700.

Since depreciation expense is claimed at the trust level, there is a PAL at the trust level. Form 8582 is completed by the trust. Form 8582 shows the nondeductible PAL of $2,000 ($15,000 rental income less $17,000 depreciation expense). The $2,000 is suspended and carried over by the trust. Since the trust cannot use the $25,000 rental real estate exemption, Part II of Form 8582 is not completed.

The dividend income of $8,000 is reported separately to the beneficiary on Schedule K-1.

Passive Activities Owned via Other Flow-through Entities.

Partnerships and S corporations typically report income or loss from passive activities on a "single line item" basis to their partners and shareholders. That is, the partnership or S corporation will provide a statement attached to Schedule K-1 identifying each activity (e.g., trade or business, rental real estate, rental activity other than rental real estate) and specifying the income (loss) and credits from each activity. The sum of these income (loss) items for each given activity will then tie to the corresponding "single line item" on the Schedule K-1. This approach means that the partner or shareholder does not generally receive detailed information such as separately stated items of gross income and deductions generated by each activity.

Since an estate or trust owning passive activities via flow-through entities does not generally receive information regarding the underlying deductions, specifically depreciation expense, any PAL received from such an entity will typically be limited at the trust or estate level. This is because the depreciation generated at the flow-through entity level and flowing through to the trust or estate cannot be allocated to the beneficiary of the trust or estate (assuming no depreciation reserve is required) because the flow-through entity did not provide the specific amount of the depreciation expense to the trust or estate.

Example 3F-1 PAL limitation at trust level for PAL received from a partnership.

The Stan Phillips Trust is a limited partner in the ABC Partnership. It is a simple trust and is not required to, nor does it, maintain a reserve for depreciation. Bart Phillips is the sole beneficiary of the trust. The trust's Schedule K-1 for 2010 from ABC shows a $10,000 net loss from rental real estate activities. The $10,000 PAL from ABC is limited at the trust level because the partnership did not provide the trust with the amount of depreciation included in the PAL.

Interest income and expense incurred on a loan between a trust or an estate and a partnership or an S corporation are passive activity income and deductions (Reg. 1.469-7). This rule applies to ownership interests that are direct or indirect and there is no minimum ownership requirement. Furthermore, the self-charged interest items must be recognized by the trust or estate and the flow-through entity in the same taxable year.

Passive Activity Losses Unused upon Termination.

Losses are not generally passed through to the beneficiary of an estate or trust except on termination. Even then, the only losses specifically passed through to the beneficiary are NOLs, capital losses, and excess deductions on termination. Thus, passive activity losses (PALs) are not passed through to the beneficiary during the existence or termination of the trust or estate. However, see later in this lesson for coverage of the effects of a Section 643(e)(3) election to recognize gain (or loss in certain situations for estates) on a distribution of an interest in a passive activity, a distribution of a passive activity in satisfaction of a pecuniary (fixed-dollar) bequest, and the Section 469(j)(12) basis adjustment to a distributed passive activity interest that has suspended passive losses.

Disposition of an Interest in a Passive Activity.

General Rules

If an estate or trust distributes its entire interest in a passive activity to a beneficiary, the basis of the interest immediately before the distribution is increased by the amount of any suspended passive activity losses allocable to the interest. None of the suspended losses are allowed as a deduction.

Gain or loss to the estate or trust and the beneficiary's basis in the property after the transaction are calculated according to the usual rules for distributions of property by fiduciaries. Generally, these rules cause no gain or loss to be recognized when property is distributed by trusts or estates, and the entity's basis in the property carries over to the distributee.

Disposition of a Passive Activity in a Fully Taxable Transaction

The general rules of IRC Sec. 469(j)(12) apply to the most common forms of dispositions of interests in passive activities from estates and trusts, such as the distribution of the residual assets of an estate to the remainder beneficiaries. In such cases, the bases of the interests are increased by any suspended losses, and the losses are not allowed as deductions. However, gain (or loss in certain situations for estates) may be recognized on the distribution. For example, satisfaction of a pecuniary (fixed-dollar) bequest with appreciated or depreciated property causes an estate to recognize gain or loss. Other property distributions (i.e., not pecuniary bequests) in conjunction with a Section 643(e)(3) election cause gain, but not loss, recognition by the distributing estate. Losses by a trust are not recognized on these transactions because of related party loss limitation rules.

When a trust or estate disposes of an entire interest in a passive activity to an unrelated party in a fully taxable transaction, both current and suspended losses generated by that activity (as well as any loss on the disposition) become fully deductible. This occurs under a favorable assumption included in IRC Sec. 469(g)(1) whereby a fully taxable disposition causes an overall loss to be treated as nonpassive, while an overall gain remains passive and can offset losses from other passive activities. Related parties for this purpose are defined under IRC Secs. 267(b) and 707(b)(1). Under these provisions, both a trust and its beneficiaries and an estate and its beneficiaries are generally considered related parties.

The related party rules do not disallow loss recognition for estates making sales or exchanges in satisfaction of a pecuniary bequest. Thus, when an estate makes a distribution of an appreciated or depreciated passive activity to fund a pecuniary bequest, the distribution is a fully taxable transaction and any loss is recognized. Such a fully taxable transaction allows the current and suspended passive activity losses to be treated as nonpassive, which are deductible by the estate. Distributions of passive activities from trusts would not be eligible for this treatment since trusts and their beneficiaries are always related parties under IRC Sec. 267(b).

The availability of a suspended loss may create an NOL that can be carried back by the entity. Also, an NOL existing at the termination of the entity can pass through to the beneficiaries.

Example 3H-1 Distribution of a passive activity by fiduciary upon termination.

The Joe Barnes Estate distributed its residual assets to the sole remainder beneficiary in December 2010 and terminated. One of the assets is a rental property with a tax basis of $75,000, suspended passive activity losses of $10,000, and a FMV of $100,000. The estate owned no other passive assets. No Section 643(e)(3) election is desired and the distribution of the rental property is not in satisfaction of a pecuniary bequest.

The rental property will have a basis in the hands of the beneficiary of $85,000 ($75,000 + $10,000), and the estate will recognize no gain or loss on the distribution. The suspended loss becomes an addition to basis.

Variation: If a terminating trust, rather than a terminating estate, made the distribution, the outcome would be the same.

Example 3H-2 Distribution of a passive activity to satisfy a pecuniary bequest.

Assume the same facts as in Example 3H-1, except the distribution of the rental property is in satisfaction of a $100,000 pecuniary bequest. In this situation, Reg. 1.1014-4(a)(3) requires a $25,000 gain (excess of the

FMV over the estate's basis in property) to be recognized by the estate. Since gain is recognized, IRC Sec. 469(g)(1) should apply and the estate can deduct the $10,000 suspended passive activity loss. In this situation, Form 8582 is bypassed, the gain is reported on Schedule D (Form 1041), and the suspended passive loss is reported by the estate on Schedule E (Form 1040).

Disposition of Passive Activity by Death

If a decedent has unused PALs at the time of death, the transfer of property due to death is considered a disposition subject to IRC Sec. 469(g)(1), which allows suspended PALs to reduce nonpassive income on the decedent's final return. To the extent, however, that an interest in an activity is subject to a step-up in basis on the decedent's date of death, the suspended PAL is reduced and never used. Any remaining PALs that would otherwise be suspended if this were not the decedent's final tax return are deductible on that tax return to the extent the unused losses from a particular passive activity are greater than the excess of—

1. the basis of the passive activity interest in the hands of the transferee, over

2. the decedent's adjusted basis in the interest immediately before death.

For decedents dying in 2010, the suspended passive losses are deductible to the extent they exceed the basis increases, if any, that is elected under IRC Sec. 1022. Similarly, for decedents dying in a year other than 2010, the suspended passive losses are deductible to the extent they exceed the date-of-death basis step-up under IRC Sec. 1014. Any remaining PALs expire unused at the date of death.

Example 3H-3 Passive activity loss of decedent.

In 2010, when Jerry Smith died, he had an interest in a passive activity that had a suspended passive activity loss of $90,000. Jerry's basis in the activity (prior to death) was $100,000. The activity's FMV at Jerry's death was $150,000. Jerry's executor elected to increase the basis of the interest by $50,000 (limited to the FMV of the property). As a result, $40,000 [$90,000 − ($150,000 − $100,000)] of passive activity losses may be deducted on Jerry's final individual income tax return. The remaining suspended PAL of $50,000 ($90,000 − $40,000) is not deducted on Jerry's final Form 1040 and does not carry forward. The estate has a $150,000 basis in the passive activity.

Variation: Assume the same facts as above, except that the executor of Jerry's estate did not elect to increase the basis of the interest in the passive activity. In that case, the amount deductible on Jerry's final individual income tax return is the full $90,000 suspended PAL, assuming there is sufficient income with which to offset the PAL. The estate's basis in the passive activity is the decedent's carryover basis of $100,000.

IRC Sec. 469(g)(2) also applies if the decedent was the income beneficiary of a qualified subchapter S trust (QSST) that held the passive activity (FSA 200106018). Furthermore, a beneficiary of a QSST is allowed to deduct the QSST's share of S corporation losses that were suspended under the at-risk rules or passive loss rules when the QSST disposes of the related S corporation stock.

Oil and Gas Working Interest Exception.

Oil and gas working interests are not passive activities, regardless of whether the taxpayer materially participates, if the interest is held either directly or through an entity that does not limit the liability of the "taxpayer" with respect to the well. The owner must not hold the investment through an entity such as a corporation, limited partnership, or any other entity which under state law would limit the owner's liability. The status is determined on a well-by-well basis.

A trust's liability is generally limited to the trust principal under state law. This includes trusts treated as grantor trusts for federal income tax purposes. It is the authors' opinion that for grantor trusts, the "taxpayer" is the grantor, and therefore the working interest exception probably will not be available through a grantor trust. The working interest income will likely be characterized as passive income or loss, or the IRS might recharacterize the income as portfolio income.

Since nongrantor type trusts are the "taxpayer," the working interest exception should apply at the trust level unless the activity is held through another entity in which its liability is limited. Therefore, nonpassive status would exist at the trust level for income retained and taxed to the trust. If the nonpassive income of the trust is distributed to the beneficiary, the character of such income as nonpassive should carry to the beneficiary.

Example 3I-1 Complex trust holding oil and gas working interest.

Trust A, a complex trust, holds the title to several oil and gas working interests. The working interest exception should apply since the interests are held outright. If the properties were held through a limited partnership, the activity will likely be passive.

SELF-STUDY QUIZ

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

33. Which of the following statements regarding rental activity is accurate?

    a. A rental activity may always be grouped with a trade or business activity.

    b. A rental activity may be grouped with a trade or business activity under certain circumstances.

    c. A rental activity may never be grouped with activities involving the rental of personal property.

    d. A rental activity may always be grouped with activities involving the rental of personal property.

34. Bill is a fiduciary in the current tax year of 2011. In which of the following scenarios is Bill deemed to materially participate in the activity (not a personal service activity) according to the prior year test?

    a. Bill materially participated in the activity in tax years 2000 through 2004.

    b. Bill materially participated in the activity in tax years 2000, 2004, and 2008.

    c. Bill materially participated in the activity in tax years 2006 through 2009.

    d. Bill materially participated in the activity in tax years 2002, 2003, 2004, 2006, and 2009.

35. A fiduciary that does not meet any of the quantitative or prior-year tests, materially participates in an activity if the statutory test requirements are satisfied. Which of the following accurately represents an aspect of the statutory test requirements?

    a. The fiduciary participated in the activity on a regular and substantial basis during the current year.

    b. The fiduciary must participate in the activity for more than 200 hours during the tax year.

    c. In addition to the fiduciary, other persons were also compensated for management services.

    d. Another individual provided more hours of management service than the fiduciary.

36. Jane Swift is the sole beneficiary of a simple trust and will receive all fiduciary accounting income. In 2010, the trust earns $52,000 of qualified dividends and incurs a $28,000 passive activity loss (PAL), none of which is attributable to depreciation and the PAL is chargeable to *principal* under the terms of the trust instrument. Based on the information provided, and the $300 standard exemption (Form 1041, Line 20), what is the trusts' taxable income?

    a. ($300).

    b. $24,000.

    c. $28,000.

    d. $51,700.

37. Brighton Trust is a simple trust with rental losses as well as capital gains and losses allocated to principal by the trust instrument. No depreciation reserve is maintained by the trustee and administration expenses are charged to trust income. Further, depreciation expense is the same for both tax and trust accounting purposes. Brighton Trust had taxable income during 2010 of $10,000, rental loss before depreciation expense of ($1,000), depreciation expense on rental property of ($5,000), installment gain on prior sale of a passive activity of $3,000, long-term capital loss from stock sales of ($10,000), and administration expenses of ($4,000). Based on this activity, what is Brighton Trusts' distributable net income (DNI)?

    a. $0.

    b. $5,000.

    c. $6,000.

    d. $20,000.

38. Which of the following statements is accurate regarding activities with net passive income?

    a. If passive income less tax depreciation results in net passive income, a PAL limitation may still exist at the trust level.

    b. If passive income less tax depreciation results in net passive income, there is no PAL limitation at the beneficiary level.

    c. If the income and the depreciation are required to be distributed to the beneficiary, distributions are reported on the beneficiary's Form 1099-DIV.

    d. If the income and the depreciation are required to be distributed to the beneficiary, the beneficiary reports net passive income from distributions on Schedule F of Form 1040.

39. The Bolen Trust is a simple trust. In 2010, the trust earns $25,000 of net rental income prior to depreciation expense and $12,500 of qualified dividend income. Depreciation expense is $8,500 and a depreciation reserve is not required to be maintained by the trust. Fiduciary accounting income is $37,500. How much income is taxable to the trust?

    a. $0.

    b. $12,500.

    c. $25,000.

    d. $37,500.

40. The title to five oil and gas working interests is held by Braden, a complex trust. Which of the following statements is accurate?

    a. The activity is likely to be passive.

    b. The working interest exception should apply.

SELF-STUDY ANSWERS

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

33. Which of the following statements regarding rental activity is accurate? **(Page 86)**

    a. A rental activity may always be grouped with a trade or business activity. [This answer is incorrect. Per Reg. 1.469-4(d), may not be grouped with a trade or business unless certain requirements are met.]

    b. A rental activity may be grouped with a trade or business activity under certain circumstances. [This answer is correct. A rental activity may only be grouped with a trade or business activity when either activity is insubstantial in relation to the other as cited in Reg. 1.469-4(d).]

    c. A rental activity may never be grouped with activities involving the rental of personal property. [This answer is incorrect. Reg. 1.469-4(d) stipulates that a rental activity may be grouped with activities involving the rental of personal property when the personal property is provided in connection with the real property.]

    d. A rental activity may always be grouped with activities involving the rental of personal property. [This answer is incorrect. There are only certain circumstances when a rental activity may be grouped with activities involving the rental of personal property per Reg. 1-469-4(d), such as when personal property is provided with real property such as a furnished apartment.]

34. Bill is a fiduciary in the current tax year of 2011. In which of the following scenarios is Bill deemed to materially participate in the activity (not a personal service activity) according to the prior year test? **(Page 87)**

    a. Bill materially participated in the activity in tax years 2000 through 2004. [This answer is incorrect. In order for Bill to be deemed to materially participate in the activity, one test indicates that he must materially participate in the activity for a specified number of tax years out of the 10 tax years preceding the current tax year of 2011. Tax year 2000 is more than 10 tax years preceding the current tax year of 2011; therefore, Bill does not meet the material participation test.]

    b. Bill materially participated in the activity in tax years 2000, 2004, and 2008. [This answer is incorrect. Bill would be deemed to materially participate in the activity if he materially participated in the activity for five of the 10 tax years immediately preceding the current tax year of 2011; thus, since Bill only materially participated in the activity for two tax years of the 10 tax years immediately preceding tax year 2011, Bill does not meet the material participation test.]

    c. Bill materially participated in the activity in tax years 2006 through 2009. [This answer is incorrect. One test requires that Bill must materially participate in the activity for five of the 10 tax years immediately preceding the current tax years of 2011 and, since he only participated in the activity for four of the 10 immediately preceding tax years, he does not meet the material participation test.]

    d. Bill materially participated in the activity in tax years 2002, 2003, 2004, 2006, and 2009. [This answer is correct. In order for Bill to be considered to materially participate in the activity, one test that satisfies that requirement is that he materially participated in the activity for any five tax years, even if not consecutive, of the 10 tax years immediately preceding tax year 2011. Since he participated in the activity in tax years 2002, 2003, 2004, 2006, and 2009, Bill is deemed to have materially participated in the activity.]

35. A fiduciary that does not meet any of the quantitative or prior-year tests, materially participates in an activity if the statutory test requirements are satisfied. Which of the following accurately represents an aspect of the statutory test requirements? **(Page 87)**

    a. The fiduciary participated in the activity on a regular and substantial basis during the current year. [This answer is correct. Temp. Reg. 1.469-5T(b)(2)(iii) and Rev. Ruls. 91-30 and 92-65 indicate that, based on facts and circumstances, the fiduciary must participate in the activity on a regular, continuous, and substantial basis during the current year if he or she does not meet any of the quantitative or prior-year tests in order to materially participate in the activity.]

    b. The fiduciary must participate in the activity for more than 200 hours during the tax year. [This answer is incorrect. Per Temp. Reg. 1.469-5T(b)(2)(iii) and Rev. Ruls. 91-30 and 92-65, in order for a fiduciary to be considered to materially participate in an activity when none of the quantitative or prior-year tests have been met, the statutory test requires a fiduciary to participate in an activity for more than 100 hours (not 200) during the tax year.]

    c. In addition to the fiduciary, other persons were also compensated for management services. [This answer is incorrect. According to Temp. Reg. 1.469-5T(b)(2)(iii) and Rev. Ruls. 91-30 and 92-65, no person, other than the fiduciary, may be compensated for management services.]

    d. Another individual provided more hours of management service than the fiduciary. [This answer is incorrect. No other individual may provide more hours of management service than the fiduciary as cited in Temp. Reg. 1.469-5T(b)(2)(iii) and Rev. Ruls. 91-30 and 92-65.]

36. Jane Swift is the sole beneficiary of a simple trust and will receive all fiduciary accounting income. In 2010, the trust earns $52,000 of qualified dividends and incurs a $28,000 passive activity loss (PAL), none of which is attributable to depreciation and the PAL is chargeable to *principal* under the terms of the trust instrument. Based on the information provided, and the $300 standard exemption (Form 1041, Line 20), what is the trusts' taxable income? **(Page 88)**

    a. ($300). [This answer is correct. When the PAL is charged to principal, the fiduciary accounting income is the amount of the dividends, in this case $52,000. $52,000 is also the amount of distributable net income (DNI). As a result, the distribution deduction is $52,000. With the standard deduction applied, the taxable income per Form 1041 is ($300).]

    b. $24,000. [This answer is incorrect. $24,000 is the trusts' fiduciary accounting income when the PAL is charged to income.]

    c. $28,000. [This answer is incorrect. The trusts' PAL is $28,000, not its taxable income when the PAL is charged to principal.]

    d. $51,700. [This answer is incorrect. The amount of the dividends is $52,000; however, this less the standard exemption is not the trusts' taxable amount when PAL is charged to principal under the terms of the trust instrument.]

37. Brighton Trust is a simple trust with rental losses as well as capital gains and losses allocated to principal by the trust instrument. No depreciation reserve is maintained by the trustee and administration expenses are charged to trust income. Further, depreciation expense is the same for both tax and trust accounting purposes. Brighton Trust had taxable income during 2010 of $10,000, rental loss before depreciation expense of ($1,000), depreciation expense on rental property of ($5,000), installment gain on prior sale of a passive activity of $3,000, long-term capital loss from stock sales of ($10,000), and administration expenses of ($4,000). Based on this activity, what is Brighton Trusts' distributable net income (DNI)? **(Page 88)**

    a. $0. [This answer is incorrect. The trust's DNI is not zero. Some items of activity for the year are not relevant when calculating DNI, such as the depreciation expense on rental property.]

    b. $5,000. [This answer is correct. Since Brighton Trusts' taxable interest income for 2010 was $10,000, their DNI is $5,000. Their DNI is calculated by taking taxable interest income of $10,000 and

subtracting the administration expense of $4,000 and the rental loss of $1,000, resulting in a DNI of $5,000.]

c. $6,000. [This answer is incorrect. The trust's fiduciary accounting income is $6,000 ($10,000 − $4,000) since the trust agreement allocates the rental loss of $1,000 to principal.]

d. $20,000. [This answer is incorrect. The $20,000 of taxable interest income is not the only activity item relevant in determining DNI. The rental loss is includable in DNI.]

38. Which of the following statements is accurate regarding activities with net passive income? **(Page 91)**

a. If passive income less tax depreciation results in net passive income, a PAL limitation may still exist at the trust level. [This answer is incorrect. There can be no PAL limitation to be considered unless passive income, less tax depreciation, results in net passive *loss*.]

b. If passive income less tax depreciation results in net passive income, there is no PAL limitation at the beneficiary level. [This answer is correct. Generally, a PAL limitation will not exist at the beneficiary level unless passive income, less tax depreciation, results in net passive *loss*.]

c. If the income and the depreciation are required to be distributed to the beneficiary, distributions are reported on the beneficiary's Form 1099-DIV. [This answer is incorrect. When the income is distributed to the beneficiary, and the depreciation is also required to be distributed to the beneficiary, such distributions are reported on the beneficiary's Schedule K-1, *Beneficiary's Income, Deductions, Credits, etc.* (not on Form 1099-DIV, *Dividends and Distributions*).]

d. If the income and the depreciation are required to be distributed to the beneficiary, the beneficiary reports net passive income from distributions on Schedule F of Form 1040. [This answer is incorrect. The beneficiary reports net passive income from distributions on Schedule E, *Supplemental Income and Loss* (not on Schedule F, *Profit and Loss from Farming*) when the income is distributed to the beneficiary and the depreciation is also required to be distributed to the beneficiary.]

39. The Bolen Trust is a simple trust. In 2010, the trust earns $25,000 of net rental income prior to depreciation expense and $12,500 of qualified dividend income. Depreciation expense is $8,500 and a depreciation reserve is not required to be maintained by the trust. Fiduciary accounting income is $37,500. How much income is taxable to the trust? **(Page 91)**

a. $0. [This answer is correct. The trust has no taxable income due to the fact that all income must be distributed in a simple trust.]

b. $12,500. [This answer is incorrect. Qualified dividend income is not taxable in a simple trust.]

c. $25,000. [This answer is incorrect. Net rental income is not taxable in a simple trust.]

d. $37,500. [This answer is incorrect. A simple trust does not require that fiduciary accounting income be taxed.]

40. The title to five oil and gas working interests is held by Braden, a complex trust. Which of the following statements is accurate? **(Page 95)**

a. The activity is likely to be passive. [This answer is incorrect. The activity would likely be passive if the properties were held through a limited partnership.]

b. The working interest exception should apply. [This answer is correct. Due to the fact that the interests are held outright, the working interest exception should apply.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (T41TG101)

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

33. Tax credits from passive activities can be used to offset the tax liability attributable to:

    a. Passive activities income.

    b. Portfolio income.

    c. Nonpassive income.

    d. Do not select this answer choice.

34. According to one of the four quantitative tests, a fiduciary materially participates in an activity when participation in the activity during the current year exceeds:

    a. 250 hours.

    b. 500 hours.

    c. 750 hours.

    d. 1,000 hours.

35. According to one of the four quantitative tests, a fiduciary materially participates in an activity when participation in the activity:

    a. Exceeds 75 hours for the current year and is less than the participation in the activity of any other owner.

    b. Exceeds 75 hours for the current year and is less than or equal to participation in the activity of any other owner.

    c. Exceeds 100 hours for the current year and is less than the participation in the activity of any nonowner.

    d. Exceeds 100 hours for the current year and is not less than the participation in the activity of any other owner or nonowner.

36. Randy Smith is the sole beneficiary of a simple trust and will receive all fiduciary accounting income. In 2010, the trust earns $52,000 of qualified dividends and incurs a $28,000 passive activity loss (PAL), none of which is attributable to depreciation and the PAL is chargeable to *income* under the terms of the trust instrument. Based on the information provided, and the $300 standard exemption (Form 1041, Line 20), what is the trusts' taxable income?

    a. $13,700.

    b. $23,700.

    c. $27,700.

    d. $33,700.

37. In cases where the governing instrument does not specify whether a PAL should be allocated to income or principal in a simple trust, which of the following takes precedence?

    a. Federal law.

    b. State law.

    c. Professional discretion should be used.

    d. It depends on the specifics of the simple trust involved.

38. When a trust or estate distributes passive income to a beneficiary and depreciation is distributed to the beneficiary receiving all the income, does authoritative guidance cover how such items should be reported in conjunction with the passive activity rules?

    a. Yes.

    b. No.

    c. Depends on income/depreciation thresholds.

    d. Do not select this answer choice.

39. In cases when net passive income less depreciation results in a net passive loss and a depreciation reserve is required and maintained by the fiduciary, the PAL limitation occurs at:

    a. The beneficiary level.

    b. The trust level.

    c. Both the beneficiary and trust level.

    d. The discretion of the fiduciary.

40. Individual taxpayers may deduct up to _____ of passive losses attributable to a rental real estate activity for active participation. This rental real estate exemption is allowed by _____.

    a. $15,000; estates.

    b. $15,000; trusts.

    c. $25,000; estates.

    d. $25,000; trusts.

GLOSSARY

At-risk rules: Special rules limiting the taxpayer's deductible business, partnership, S corporation, or real estate loss to cash invested plus debt the taxpayer is legally obligated to pay and adjusted basis of property contributed.

Beneficiary: The party for whose benefit a will, a trust, an insurance policy, or a contract is created. The party may be an individual or organization (e.g., charity, school, club, or business). The party may receive title to property by will or by equitable interest in a trust.

Buy-sell agreement: A legal document that specifies conditions under which interests in a business could be bought or sold. In a family or closely held business, such an agreement is critical to protect against ownership being transferred to individuals with whom remaining business owners do not want to be in business. Important aspects of a buy-sell agreement include: who can and cannot own, price formula and payment plan, specification of situations where it applies, and whether the agreement makes buyout optional or mandatory.

Capital: The interest of owner(s) in the net assets (total assets minus total liabilities) of an entity. It is the measure of the resources provided to an entity that are considered permanent in nature—long-term debt and owners' equity.

Community property: A system of property law adopted in a number of states whereby the property of a husband and wife is deemed to be owned in common as marital partnership.

Complex trust: A trust in which the trustee is not required to distribute income currently, or distributes amounts other than income, or makes a charitable contribution; opposite of a simple trust.

Decedent: The deceased individual whose estate is being administered.

Distributable net income (DNI): Represents the amount of the fiduciary's net income that is available for distribution to the income beneficiaries. It establishes the maximum amount of distributions that may be treated as income to the beneficiaries even if the actual distribution is greater, and it provides the basis for allocating various types of income among the beneficiaries.

Distribution: Money a taxpayer withdraws from a retirement plan such as an individual retirement account or an employer-maintained pension plan.

Dividend: The distributions of cash, other corporate assets or property, or the corporation's own stock to stockholders in proportion to the number of outstanding shares held. Accounting for dividends represents a debit to retained earnings and a reduction (credit) to the account of the asset (or stock) distributed. The dividends must meet the preferences of preferred stock first and then may be extended to common stock.

Estate: A taxable, organizational entity used to wind up the affairs and distribute the property of a deceased person. It comes into existence only upon a person's death and holds title to the property of the deceased and exists for a limited time. An estate succeeds to the title of all property of the deceased and is liable for debts. It must pay federal estate tax, applicable state inheritance tax, federal income tax, and any other tax that becomes due on the real and personal property of the estate.

Interest: The charge for the use of money over time. It is the time value of money. Interest is the amount paid (or received) in excess of the amount borrowed (loaned). Interest is a financing expense (income) and is dependent on the interest rate, principal amount, and number of interest periods.

Market discount bond: A bond has a market discount if the bondholder purchases the bond from another bondholder for less than the stated redemption value *and* the bond was initially issued at or above par value (IRC §1278(a)(2)). Thus, a market discount does not pertain to bonds initially purchased from the issuing corporation or brokerage firm.

Material participation: The standard used to define whether a business activity is passive with respect to a taxpayer. If the taxpayer *materially participates* in the activity, it is nonpassive. If the taxpayer fails to materially participate, the

activity is passive. Material participation requires regular, continuous, and substantial involvement in the business. It is tested on an annual basis. The regulations list seven separate tests which can be satisfied to meet the material participation standard. Four are quantitative and three are qualitative.

Original issue discount (OID): The amount of the original issue price of a bond or other debt instrument discounted below par or face value. This can apply also to a collateralized mortgage obligation.

Passive activity: If the taxpayer does *not* materially participate in an activity, the income or loss resulting is *passive.* The passive loss rules limit the amount of losses from passive activities that can reduce income from nonpassive sources. Generally, losses from passive activities in excess of passive income may *not* reduce nonpassive income (active income and portfolio income). Passive losses that cannot offset other types of income are suspended losses and must be carried forward to offset future passive income.

Pecuniary bequest: Money given to an heir by a decedent.

Required beginning date (RBD): Generally April 1 of the year following the year in which the owner attained age 70 1/2.

Roth IRA: Similar to a traditional IRA with a few exceptions. Contributions to a Roth IRA are always nondeductible, do not depend on whether the taxpayer or spouse is an active participant in a company-sponsored qualified retirement plan, and may be made after the taxpayer attains the age of 70 1/2. In addition, qualified distributions are nontaxable. (Funds must be held in the IRA for five years prior to the initial distribution for the funds to be nontaxable.) Accounts may be passed to beneficiaries at death and remain nontaxable for income tax purposes.

Royalty: A payment received for the right to exploit a taxpayer's ownership of natural resources or a taxpayer's literary, musical, or artistic creation.

S Corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in Subchapter S of the Internal Revenue Code (IRC).

Simple trust: A trust in which the beneficiary has a right to both income and capital and may call for both to be remitted into his own name. He is also entitled to take actual ownership and control of the trust property.

Trust: A fiduciary relationship in which one person holds legal title to property subject to an equitable obligation to safeguard or use the property for the benefit of another. A trust represents a separation of legal and equitable title and may be of two types—*inter vivos* or testamentary. A trust may have different characteristics, such as accumulation, charitable, Clifford, complex, constructive, irrevocable, living, private, or revocable.

Zero coupon bonds: Bonds that carry no stated interest rate are zero-coupon bonds.

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 2

DISTRIBUTIONS (T41TG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses different types of distributions available to estates and trusts. Lesson one covers the basics of making distributions to beneficiaries, including income distribution deductions, distributable net income, and other issues. Lesson two discusses property distributions, including specific bequests, pecuniary requests, and more.

PUBLICATION/REVISION DATE: December 2010

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

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of income taxes

CPE CREDIT: 9 QAS Hours, 9 Registry Hours

9 CTEC Federal Hours, 0 CTEC California Hours

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

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

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Distributions to Beneficiaries

Completion of this lesson will enable you to:

- Summarize the important elements of deducting distributions of taxable income.
- Define distributable net income (DNI), compute DNI, and determine when taxable gains are included.
- Compute the distribution deduction for simple trusts and complex trusts and estates, as well as determine distributions of amounts other than current income.
- Assess issues related to the separate share rule, treating distributions as made in the prior year, distributions of tax-exempt income, and generation-skipping transfer tax reporting.

Lesson 2—Property Distributions

Completion of this lesson will enable you to:

- Summarize the tax effects of property distributions and determine when distributions of specific property are considered specific bequests and, thus, are not eligible for the distribution deduction.
- Develop a strategy for dealing with distributions of property that are not specific bequests.
- Assess and compute gain or loss recognition related to distributions in lieu of specific property or dollar amounts, distributions of property in lieu of income, and distributions of depreciated property.

- Determine the tax implications of distributions of installment obligations, partnership interests, and S corporation stock.

TO COMPLETE THIS LEARNING PROCESS:

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

Thomson Reuters
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T41TG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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

ADMINISTRATIVE POLICIES:

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Lesson 1: Distributions to Beneficiaries

INTRODUCTION

Although estates and trusts are subject to income tax as separate taxable entities, they also serve as conduits when they distribute income to beneficiaries. Distributable net income (DNI) is a tax concept originating conceptually in the Internal Revenue Code. The primary purpose of DNI is to allocate the trust's or estate's taxable (and tax-exempt) income between the fiduciary and its beneficiaries, ensuring income is only taxed once, either to the fiduciary or the beneficiaries. Estates or trusts making, or required to make, distributions are allowed an income tax deduction, referred to as the distribution deduction, which ensures that the estate or trust is not taxed on those amounts. An estate or trust can generally deduct amounts distributed, or required to be distributed, to the extent of the taxable portion of DNI. Any taxable income accumulated or remaining after the distribution deduction and exemption amount is taxed to the estate or trust.

To the extent a trust or estate is required or permitted by its governing instrument to make distributions that qualify for a distribution deduction, the beneficiaries must include a corresponding amount in their own gross income. The tax attributes of distributions to estate or trust beneficiaries are reported to the IRS and the beneficiaries via Schedule K-1 (Form 1041).

Distributions of property are governed by different rules than distributions of cash.

Distributions made in error are not taxed to a beneficiary if they are returned to the trust.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the important elements of deducting distributions of taxable income.
- Define distributable net income (DNI), compute DNI, and determine when taxable gains are included.
- Compute the distribution deduction for simple trusts and complex trusts and estates, as well as determine distributions of amounts other than current income.
- Assess issues related to the separate share rule, treating distributions as made in the prior year, distributions of tax-exempt income, and generation-skipping transfer tax reporting.

Taxable Income and the Deduction for Distributions

Overview of Distribution Deduction and DNI Rules

For tax purposes, a distribution of cash or other property (whether from income or principal), from an estate or trust to a beneficiary is generally treated as a distribution of current taxable income to the extent of distributable net income (DNI). The fiduciary deducts the taxable income so distributed and a corresponding amount is included in the gross income of the beneficiary. However, distributions made in error are not taxed to the beneficiary if they are returned to the trustee. Widow's or family allowances are subject to the normal distribution rules when paid to estate beneficiaries if such allowances are at the discretion of the executor or probate court.

The word "income," in Subchapter J (except in Subpart E, dealing with grantor trusts) when not prefaced with modifiers such as "gross," "taxable," or "distributable net," means fiduciary accounting income. When the governing instrument requires the fiduciary to distribute all or a portion of the income currently, the reference is to fiduciary accounting income. The fiduciary determines fiduciary accounting income by referring to the governing instrument, which is based on the intent of the creator. If the instrument is silent, the fiduciary must turn to local (i.e., state) law for guidance. Most states have adopted a version of the original (1931) or Revised (1962 or 1997) Uniform Principal and Income Act, which, in absence of direction in the governing instrument, provides guidance as to whether certain receipts and disbursements should be classified as income or principal (corpus) transactions.

The Internal Revenue Code creates a parallel concept referred to as distributable net income (DNI), which serves as the maximum amount of taxable income for which the fiduciary can claim as an income distribution deduction

and the maximum amount required to be included in gross income of the beneficiaries. DNI is a modified form of fiduciary taxable income before the distribution deduction, which may or may not equal fiduciary accounting income.

Example 1A-1 Relationship between the distribution deduction and DNI.

The terms of the William Wonka Family Trust require the trust to pay all college expenses of Billy Wonka. College expenses are not a parental support obligation under local law. In 2010, the trustee paid $15,000 for Billy's tuition, books, room, and board, and made no other distributions. DNI for the year was $12,000 and there was no tax-exempt trust income.

The trust's distribution deduction is limited to the $12,000 of DNI. Billy will receive a Schedule K-1 from the trust reflecting $12,000 of taxable income, even though he received $15,000. The $12,000 is included in Billy's gross income for 2010 and taxed to him individually. The $3,000 distribution in excess of DNI is either a distribution of undistributed net income accumulated in prior years or a distribution of principal. If the trust had distributed $10,000 instead of $15,000, the distribution deduction and income inclusion amounts each would have been $10,000.

Example 1A-2 Distribution from principal rather than income.

In 2010, the DNI and fiduciary accounting income of the Mae Daye Testamentary Trust were both $30,000. The trust instrument provides that the trustee may distribute or accumulate income. The trustee also has the discretion to invade trust principal for the benefit of the sole beneficiary, Dee Daye.

According to the accounting records, on November 2, 2010, the trustee distributed $50,000 to Dee from the proceeds from a bond that matured November 1. The bond proceeds were allocated to principal. The trustee made no other distributions during the year and did not have a regular practice of distributing capital gains.

For fiduciary accounting purposes, the trustee made a distribution of $50,000 of principal. However, for federal income tax purposes, the first $30,000 of the distribution is deemed to have been made from DNI, which will be deductible by the trust and included as income on Dee's Schedule K-1 from the trust.

Exception for Specific Bequests

The general rule discussed previously treats a distribution of cash or other property (whether from income or principal) as coming from current income to the extent of DNI. However, any amount that, under the terms of the governing instrument, is (1) payable either as a gift or bequest of a specific sum of money or of specific property, (2) that is paid or credited all at once or in not more than three installments, and (3) is not payable out of income generally does not carry out DNI to the beneficiaries. Therefore, no DNI is allocated to such specific gifts or bequests. The fiduciary cannot claim a deduction for the distributions, nor will the specific gifts or bequests be taxable to the beneficiaries. DNI is only carried out if the bequest is entitled to income or to share in appreciation/depreciation of the assets. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI.

To qualify as a gift or bequest of a specific sum of money or of specific property, the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of death or under the terms of an *inter vivos* trust instrument as of the date of the inception of the trust. An amount that can be paid only from income cannot be treated as a specific bequest.

Example 1A-3 Specific cash bequest does not carry out DNI.

According to the provisions in the decedent's will, a specific sum of $25,000 is to be distributed to the decedent's niece within two years of death (2010). The estate has taxable DNI in 2010 of $100,000. The executor makes the $25,000 distribution to the niece in 2010, and there were no other distributions that year.

Even though the estate had taxable undistributed income for 2010, there is no distribution deduction for the $25,000 distributed to the niece since the amount qualifies as a distribution of a specific bequest.

Computing the Distribution Deduction on Form 1041

Schedule B on page 2 of Form 1041 provides the format for calculating distributable net income (DNI) and the income distribution deduction. In addition, fiduciary accounting income must be disclosed by complex trusts on Schedule B.

Once DNI has been determined, it is compared to the amount of total distributions for the tax year (excluding specific bequests), and the lesser amount is generally the distribution deduction. However, no distribution deduction is allowed for amounts not included in the gross income of the estate or trust. Therefore, tax-exempt income, net of allocable expenses, is not included in DNI or in total distributions when computing the income distribution deduction.

The amount of total distributions on Schedule B is the sum of two amounts: (1) income required to be distributed currently, and (2) other amounts paid, credited, or required to be distributed.

"Income required to be distributed currently" refers to fiduciary accounting income, whether or not actually distributed. Thus, the estate or trust is entitled to a distribution deduction if the income is *payable* to the beneficiary each year regardless of whether income is actually distributed. If the fiduciary can make a required distribution from income or principal, the amount to enter on Schedule B as income required to be distributed currently is the portion of the distribution paid from current income.

"Other amounts paid, credited, or required to be distributed" include all other distributions, whether from income or principal.

Example 1A-4 Distribution deduction for income required to be distributed.

In 2010, the taxable DNI and fiduciary accounting income of the Allen Pate Testamentary Trust were both $50,000. The trust instrument provides that the trustee must distribute $15,000 from income, $20,000 from principal (not a specific bequest), and $10,000 from either income or principal. The fiduciary makes the $10,000 distribution from income.

The "income required to be distributed currently" is $25,000 and the "other amounts paid, credited, or required to be distributed" is $20,000. If the fiduciary had made the $10,000 distribution from principal, the "income required to be distributed" would have been $15,000, and the "other amounts paid, credited, or required to be distributed" would have been $30,000. Either way, the total distribution deduction is $45,000.

Without a special election under IRC Sec. 643(e)(3), the amount to report on Schedule B for noncash distributions is the lesser of the adjusted basis of the property to the beneficiary or the property's fair market value on the date of distribution. If the Section 643(e)(3) election is made, the amount of the distribution is the fair market value of the property distributed. This rule does not pertain to specific bequests, which are not reported as distributions on Schedule B.

Tier System Determines Who Bears the Tax Burden

Simple Trusts. Simple trusts have the following characteristics:

1. they are required to distribute all income currently,

2. they make no distributions of principal in a given year, and

3. they cannot claim a charitable contribution deduction under IRC Sec. 642(c) for the year.

A simple trust is allowed to deduct the amount of income required to be distributed currently, up to the amount of taxable DNI.

Complex Trusts and Estates. All other trusts, referred to as "complex trusts," and estates compute their distribution deduction under a tier system in which all amounts distributed to beneficiaries are classified as Tier 1 or Tier 2

distributions. Income required to be distributed currently is considered a Tier 1 distribution, and the beneficiaries are referred to as Tier 1 beneficiaries. Note that distributions of principal can be made as a Tier 1 distribution, but only to the extent of current income. Other distributions (whether from income or principal) are Tier 2 distributions, and the beneficiaries are referred to as Tier 2 beneficiaries. Tier 2 distributions include discretionary distributions of income and all distributions of principal that are in excess of required income, whether required or discretionary (excluding specific bequests).

DNI, computed without any deduction for charitable contributions, is first allocated to Tier 1 distributions. To the extent there is DNI remaining after Tier 1 distributions and any charitable contributions deduction, it is allocated to Tier 2 distributions. A single beneficiary can be both a Tier 1 and a Tier 2 beneficiary if he or she receives both mandatory and discretionary distributions of income in a single tax year.

Distribution Deduction Triggers AMT Reporting Requirements

Every estate or trust claiming an income distribution deduction must complete Schedule I, Form 1041, to compute:

1. the fiduciary's alternative minimum taxable income,

2. the income distribution deduction on a minimum tax basis, and

3. the fiduciary's alternative minimum tax (AMT).

Timing of Beneficiary Income Inclusion

Nongrantor trusts, other than those exempt from tax and certain wholly charitable trusts, are required to use a calendar year for tax reporting purposes. However, the executor or administrator of a decedent's estate can choose any tax year permitted under the general rules for selecting allowable year ends.

When the fiduciary and beneficiary share a common tax year, the beneficiary must report the income from the estate or trust in the same year the fiduciary claims the distribution deduction. When the fiduciary and beneficiary have different tax years (i.e., an estate), the beneficiary generally must report the income in his or her year during which the fiduciary's tax year ended. This rule applies to short tax years as well as full years. However, in the year of an individual beneficiary's death, the final Form 1040 includes only the income to which the beneficiary is entitled that is actually distributed to the beneficiary before his or her death. Income required to be distributed, but distributed to the decedent's estate is included in the gross income of the estate as income in respect of a decedent (IRD).

SELF-STUDY QUIZ

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

1. In 2010, the Nelson Trust distributes $15,000 to each of the trust's two beneficiaries. The cash used for the distributions came from trust income. How will the distributions be handled for tax purposes?

   a. As distributions of current taxable income to the extent of distributable net income (DNI).

   b. As widow's or family allowances excluded from the DNI rules.

   c. The entire distribution amount is included in the trust's gross income.

   d. The distributions will not be included in DNI or carried out to either of the beneficiaries.

2. Marilyn is the sole beneficiary of the Bleaker Testamentary Trust. According to the trust instrument, the trustee may distribute or accumulate income, and the trustee is granted the discretion to invade trust principal for Marilyn's benefit. In 2010, the trust had DNI and fiduciary accounting income of $50,000. On October 7, 2010, the trustee distributed $75,000 to Marilyn. These funds were the proceeds from a bond that matured on October 6. The bond proceeds were allocated to principal. This was the only distribution made by the trustee in 2010, and the trustee did not have a regular practice of distributing capital gains. Which of the following statements best describes the consequences of this transaction for fiduciary accounting purposes?

   a. The $75,000 was a distribution of principal.

   b. The first $50,000 is deemed to be DNI.

   c. $50,000 is deductible by the trust.

   d. $50,000 is deductible by Marilyn.

3. The Gregor Trust has both DNI and fiduciary accounting income of $30,000 in 2010. Under the trust instrument, the trustee must distribute $5,000 from income, $7,000 from principal, and $12,000 from either income or principal. None of these distributions are specific bequests. Of the total $24,000 distributed by the trustee in 2010, $12,000 is from income. What is the trust's total distribution deduction?

   a. $7,000.

   b. $12,000.

   c. $24,000.

   d. $30,000.

4. What is reported on Schedule B of Form 1041?

   a. The fiduciary's alternative minimum taxable income and alternative minimum tax.

   b. The fiduciary's income distribution deduction on a minimum tax basis.

   c. The fiduciary's DNI calculation and income distribution deduction.

   d. The fiduciary's charitable contribution deduction.

SELF-STUDY ANSWERS

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

1. In 2010, the Nelson Trust distributes $15,000 to each of the trust's two beneficiaries. The cash used for the distributions came from trust income. How will the distributions be handled for tax purposes? **(Page 113)**

   a. As distributions of current taxable income to the extent of distributable net income (DNI). [This answer is correct. The fiduciary deducts the taxable income distributed by claiming an income distribution deduction up to DNI. That amount is included in the beneficiaries' gross income.]

   b. As widow's or family allowances excluded from the DNI rules. [This answer is incorrect. Widow's or family allowances are subject to normal DNI rules when paid to beneficiaries at the discretion of probate court or the trustee.]

   c. The entire distribution amount is included in the trust's gross income. [This answer is incorrect. In this scenario, the amount that corresponds to the amount that the trustee deducted in taxable income would be included in the beneficiaries' gross income. It would not be included in the trust's gross income.]

   d. The distributions will not be included in DNI or carried out to either of the beneficiaries. [This answer is incorrect. This would be true if the distribution, under the terms of the governing instrument, is a gift or bequest of a specific property or sum of money. Such a gift must be paid all at once or in not more than three installments.]

2. Marilyn is the sole beneficiary of the Bleaker Testamentary Trust. According to the trust instrument, the trustee may distribute or accumulate income, and the trustee is granted the discretion to invade trust principal for Marilyn's benefit. In 2010, the trust had DNI and fiduciary accounting income of $50,000. On October 7, 2010, the trustee distributed $75,000 to Marilyn. These funds were the proceeds from a bond that matured on October 6. The bond proceeds were allocated to principal. This was the only distribution made by the trustee in 2010, and the trustee did not have a regular practice of distributing capital gains. Which of the following statements best describes the consequences of this transaction for fiduciary accounting purposes? **(Page 113)**

   a. The $75,000 was a distribution of principal. [This answer is correct. The treatment used for fiduciary accounting purposes should reflect the way amounts of cash actually moved. In this scenario, the trustee accumulated all of the year's income and made a $75,000 distribution from principal.]

   b. The first $50,000 is deemed to be DNI. [This answer is incorrect. This would be correct for federal income tax purposes, not fiduciary accounting purposes.]

   c. $50,000 is deductible by the trust. [This answer is incorrect. Though the trust can make this deduction, it is for federal income tax purposes, not fiduciary accounting purposes.]

   d. $50,000 is deductible by Marilyn. [This answer is incorrect. For federal income tax purposes, Marilyn would count all $75,000 of the distribution as income, and it would be reported on her Schedule K-1 from the trust.]

3. The Gregor Trust has both DNI and fiduciary accounting income of $30,000 in 2010. Under the trust instrument, the trustee must distribute $5,000 from income, $7,000 from principal, and $12,000 from either income or principal. None of these distributions are specific bequests. Of the total $24,000 distributed by the trustee in 2010, $12,000 is from income. What is the trust's total distribution deduction? **(Page 113)**

   a. $7,000. [This answer is incorrect. The amount paid from principal would be included in the trust's 2010 distribution deduction, but other amounts are included in the calculation.]

   b. $12,000. [This answer is incorrect. The amount that the trustee paid to the beneficiary is included in the trust's distribution deduction for 2010; however, other amounts factor into the calculation of the total deduction.]

c. $24,000. [This answer is correct. The "other amounts paid, credited, or required to be distributed" is 7,000, and the "income required to be distributed currently" is $17,000. The total distribution deduction is $24,000. The trust is entitled to a distribution deduction for all of the income that is payable to beneficiaries during the year (but not more than DNI), rather than what is actually paid.]

d. $30,000. [This answer is incorrect. Neither the total amount of DNI nor the total amount of fiduciary accounting income would be the trust's 2010 distribution deduction because the actual distributions must be taken into account.]

4. What is reported on Schedule B of Form 1041? **(Page 113)**

a. The fiduciary's alternative minimum taxable income and alternative minimum tax. [This answer is incorrect. An estate or trust would compute these two items on Schedule I of Form 1041.]

b. The fiduciary's income distribution deduction on a minimum tax basis. [This answer is incorrect. A fiduciary's income distribution deduction on a minimum tax basis is reported on Schedule I of Form 1041.]

c. The fiduciary's DNI calculation and income distribution deduction. [This answer is correct. Schedule B on page 2 of Form 1041 provides the format for calculating distributable net income (DNI) and the income distribution deduction. Additionally, if the fiduciary is a complex trust, it must also disclose its fiduciary accounting income on the Schedule B.]

d. The fiduciary's charitable contribution deduction. [This answer is incorrect. This would be reported on Schedule A of Form 1041, not Schedule B.]

The Important Elements of Distributable Net Income (DNI)

Maximum Distribution Deduction to Fiduciary and Income Inclusion to Beneficiary

Distributable net income (DNI) serves as an upper limitation on the amount of the distribution deduction that can be claimed by simple trusts, complex trusts, and estates in computing the taxable income of the fiduciary entity. DNI is also the maximum amount the beneficiaries will have to include in their gross income.

Example 1B-1 DNI provides upper limit for distribution deduction.

The Robert Johnson Testamentary Trust requires all income to be distributed currently. In 2010, the trust has $3,000 of dividend income, $8,000 of taxable interest income, and the trustee's fee is $1,000. DNI in this example is simply the sum of the dividend and interest income less the trustee's fee, or $10,000. Fiduciary accounting income is also $10,000, assuming the entire trustee's fee is allocated to income. Therefore, the trustee is required to distribute $10,000. The maximum distribution deduction that can be claimed by the trust is also $10,000.

If the trustee's fees of $1,000 were allocated to principal, DNI would remain at $10,000 while the fiduciary accounting income would be $11,000. The distribution deduction would be limited to $10,000, because DNI is the upper limit for the distribution deduction.

If the trust had an additional $5,000 of tax-exempt interest income, DNI (and fiduciary accounting income) would include the tax-exempt income, but the distribution deduction would not; the deduction is limited to the taxable portion of DNI by IRC Sec. 651(b) (simple trusts) and IRC Sec 661(c) (complex trusts and estates).

The limitation on the distribution deduction applies even if a trust or estate distributes an amount greater than DNI to beneficiaries. A simple trust could distribute an amount greater than DNI in a given year if fiduciary accounting income is greater than DNI (e.g., if tax-deductible trustee fees are allocated to principal under the terms of the trust agreement for fiduciary accounting purposes). An estate or complex trust could make distributions in excess of DNI since those entities are defined, among other criteria, as fiduciaries that make distributions of principal. However, the maximum distribution deduction is limited to DNI.

The amount included in the gross income of the beneficiaries may be less, but never more than DNI, even when all income is required to be distributed. For example, a simple trust whose DNI is greater than fiduciary accounting income is required to distribute only the amount of fiduciary accounting income. The amount taxable to the beneficiary cannot exceed the amount of DNI distributed.

Example 1B-2 Taxable distribution to beneficiary is limited to DNI.

The preparer of a 2010 Form 1041 for a complex trust determines from the information provided by the trustee that the trust received dividend income of $5,000 and taxable interest income of $15,000. The trust paid a fiduciary fee of $2,000. The trustee made a $20,000 discretionary distribution to the beneficiary as permitted by the trust instrument.

DNI equals $18,000 (dividends plus taxable interest less trustee fee). Even though $20,000 was distributed, the beneficiary will include only $18,000 in his gross income, an amount equal to DNI.

Determining Character of Distributions to Beneficiaries

DNI is also important in determining the character of amounts distributed to beneficiaries. The gross income distributed by an estate or trust to its beneficiaries generally retains the same character in the hands of the beneficiary as it had to the estate or trust. Therefore, DNI must be broken down by class of income, net of expenses, before the income can be allocated to the beneficiaries.

Income is reportable to beneficiaries if it is included in DNI and distributions are made, regardless of whether it is included in fiduciary accounting income. The fact that a distribution is classified as principal for fiduciary accounting purposes does not determine its tax treatment for inclusion in DNI. However, distributions of cash or property that are considered specific bequest do not carry out DNI to beneficiaries.

The governing instrument or state law can require a special allocation of income among beneficiaries, although this is quite uncommon. To be effective, the allocation must have "economic effect."

Deductions directly attributable to one class of income are allocated to that income. If the direct expenses exceed the related income, they can be allocated to other classes of income. Indirect expenses may be allocated to any item of income included in DNI, as long as a "reasonable portion" is allocated to nontaxable income.

Computing DNI

Defining DNI for Domestic Estates and Trusts

For domestic estates and trusts, DNI is defined as the taxable income of the estate or trust computed with the following modifications:

1. No deduction is allowed for distributions made to the beneficiaries.
2. No deduction is permitted for the personal exemption.
3. Capital gains are generally *excluded* from DNI. However, capital gains are *included* in DNI if the gains are:
    a. Allocated to income under the terms of the governing instrument and local law by the fiduciary on its books or by notice to the beneficiary.
    b. Allocated to principal, but actually distributed to the beneficiaries during the tax year (e.g., a distribution required by the terms of the governing instrument upon the occurrence of a specified event). This includes capital gains realized by a trust or estate in its final year or in years in which a partial termination occurs, such as a distribution made to a beneficiary who attains a specified age.
    c. Used in determining the amount distributed or required to be distributed by the fiduciary, under the terms of the governing instrument or in accordance with the consistent practice of the fiduciary.
    d. Contributed to charity (producing a charitable deduction) under IRC Sec. 642(c).
4. Short-term capital gain dividends from a regulated investment company (mutual fund) are generally included in DNI. (Note that after 2010, all dividends are scheduled to be taxed at ordinary income rates, i.e., the favorable long-term capital gain rates will no longer apply.)
5. Capital losses are excluded except to the extent they are taken into account in determining the amount of gain from the sale or exchange of capital assets paid, credited, or required to be distributed to any beneficiary during the tax year.
6. The income tax deduction for estate taxes paid on income in respect of a decedent (IRD) is not allowed.
7. Gains on the disposition of qualified small business stock may be excluded from taxable income under IRC Sec. 1202 but must be included in DNI.
8. For simple trusts, extraordinary dividends or taxable stock dividends are excluded from DNI if the fiduciary, in good faith, does not pay or credit them to any beneficiary by reason of his determination that such dividends are allocable to principal under the terms of the governing instrument and applicable local law. However, such dividends are included in the distributable net income of complex trusts and estates.
9. Net tax-exempt interest is included in DNI. Net tax-exempt interest is gross tax-exempt interest, reduced by the tax-exempt interest paid or set aside for charity and by otherwise deductible expenses (e.g., trustee fees) allocated to the tax-exempt interest.

DNI Mechanism Ensures No Deductions Are Lost

When calculating DNI, there is no adjustment for expenses charged to principal (such as state income taxes on capital gains taxed to the trust or fiduciary fees allocated to principal). Since the starting point for the DNI calculation is the taxable income of the entity before any distribution deduction and without any adjustment for items charged to principal, the income beneficiary receives the full tax benefit (i.e., deduction) of principal expenses when fiduciary accounting income is greater than or equal to DNI. If the entity is an estate or complex trust making no distributions to beneficiaries, the entity itself will receive the tax benefit of deductions allocated to principal.

Example 1C-1 Income beneficiary receives tax benefit from fees charged to principal.

The Ann Smith Testamentary Trust was created to benefit Ann's surviving spouse, Tom, and her daughter, Elizabeth. Tom is to receive income for his life, and Elizabeth will receive the remainder interest after Tom's death. For the current year, the trust has interest income of $10,000; dividend income of $20,000; long-term capital gains of $40,000; and trustee fees amounting to $30,000. The trust document requires that all trustee fees are charged to principal. This treatment results in an advantage for the income beneficiary as follows:

	DNI	Allocated to Income	Allocated to Principal
Interest income	$ 10,000	$ 10,000	
Qualified dividends	20,000	20,000	
Long-term capital gains			$ 40,000
Trustee fees	(30,000)		(30,000)
	$ -0-	$ 30,000	$ 10,000

Tom, as income beneficiary, receives a distribution of $30,000 but reports no taxable income because he has received the tax benefit of the deductible trustee fees, even though the fees were charged to principal. When Elizabeth, the remainder beneficiary, ultimately receives the trust assets, those assets will have been reduced by the fees charged to principal in prior years; however, she will not receive any tax benefit from those fees. She will only receive tax benefit from any fees applicable to the DNI calculation in the year of final distribution.

Similarly, DNI is not adjusted for income items allocated to principal. This could mean that DNI exceeds fiduciary accounting income due to capital transactions or other gross receipts allocated to principal (e.g., receipts of income in respect of a decedent) rather than income. When this occurs, even a simple trust could bear the tax burden (and receive the tax benefits of expenses charged to principal), as demonstrated in Example 1C-2.

Example 1C-2 DNI may exceed fiduciary accounting income.

During the tax year, the preparer of a 2010 Form 1041 for a simple trust reviews the following receipts and other transactions shown on the trust records provided by the trustee bank:

Description of Receipt or Disbursement	Amount of Transaction	
1. 1,000 shares XYZ common stock (gift—basis $1,000)	$ 200,000	(FMV)
2. Decedent's pension (under will—lump sum distribution)	350,000	
3. Cash, ABC stock sale (prior-year gift—basis $1,000)	75,000	(FMV)
4. DEF stock receipt (IRC Sec. 355 spin-off—basis $3,000)	55,000	(FMV)
5. GHI stock (50% stock dividend—basis $200)	10,000	
6. Cash (extraordinary dividend on JKL stock)	13,000	
7. Gross oil royalties (qualifies for percentage depletion)	8,000	
Production tax paid on oil royalty income	(500)	
Property tax paid on producing oil property	(600)	
8. Imputed income on zero-interest term loan received from the decedent's estate	40,000	
9. Cash, sale of business equipment (fully depreciated)	17,000	
10. Fines paid (allocable to income & not reimbursed)	(1,000)	
11. Trustee fee paid (allocable to income)	(3,200)	
12. Trustee fee paid (allocable to principal)	(3,200)	
13. Interest expense paid to IRS for underpayment of income taxes	(1,500)	
14. Legal fee paid to defend trust's title to real property	(3,000)	

The trust document requires a depreciation reserve and requires a depletion reserve equal to the depletion deductible for federal income tax purposes. The trust records indicate the depletion expense for the year

taken by the trustee and the accumulated depreciation and depletion reserve amounts at year-end. There is no depreciation expense for 2010 since the depreciable assets were fully depreciated in prior years. The trust instrument allocates capital gain to trust principal, and the trustee, in good faith, allocated the extraordinary dividend to principal.

After calculating the trust's taxable income (as if there were no distribution deduction), the preparer determines the modifications necessary to reach the DNI for 2010 as follows:

Description of Receipt or Disbursement	Taxable Amount
2. Lump-sum pension distribution is fully taxable (employer contributions)	$ 350,000
3. Stock sale produced capital gain	74,000
6. Extraordinary cash dividend is taxable	13,000
7. Oil royalties are taxable	8,000
Production tax paid is deductible	(500)
Property tax paid is deductible	(600)
Percentage depletion allowed (15%) is deductible	(1,200)
8. Imputed OID income on zero-interest loan is taxable	40,000
9. Section 1245 recapture amount is taxable	17,000
11. Trustee fees allocable to income are deductible (not subject to 2% limit)	(3,200)
12. Trustee fees allocable to principal are deductible (not subject to 2% limit)	(3,200)
Exemption allowed for a trust required to currently distribute all its income	(300)
Taxable income of simple trust (before distribution deduction)	493,000
Adjustments to taxable income required to reach DNI:	
Add back personal exemption	300
Eliminate capital gain	(74,000)
Eliminate extraordinary dividend (principal) paid to simple trust	(13,000)
Distributable net income (DNI)	$ 406,300
(Items 1, 4, 5, 10, 13, and 14 have no income tax effect.)	

Although DNI is $406,300, fiduciary accounting income is zero. When computing fiduciary accounting income, all receipts other than the royalties are allocated to principal, and the royalty income ($8,000) is offset by the production ($500) and property ($600) taxes, depletion ($1,200), fines ($1,000), trustees fee charged against income ($3,200), and interest expense ($1,500). A simple trust is required to distribute all of its fiduciary accounting income but no other amounts of any kind. Since fiduciary accounting income was zero, this simple trust will not be required to make any distributions to the beneficiaries and will pay tax at the trust level on the $493,000 of taxable income.

Computing DNI for Simple Trusts

Distributions of income required to be distributed (or payable) each year are referred to as Tier 1 distributions, as discussed previously. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, before any deduction for charitable contributions.

Example 1C-3 DNI is modified taxable income.

In 2010, its first tax year, the Harold Hollis Family Trust had the following receipts and other transactions:

	Effect on Fiduciary Accounting Income	
Description of Receipt or Disbursement	**Income**	**Principal**
1. Cash from grantor—funding of the trust		$ 250,000
2. ABC Mutual Fund—ordinary cash dividends	$ 4,800	
3. Certificates of deposit—interest received	6,560	
4. DEF Corporate Bond Fund—income received	4,000	
5. Trustee fee paid	(1,360)	

The trust instrument states that "All current income is to be distributed monthly to the income beneficiary, Bill Hollis, while he is alive." Upon Bill's death, the entire principal is to be distributed to Bill's daughter, Betty. The trust instrument does not permit the trustee to make charitable contributions of any kind and allocates capital gain to principal. State law requires a trustee's fee to be charged against trust income.

DNI are calculated as follows:

Description of Receipt or Disbursement	**Taxable Amount**
1. The gift to the trust is not taxable	$ —
2. Ordinary dividends are taxable	4,800
3. CD interest income is taxable	6,560
4. Corporate bond fund income is taxable	4,000
5. The trustee fee is deductible (not subject to 2% of AGI limit)	(1,360)
6. Personal exemption for a trust required to currently distribute its income	(300)
Taxable income of simple trust, before distributions	13,700
Modifications to taxable income required to reach DNI:	
Add back personal exemption	300
Distributable net income (DNI)	$ 14,000

Since fiduciary accounting income is also $14,000, this simple trust is required to distribute $14,000 to the income beneficiary. The trust will obtain a distribution deduction equal to the taxable portion of DNI (also $14,000 in this case since there was no tax-exempt income). Bill, the current income beneficiary, will report $14,000 of gross income on his Form 1040 for 2009.

If the trustee had distributed less than $14,000, the trust would still check the "simple trust" box at the top of Form 1041, page 1, since the trust instrument requires the trustee to distribute all fiduciary accounting income. The Schedule K-1 supplied to the beneficiary would report $14,000 of income, even if an amount less than $14,000 was actually distributed. n this example, DNI equals fiduciary accounting income in Example 17C-3. DNI and fiduciary accounting income can be quite different, even for a simple trust.

Example 1C-4: DNI may not be the same amount as fiduciary accounting income.

Assume in Example 17C-3 that trustee fees were $2,720 and are allocated 50% to income and 50% to principal. In that case, fiduciary accounting income is $14,000 ($4,800 dividends plus $6,560 interest plus $4,000 interest less $1,360 trustee fees). Taxable income before distributions is $12,340 ($4,800 dividends plus $6,560 interest plus $4,000 interest less $2,720 trustee fees less $300 personal exemption). Thus, DNI would be $12,640 ($12,340 taxable income plus $300 personal exemption). Since this is a simple trust, the trustee is required to distribute the $14,000 fiduciary accounting income to the beneficiary. However, the beneficiary's Schedule K-1 only reports $12,640 in income.

Computing DNI for Complex Trusts and Estates

Distributions from complex trusts and estates are classified as either Tier 1 or Tier 2 distributions. Tier 1 distributions are made from income required to be distributed currently. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, computed without any deduction for charitable contributions. Tier 2 distributions consist of other amounts paid or credited or required to be distributed during the tax year (whether from income or principal). The deduction for Tier 2 distributions is limited to the amount of taxable DNI remaining after Tier 1 distributions and deductible charitable contributions.

Example 1C-5 DNI and application of the tier system.

The trust instrument of the Theodore Turner Testamentary Trust provides that $60,000 of its income must be distributed to beneficiary Ty (Tier 1). Any remaining income may either be distributed to beneficiary Ted (Tier 2), given to charity, or accumulated.

The trust has $80,000 of taxable interest income in 2010. There are no other income items and no trust expenses. The trustee distributed the required $60,000 to Ty and made a discretionary distribution of $20,000 to Ted and $100,000 to charity in 2010.

The maximum amount of Ty's (Tier 1) distribution deduction is $80,000, which is the modified taxable DNI (computed without the charitable contribution deduction). Tier 1 distributions receive no benefit of the charitable contribution deduction against DNI. Thus, the deduction for the distribution to Ty is $60,000, the income required to be distributed currently.

When determining the amount of distribution deduction at the trust level and the corresponding income inclusion amount to Ted for the $20,000 distribution, the full charitable contribution is deducted in computing DNI, because the distribution to Ted is discretionary (i.e., a Tier 2 distribution). Ted's distribution is entirely tax-free because there is no remaining DNI to be allocated to Tier 2 beneficiaries after the Tier 1 distribution and charitable deduction are taken into account (i.e., deducted).

Depreciation and Depletion and DNI

According to IRC Sec. 642(e), depreciation and depletion are deductible by an estate or trust only to the extent not allocable to the income beneficiaries. For trusts, unless the controlling instrument or state law requires or permits a reserve to be maintained at the entity level and the trustee actually does so, this type of deduction is apportioned between the trust and the income beneficiaries on the basis of the fiduciary accounting income allocated to each.

When depreciation and depletion deductions are allocated to the income beneficiaries, they are allocated directly and do not flow through to page 1 of Form 1041. Thus, for a trust required to distribute all income currently that does not require or permit a reserve for depreciation or depletion to be maintained, DNI is not reduced by the amount of the depreciation or depletion deductions; rather, the income beneficiaries receive the depreciation and depletion deductions directly via Schedule K-1.

For trusts, if the controlling instrument or local law requires or permits a reserve to be maintained and the trustee does so, the current income beneficiaries may bear the burden of the reserve in the form of reduced distributions since fiduciary accounting income is decreased by the reserve. This will occur in the case of a simple trust, and in the case of a complex trust that makes a distribution based on fiduciary accounting income.

Simultaneous Equations May Be Required

As with individuals, certain deductions by estates and trusts must be reduced by a percentage of adjusted gross income (AGI). A fiduciary's AGI, as defined in IRC Sec. 67(e), is computed net of the income distribution deduction. However, the distribution deduction may be contingent on DNI, and DNI is computed after application of the 2% of AGI floor for miscellaneous itemized deductions, which in turn can only be determined if the distribution deduction is known.

To properly compute both DNI and the deductible portion of miscellaneous itemized deductions, simultaneous equations for the two unknown values are required.

Once DNI is calculated, the various components of income (e.g., ordinary, capital gains, and tax-exempt) must be determined. The character of each item of income will be the same to the beneficiaries as reportable by the estate or trust.

DNI and Capital Gains

Capital Gains Generally Excluded from DNI

Capital gains are not generally included in DNI and "are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." (Thus, any capital gains are taxed to the fiduciary rather than being included in DNI and "carried out" to the beneficiaries.) Under this general rule, gains from the sale or exchange of capital assets are *excluded* from DNI to the extent such gains are:

1. allocated to principal under the terms of the governing instrument or local law by the fiduciary on its books, or by notice to the beneficiary, and
2. not paid, credited, or required to be distributed to any beneficiary during the tax year, or
3. not paid, permanently set aside, or used for charitable purposes.

However, there are certain exceptions of when capital gains are included in DNI.

Example 1D-1 Distributed capital gains are generally not included in DNI.

Under the will of the late John Hill, assets worth $400,000 were transferred into trust for the benefit of Joan Hill. The instrument required that $20,000 be distributed to Joan each year during her lifetime, with any excess of current income accumulated and distributed to Joan's younger brother, Bill, when he reaches age 25. Neither the trust instrument nor state law allocates capital gains to income or gives the trustee the discretionary power to treat distributions that are in excess of ordinary income as being made from capital gains.

In the current year, the trust earned $17,000 in interest and dividends. To satisfy the required $20,000 payment to Joan, the trustee sold some of the trust's stock for a capital gain of $3,000. In satisfaction of its obligation, the trust distributed $20,000 to Joan.

Although the $3,000 capital gain is included in the taxable income of the trust, it is excluded from DNI (i.e., not allocated to Joan) because the gain was (a) allocated to principal, rather than income, for fiduciary accounting purposes, (b) not paid or required to be paid to Joan (although income is required to be distributed, there is no such requirement for capital gains), and (c) not allocated to charity.

On Schedule D, the gain is allocated to the trust (rather than to Joan) in Part III. The gain will flow from Schedule D to page 1 of Form 1041; it will not be reflected on Schedule K-1. On Schedule B, the capital gain is excluded (backed out) from "adjusted total income" (which is taxable income before the distribution deduction, personal exemption, and estate tax deduction) to arrive at DNI. Joan is treated as having received taxable DNI of $17,000 and principal of $3,000.

Capital losses are netted against capital gains at the fiduciary level, except for capital gains used in determining the amount distributed, or required to be distributed, to a particular beneficiary. Thus, if a fiduciary determines that current year capital gains are included in computing the income distributions, such gains will not be available to offset a capital loss carryover.

Specific Bequests. If the fiduciary is required to distribute a specific bequest, any capital gain included in the distribution to satisfy the bequest is not included in DNI, even if made in partial termination of the beneficiary's interest.

Example 1D-2 Capital gains are excluded from DNI if distributed as specific bequest, including a specific dollar amount each year.

Assume the same facts as in Example 1D-1, except the trust instrument requires the trustee to distribute $20,000 a year for 10 years (note that this requirement is for a specific sum of money, rather than an amount

of trust accounting income), before distributing the remainder of the trust assets to Bill. The results are the same as in Example 1D-1, i.e., the capital gain would not be included in DNI.

When Capital Gains Are Included in DNI

There are a number of exceptions to the general rule of excluding capital gains from DNI. Capital gains are *included* in DNI if they are:

1. Specifically allocated to income according to the governing instrument and local law.

2. Exercised according to the fiduciary's reasonable and impartial discretionary power and

   a. allowed by the governing instrument and local law or

   b. made according to the fiduciary's reasonable and impartial discretion as one of the following items, which is authorized in the governing instrument and not prohibited by local law:

      (1) *Fiduciary Accounting Income*. However, if the amount of income is determined by a unitrust amount (e.g., a fixed rate of 4%), the discretionary power must be exercised consistently because a fixed amount of income is determined by the unitrust amount. This exercise of discretionary power has no effect on the amount of the distribution, but on who will be taxed on the capital gains (the beneficiary or fiduciary).

      (2) *Principal but Treated Consistently by the Fiduciary on the Trust's Books, Records, and Tax Returns as Part of a Distribution to a Beneficiary.*

      (3) *Principal but Actually Distributed to the Beneficiary.* Note, however, that the IRS has ruled that there must be a connection specified in the trust instrument between the distribution and a particular event (e.g., termination of the trust, marriage of the beneficiary, or the beneficiary reaching a certain age) for DNI to include capital gains allocated to principal but actually distributed.

      (4) *Principal but Utilized by the Fiduciary in Determining the Amount that Is Distributed or Required to be Distributed to a Beneficiary.*

3. Paid, permanently set aside, or used for charitable purposes [thus producing a charitable deduction under IRC Sec. 642(c)].

If capital gains are included in DNI, but only a portion are distributed to the beneficiaries in the current year, an allocation must be made to determine the amount reportable to the beneficiaries versus the amount taxable to the fiduciary.

If Directed by Governing Instrument and Local Law. Capital gains can be included in DNI if directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in fiduciary income, as defined in IRC Sec. 643(b), is included in DNI.

Example 1D-3 Capital gains properly allocated to income are included in DNI.

Assume the same facts as in Example 1D-1, except that the trust instrument allocates capital gains to income, which is consistent with local law. In this case, the $3,000 capital gain is taxed to Joan. The gain is included on Line 3 of Schedule B and allocated to the beneficiary in Part III of Schedule D.

When fiduciary income is based on a unitrust amount, e.g., a fixed rate of 4%, capital gains are included in DNI according to the governing instrument or local law, which should refer to the sources of income from which the unitrust amount is deemed to be paid. (For example, the provisions may read: "The trustee shall determine the unitrust distribution in accordance with the following ordering rules.") The capital gain allocated to DNI is the extent to which the unitrust amount exceeds DNI, determined without regard to the capital gains.

Example 1D-4 Capital gains are included in DNI when state law defines fiduciary income as a unitrust amount, and the capital gain is a component of the unitrust amount.

Assume the same facts as in Example 1D-1, except that the governing instrument is silent as to how fiduciary income is defined. According to local law, however, the trustee is to pay Joan (the income beneficiary) a unitrust amount of 4% of the annual fair market value of the trust assets. Local law also provides an ordering rule for characterizing the unitrust amount so that it is first considered paid from ordinary income, then from net short-term capital gain (if any), then from net long-term capital gain (if any) and finally from a return of principal. The trustee elects to use the unitrust amount to determine what to pay Joan.

At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, the Trust receives $5,000 of dividend income and realizes $80,000 of net long-term capital gain from the sale of ABC stock. The trustee distributes $20,000 to Joan (4% of $500,000) in satisfaction of her right to income. Of the $20,000 unitrust distribution, $5,000 is allocated to ordinary income and $15,000 is allocated to net long-term capital gain according to the state law's ordering rules. Thus, the $15,000 capital gain is included in the Trust's DNI for the year, which is then "carried out" to Joan. The remaining $65,000 capital gain ($80,000 − $15,000) is excluded from DNI and is taxed entirely to the Trust.

If Allowed by Discretionary Power. Capital gains can also be allocated to DNI if a fiduciary, according to a discretionary power granted by local law or the governing instrument (if not inconsistent with local law), reasonably and impartially treats the capital gains as income. For example, if a fiduciary exercises a discretionary power to consistently treat any distribution in excess of ordinary income as being made from realized capital gains, such distributions of capital gains are included in DNI.

A "consistent practice" is determined by how the capital gains are classified in the first year the estate or trust reports them. However, Rev. Rul. 68-392 takes the position that distributions of capital gains cannot be included in DNI in the first year the estate or trust reports capital gains because first-year distributions are not part of a "regular practice" of distributing capital gains (i.e., only capital gain distributions in later years could qualify). In the opinion of this course, the revenue ruling extends beyond the scope of the Code and existing regulations.

Example 1D-5 Capital gains are included in DNI if trustee exercises power to treat discretionary distributions of principal as being paid from income.

According to the terms of the Keller Trust's governing instrument, all income is to be paid to Sam for the trust term, with the remainder payable to Matt. The trust instrument gives the trustee (Sam's aunt, Dottie) discretionary powers (in a provision not prohibited by law) to invade principal as needed for Sam's benefit and to treat such distributions as being made from capital gains realized during the year.

During its first taxable year, the Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of ABC stock. According to the terms of the trust instrument and applicable local law, Dottie allocates the $10,000 capital gain to income. During the year, she distributes $17,000 to Sam, consisting of the trust income ($5,000) and a discretionary distribution of principal ($12,000). However, Dottie decides to treat the discretionary distributions of principal as being paid from income during the year. Therefore, the realized capital gains are included in DNI and are taxed entirely to Sam.

Note that Dottie must be consistent from year to year in her choice to exercise (or to not exercise) her power to treat discretionary distributions as being made from realized capital gains. Dottie's choice to exercise her power in the Trust's first year apparently establishes a precedent for the same treatment in successive years. However, she should be able to file amended fiduciary income tax returns if, in future years, she believes she made the wrong choice.

If the fiduciary income is based on a unitrust amount, e.g., a fixed rate of 4%, and the governing instrument or local law includes discretionary language for ordering ("the trustee may determine . . . ."), the fiduciary may decide whether to include capital gains in DNI, but the fiduciary's exercise of discretion must be used consistently from year to year. The amount allocated may not be greater than the excess of the unitrust amount over the DNI determined without the capital gain.

Example 1D-6 Capital gains are included in DNI when state law defines fiduciary income as a unitrust amount, and the trustee exercises discretionary power to treat the capital gain component of the unitrust amount as income.

Assume the same facts as in Example 1D-5, except that there is no ordering rule in the trust instrument or state law, but leaves that to the trustee's discretion. The trustee intends to consistently treat the excess of the 4% unitrust amount over ordinary income as income.

Thus, the entire $10,000 of net long-term capital gain will be included in DNI, so that it is taxed entirely to Sam, rather than by the trust. Sam is taxed only on $5,000 ordinary income. In future years, the trustee must follow this same treatment on all realized capital gains.

If Used To Determine Amount of Distribution. If the capital gain is allocated to principal but actually distributed to the beneficiary or used to determine the amount distributed or required to be distributed, according to the terms of the governing instrument or the customary practice of the fiduciary, the gain is included in DNI.

Example 1D-7 Capital gains are included in DNI when allocated to principal but used to determine the amount that is to be distributed to the beneficiary.

Assume the same facts as in Example 1D-5, except that Dottie decides that discretionary distributions of principal will be made only if the Trust has realized capital gains during the year and capital gains are allocated to principal under the trust instrument. The discretionary distribution to Sam is $10,000, rather than $12,000. Because Dottie will consistently use the amount of any realized capital gain to determine the amount of the discretionary distribution to Sam, the $10,000 capital gain is included in the Trust's DNI for the taxable year. Thus, Sam, rather than the trust, will be taxed on the capital gain.

Example 1D-8 Capital gains are included in DNI if sale proceeds determine the amount of the required distribution to the beneficiary.

The Kramer Trust is required by the trust instrument to hold closely held stock for 12 years, then sell it and distribute all net proceeds to Ryan Kramer. Since the trustee must use the sales proceeds, which include realized capital gains, to determine the amount of the distributions to Ryan, the capital gains are included in DNI and are taxed to Ryan.

If Distributed as Partial or Complete Termination. Capital gains are included in DNI if they are allocated to principal but distributed to the beneficiaries in partial or complete liquidation of the beneficiary's interest.

Example 1D-9 Capital gains are included in DNI if made in partial or complete termination of beneficiary's interest in the trust.

Assume the same facts as in Example 1D-8, except that all income is to be paid to Ryan during the trust's term. Upon attaining age 35, Ryan is to receive one-half of the trust assets, with the balance to be distributed when he reaches age 45. If the trustee sells half of the stock and distributes the net sale proceeds to Ryan, all the capital gain on that sale is included in DNI and taxed to Ryan.

If the trustee sells all of the stock and distributes the required one-half of the sales proceeds to Ryan when he reaches age 35, the trustee may, if authorized by the governing instrument and state law, determine how much of the capital gain is distributed to Ryan, up to a maximum of the total capital gain amount. If not authorized by the governing instrument and state law, only one-half of the capital gain on the sale can be included in DNI, since that is the amount actually distributed to Ryan.

Variation: If the trust had required that all of the trust assets were to be distributed to Ryan upon his attaining age 35, all capital gains realized in the trust's final year are included in DNI and taxed to Ryan.

Short-term Capital Gains and DNI

Although IRC Sec. 643(a)(3) does not distinguish between the treatment of short-term and long-term capital gain, the IRS has held that ordinary dividends from a regulated investment company are included in DNI even if they consist of short-term capital gain not includible in DNI under the provisions of IRC Sec. 643(a)(3).

Example 1D-10 Short-term capital gain distributions and DNI.

A newly-created testamentary trust requires that the trust's "net income" be paid annually to the income beneficiary for life. The trust instrument contains no provision regarding capital gain. The trustee has invested the principal in equity funds and income funds that qualify as regulated investment companies ("mutual funds").

The trust's total cash dividend payments from the regulated investment companies during the year totaled $15,000, consisting of "capital gain dividends" of $5,000 and "ordinary dividends" of $10,000. Based upon the supplemental information provided by the investment companies, the trustee determines that $6,000 of the $10,000 "ordinary dividend" amount is short-term capital gain income. The trust has no expenses. Fiduciary accounting income is determined to be $4,000 under the general rule that fiduciary accounting income does not include capital gain (regardless of the holding period of the asset).

IRC Sec. 643(a)(3) establishes a uniform standard on whether or not capital gain recognized by the trust is included in DNI and requires the capital gain income of this trust to be excluded from DNI. However, a regulated investment company's ordinary dividend distribution, including any portion derived from short-term capital gain realized, is considered a dividend from a corporation that is ordinary income in its entirety and is thus includible in DNI.

DNI of the trust is therefore $10,000, the entire amount of the ordinary income distribution, even though $6,000 of the $10,000 is short-term capital gain. Because the trustee is required to distribute the trust "net income" (i.e., the annual net fiduciary accounting income) to the income beneficiary, $4,000 is distributed to that person. This results in a distribution deduction of the same amount, leaving both the $5,000 of "capital gain dividends" to be treated by the trust as long-term capital gain under the provisions of IRC Sec. 1222(11) and the $6,000 of short-term capital gain income to be taxed at the trust level.

SELF-STUDY QUIZ

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

5. In 2010, the Justin Mills Trust has $5,000 of dividend income, $7,000 of taxable interest income, $3,000 of tax-exempt interest income, and $500 of trustee's fees. The trustee's fees are allocated to income, and all income is required to be distributed currently. Calculate the trust's DNI.

   a. $11,500.

   b. $12,000.

   c. $14,500.

   d. $15,000.

6. Assume the same details as in the question above. What is the trust's distribution deduction?

   a. $11,500.

   b. $12,000.

   c. $14,500.

   d. $15,000.

7. Which of the following is a modification made to taxable income when computing a domestic estate or trust's DNI?

   a. All capital gains and losses must be excluded from DNI.

   b. Distributions made to beneficiaries are deducted from DNI.

   c. The personal exemption amount is deducted from DNI.

   d. Net tax-exempt interest is included in DNI.

8. A trust receives the following in 2010:

Interest income:	$ 30,000
Qualified dividends:	50,000
Long-term capital gains:	110,000
Trustee's fees:	80,000

   Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal.

   a. DNI: $80,000; Income: $30,000; Principal: $50,000.

   b. DNI: $30,000; Income: $0; Principal: $80,000.

   c. DNI: $0; Income: $80,000; Principal: $30,000.

   d. DNI: $0; Income: $110,000; Principal: $80,000.

9. Due to a series of capital transactions, a simple trust's DNI exceeds its fiduciary accounting income. For the tax year, the trust's DNI is $47,000, but its fiduciary income is zero. What are the consequences of these results?

    a. The trust is required to distribute the $47,000 to the beneficiaries.

    b. The trust will pay tax at the trust level on the $47,000.

    c. The lack of fiduciary accounting income changes the trust to a complex trust.

    d. The trust is forced to use a depreciation reserve.

10. When dealing with a complex trust, which of the following would be considered a Tier 2 distribution?

    a. An income distribution to a beneficiary required by the trust document.

    b. A distribution limited to the taxable portion of DNI.

    c. A distribution made to a beneficiary at the trustee's discretion.

    d. A distribution made from income required to be distributed currently.

11. Which of the following statements about the relationship of depreciation and depletion to DNI is true?

    a. Estates or trusts only deduct depreciation and depletion to the extent it is not allocable to beneficiaries.

    b. Neither trusts nor estates can maintain a reserve to address the depreciation and depletion deduction.

    c. Depreciation and depletion deductions flow to income beneficiaries by the beneficiary's receipt of Form 1041.

    d. DNI is always reduced by the amount of the depreciation or depletion deduction.

12. When Casey dies, his will instructs assets to be placed in a trust for his daughter, Deana, and requires $10,000 to be distributed to her every year during her lifetime with any excess income distributed to charity. In 2010, the trust only earns $9,000 in interest and dividends, so the trustee sells trust stock for a capital gain of $1,000 to complete the annual distribution to Deana. What are the consequences of this action?

    a. Deana will report $10,000 of DNI for 2010.

    b. The capital gain is included in the trust's taxable income.

    c. The capital gain is allocated to income.

13. Assume the same details as the question above; however, the governing instrument is silent about how to define fiduciary income. Under local law, the trustee must pay Deana a unitrust amount that equals 4% of the annual fair market value (FMV) of the trust's assets. Under the law, the unitrust amount is first considered paid from ordinary income, then from long-term capital gain, and then from a return of principal. The trustee uses the unitrust amount to determine what to pay Deana. In 2010, the trust's assets are valued at $250,000. During the year, the trust receives $3,000 of dividend income and $15,000 of net long-term capital gain from the sale of stock. What will happen after the trust distributes the annual $10,000 distribution to Deana?

    a. All $10,000 will be allocated to the net long-term capital gain.

    b. The trust must distribute all $15,000 of the capital gain to Deana.

    c. All $15,000 of the capital gain is taxed entirely to the trust.

    d. $7,000 of the capital gain is included in DNI and carried out to Deana.

SELF-STUDY ANSWERS

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

5. In 2010, the Justin Mills Trust has $5,000 of dividend income, $7,000 of taxable interest income, $3,000 of tax-exempt interest income, and $500 of trustee's fees. The trustee's fees are allocated to income, and all income is required to be distributed currently. Calculate the trust's DNI. **(Page 120)**

   a. $11,500. [This answer is incorrect. If the trust had no tax-exempt interest in 2010, this would be the correct amount of DNI.]

   b. $12,000. [This answer is incorrect. Neither the trustee's fees nor the tax-exempt interest were addressed correctly in this calculation.]

   c. $14,500. [This answer is correct. DNI is calculated as the dividend income ($5,000), plus the taxable interest income ($7,000), plus the tax-exempt interest income ($3,000), minus the trustee's fees.]

   d. $15,000. [This answer is incorrect. If the trustee's fees had been allocated to principal instead of income, this would be the correct DNI amount.]

6. Assume the same details as in the question above. What is the trust's distribution deduction? **(Page 120)**

   a. $11,500. [This answer is correct. Though DNI includes the tax-exempt income, the distribution deduction is limited to the taxable portion of DNI; therefore, the calculation would be $5,000 + $7,000 − $500 = $11,500.]

   b. $12,000. [This answer is incorrect. If the trustee's fees had been allocated to principal instead of to income, this would be the correct distribution deduction.]

   c. $14,500. [This answer is incorrect. If all of the interest income in the scenario were taxable, the DNI and the distribution deduction would be the same; however, that is not the case in this scenario.]

   d. $15,000. [This answer is incorrect. Neither the tax-exempt interest income nor the trustee's fees were correctly dealt with in this calculation.]

7. Which of the following is a modification made to taxable income when computing a domestic estate or trust's DNI? **(Page 121)**

   a. All capital gains and losses must be excluded from DNI. [This answer is incorrect. As stated in IRC Sec. 643(a); Reg. 1.643(a)-3, generally, capital gains are excluded from DNI, but there are some exceptions. Capital losses are excluded except to the extent that they must be taken into account to determine the amount of gain from the sale or exchange of capital assets credited, paid, or required to be distributed during the tax year to the beneficiary.]

   b. Distributions made to beneficiaries are deducted from DNI. [This answer is incorrect. As stated in IRC Sec. 643(a); Reg. 1.643(a)-3, when calculating DNI, no deduction is allowed for distributions to beneficiaries.]

   c. The personal exemption amount is deducted from DNI. [This answer is incorrect. As stated in IRC Sec. 643(a); Reg. 1.643(a)-3, in the DNI calculation, no deduction is allowed for the personal exemption. That amount must be added back to the taxable income.]

   d. Net tax-exempt interest is included in DNI. [This answer is correct. To calculate net tax-exempt interest, the gross tax-exempt interest income is reduced by any tax-exempt interest paid or set aside for charity and also by other deductible expenses allocated to the tax-exempt interest (such as trustee fees) per IRC Sec. 643(a); Reg. 1.643(a)-3.]

8. A trust receives the following in 2010:

Interest income:	$ 30,000
Qualified dividends:	50,000
Long-term capital gains:	110,000
Trustee's fees:	80,000

Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal. **(Page 121)**

a. DNI: $80,000; Income: $30,000; Principal: $50,000. [This answer is incorrect. Though the interest income figures into the calculation of the allocated income, there is more that must be considered. Similarly, though the trustee fees are considered in the DNI calculation, other amounts must also be taken into account. The qualified dividend amount is not part of the calculation of allocated principal.]

b. DNI: $30,000; Income: $0; Principal: $80,000. [This answer is incorrect. Though the interest income would be considered in the DNI calculation, other amounts would figure into the calculation, as well. The trustee fees would not be considered allocated principal, and based on the amounts in this scenario, there would be allocated income.]

c. DNI: $0; Income: $80,000; Principal: $30,000. [This answer is correct. Because the interest income and the qualified dividends are equal to the trustee fees, there is no DNI. Allocated income is determined by adding the interest income and the qualified dividends. Allocated principal is the long-term capital gains minus the trustee fees.]

d. DNI: $0; Income: $110,000; Principal: $80,000. [This answer is incorrect. All of the long-term capital gains would not be allocated income, and neither the trustee fees nor the total of the interest income and the qualified dividends would be considered allocated principal.]

9. Due to a series of capital transactions, a simple trust's DNI exceeds its fiduciary accounting income. For the tax year, the trust's DNI is $47,000, but its fiduciary income is zero. What are the consequences of these results? **(Page 121)**

a. The trust is required to distribute the $47,000 to the beneficiaries. [This answer is incorrect. A simple trust is only required to distribute its fiduciary income, and that amount was zero in this scenario; therefore, the trust is not required to make a distribution to its beneficiaries during this tax year.]

b. The trust will pay tax at the trust level on the $47,000. [This answer is correct. When DNI exceeds fiduciary accounting income, the trust bears the tax burden, as well as receives the tax benefits of expenses charged to principal.]

c. The lack of fiduciary accounting income changes the trust to a complex trust. [This answer is incorrect. DNI exceeding fiduciary accounting income will not cause the trust to convert from a simple trust to a complex trust. A simple trust could bear the tax burden if DNI exceeds fiduciary accounting income due to capital transactions or other gross receipts allocated to principal (e.g., receipts of income in respect of a decedent) rather than income.]

d. The trust is forced to use a depreciation reserve. [This answer is incorrect. A depreciation reserve must be required by the trust document—it is not an automatic requirement when DNI exceeds fiduciary accounting income.]

10. When dealing with a complex trust, which of the following would be considered a Tier 2 distribution? **(Page 121)**

a. An income distribution to a beneficiary required by the trust document. [This answer is incorrect. As stated in IRC Sec. 662(a)(1), this distribution is required to be distributed currently and it comes from income; therefore, it is a Tier 1 distribution.]

b. A distribution limited to the taxable portion of DNI. [This answer is incorrect. As stated in IRC Sec. 662(a)(1), the distribution deduction for a Tier 1 distribution is limited to the taxable portion of DNI.]

c. A distribution made to a beneficiary at the trustee's discretion. [This answer is correct. Another example of a Tier 2 distribution would be a distribution to charity made at the trustee's discretion. Tier 2 distributions are other amounts paid, credited, or required to be distributed during the year either from income or principal.]

d. A distribution made from income required to be distributed currently. [This answer is incorrect. A Tier 1 distribution is made from income required to be distributed currently per IRC Sec. 662(a)(1).]

11. Which of the following statements about the relationship of depreciation and depletion to DNI is true? **(Page 126)**

a. Estates or trusts only deduct depreciation and depletion to the extent it is not allocable to beneficiaries. [This answer is correct. Under IRC Sec. 642(e), this is the correct way for estates and trusts to deal with any depreciation or depletion deduction.]

b. Neither trusts nor estates can maintain a reserve to address the depreciation and depletion deduction. [This answer is incorrect. Trusts are allowed to maintain such a reserve if either state law or the controlling instrument requires or permits such a reserve. If the trustee actually maintains such a reserve, the depreciation and depletion deduction will then be apportioned between the trust and the income beneficiaries on a fiduciary accounting income basis.]

c. Depreciation and depletion deductions flow to income beneficiaries by the beneficiary's receipt of Form 1041. [This answer is incorrect. Such deductions are allocated directly to income beneficiaries, so they receive the deductions directly on the Schedule K-1.]

d. DNI is always reduced by the amount of the depreciation or depletion deduction. [This answer is incorrect. If a trust is required to distribute all of its income currently and does not have a reserve for depreciation or depletion, the DNI will not be reduced by the amount of any depreciation or depletion deductions.]

12. When Casey dies, his will instructs assets to be placed in a trust for his daughter, Deana, and requires $10,000 to be distributed to her every year during her lifetime with any excess income distributed to charity. In 2010, the trust only earns $9,000 in interest and dividends, so the trustee sells trust stock for a capital gain of $1,000 to complete the annual distribution to Deana. What are the consequences of this action? **(Page 126)**

a. Deana will report $10,000 of DNI for 2010. [This answer is incorrect. The $1,000 of capital gain would be excluded from DNI; therefore, it will not be reflected on Deana's Schedule K-1. Deana will only report DNI of $9,000 per IRS regulations.]

b. The capital gain is included in the trust's taxable income. [This answer is correct. The $1,000 of capital gain is included in the trust's taxable income; however, it will be excluded from DNI per IRS regulations.]

c. The capital gain is allocated to income. [This answer is incorrect. Because stock had to be sold to earn the $1,000, the capital gain is allocated to principal, not income per IRS regulation.]

13. Assume the same details as the question above; however, the governing instrument is silent about how to define fiduciary income. Under local law, the trustee must pay Deana a unitrust amount that equals 4% of the annual fair market value (FMV) of the trust's assets. Under the law, the unitrust amount is first considered paid from ordinary income, then from long-term capital gain, and then from a return of principal. The trustee uses the unitrust amount to determine what to pay Deana. In 2010, the trust's assets are valued at $250,000. During the year, the trust receives $3,000 of dividend income and $15,000 of net long-term capital gain from the sale of stock. What will happen after the trust distributes the annual $10,000 distribution to Deana? **(Page 126)**

a. All $10,000 will be allocated to the net long-term capital gain. [This answer is incorrect. Under local law, the first $3,000 of the annual distribution is allocated to the dividend income received by the trust in 2010 per IRS regulations.]

b. The trust must distribute all $15,000 of the capital gain to Deana. [This answer is incorrect. Only 4% of the FMV of the trust's assets is a required payment to Deana as the unitrust amount. The rest of the capital gain is not a required distribution per IRS regulations.]

c. All $15,000 of the capital gain is taxed entirely to the trust. [This answer is incorrect. Only $8,000 of the capital gain is taxed entirely to the trust due to the requirements of local law for the unitrust amount per IRS regulations.]

d. $7,000 of the capital gain is included in DNI and carried out to Deana. [This answer is correct. The $7,000 of capital gain that is allocable to Deana's annual distribution (after the $3,000 of dividend income is accounted for) will be included in the trust's DNI (and, thus, carried out to Deana) per IRS regulations.]

Distribution Deduction for Simple Trusts

Overview of Allowable Distribution Deduction Rules

If the terms of a trust governing a particular tax year (1) require all "income" to be distributed to the beneficiaries currently, and (2) do not provide for any amounts to be paid, permanently set aside, or used for charitable purposes, and if the trust makes no distributions other than of current income during the year, the trust is classified as a "simple" trust for that tax year. Income, for this purpose, is fiduciary accounting income.

For simple trusts, an income distribution deduction is allowed, generally in the amount of the taxable portion of income required to be distributed for that year. However, the deduction is limited to the taxable portion of the trust's DNI.

Income does not actually have to be distributed to beneficiaries in order for a simple trust to claim the income distribution deduction. The important consideration is whether the fiduciary is under a duty to distribute the income currently, even if, as a practical matter, the income is not distributed until after the close of the trust's taxable year.

Example 1E-1 Income distribution requirement, rather than actual payment, is determining factor for a simple trust.

Jed Stewart is the beneficiary of a trust created by his deceased father. The trust agreement requires all income to be distributed currently to Jed during his lifetime. In 2010, the trustee notified Jed that the current income was available to him. However, the income was never actually distributed by the trustee, and Jed never disclaimed, renounced, or made any other effective assignment of his rights under the trust.

Even though the trust's income for 2010 was never distributed, the trust is entitled to an income distribution deduction on its 2010 Form 1041. In addition, Jed is required to report the income deemed distributed from the trust on his 2010 Form 1040. Under an identical fact pattern, the Tax Court ruled that an individual taxpayer who was a beneficiary of a simple trust was in constructive receipt of the trust's income and was liable for additional tax and penalties for negligent or intentional disregard of the rules and regulations.

If all income is required to be distributed currently, a trust otherwise qualifying as a simple trust will not lose that status merely because the trustee has the discretion to distribute (i.e., sprinkle) the income among a class of beneficiaries or among named beneficiaries as he or she sees fit.

Example 1E-2 Sprinkling power of trustee does not affect simple trust status.

The Fox Children's Trust requires the trustee to distribute all income among the three Fox children each year as he, in his sole discretion, sees fit.

Even though the amount distributable to a particular beneficiary is unknown until the trustee exercises his discretion, the trust is still a simple trust. It is irrelevant that the amount of income allocated to a particular beneficiary is not specified in the instrument, as long as all income is required to be distributed currently.

A trust's classification as a simple trust does not change if the trust instrument also grants the fiduciary the discretion to invade trust principal for the benefit of a beneficiary, provided that if a distribution of trust principal is made for the year in question, it does not exceed current income. However, if the trust instrument grants the power to accumulate income, the trust is not a simple trust for that year even though all income is distributed. In other words, the power to distribute amounts in excess of the required income is fatal to simple trust status only if exercised, but the power to accumulate income causes a trust to be complex even if that power is not exercised.

Example 1E-3 Trust classification may change from complex to simple.

Brenda Lane established a trust for her son, Ted. The trust document specifies that the fiduciary may accumulate income until Ted reaches the age of 40. Thereafter, income must be distributed currently. The trust is a complex trust until Ted reaches the age of 40, and it is a simple trust for subsequent taxable years, unless amounts other than income are distributed.

If a trust instrument requires that a reserve for depreciation be maintained, the charge to fiduciary accounting income for that purpose will not disqualify the trust from being a simple trust.

A trust entitled to a charitable contribution deduction in a given year is not a simple trust for that year. However, a trust with a remainder to a charitable organization generally is not disqualified as a simple trust for any year in which it does not claim a charitable deduction.

An otherwise "simple" trust becomes a complex trust in the year of termination, since it is distributing principal.

Meaning of the Unmodified Word "Income" in a Trust/Estate Context

The word *income* when used in the Internal Revenue Code in conjunction with the income taxation of estates and trusts, if not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means fiduciary accounting income. Fiduciary accounting income (also called "trust accounting income") is the income of the estate or trust determined according to the terms of the governing instrument and local (usually state) law.

Meaning of the Term *Fiduciary Accounting Income*

Generally, fiduciary accounting income may be thought of as the "fruit" (income) that grows from one or more "trees" (assets) after the settlor or grantor (donor) transfers them to the trust. Expenditures closely associated with producing income are charged against the particular type of income. Expenditures closely associated with the assets in the body (or principal) of the trust, are generally charged to the particular asset (principal) and not against income.

Although fiduciary accounting income is more of a common law than an income tax concept, it is important in determining which entity bears the income tax liability associated with the fiduciary's income. If there is any doubt when determining fiduciary accounting income as to whether a particular receipt is income or principal (or whether a given expenditure is chargeable to income or principal), the controlling instrument and the particular state's Principal and Income Act should be consulted.

The creator of a trust may specify the fiduciary accounting rules applying to the trust. However, if the provisions depart fundamentally from local law in the determination of what is income, they will be ignored for tax purposes. A decedent may do the same for an estate by means of language in the will.

Income Distributions in the Form of Property

A simple trust may distribute property in satisfaction of the income beneficiary's right to receive all income currently and still retain classification as a simple trust if no amount in excess of fiduciary accounting income is distributed during the year. The trust claims an income distribution deduction for the income required to be distributed, limited to DNI. However, because the trust is treated as having sold the property for its fair market value on the date of distribution, the trust must recognize gain on the distribution. No loss would be allowed because of the related party rules under IRC Sec. 267(b). The beneficiary of the simple trust takes the property with a basis equal to fair market value. The results would be the same for property distributed in satisfaction of income required to be distributed (i.e., Tier 1) from a complex trust.

Example 1E-4 Property distributions by simple trusts.

Hillary Hartman is the current income beneficiary of the Harvey Hartman Testamentary Trust. The trust instrument requires all income to be distributed to Hillary each year, and makes no allowance for charitable contributions. In 2010, the trust had $40,000 of gross income. In lieu of cash, the trustee distributed stock worth $40,000 (with a basis to the trust of $25,000) to Hillary.

The distribution of the stock is treated as if the trustee had distributed $40,000 cash to Hillary, who in turn purchased the stock from the trustee with the cash at fair market value. The trust is allowed an income distribution deduction of $40,000, and Hillary will include $40,000 in gross income on her personal return. In addition, the transfer of the stock in satisfaction of the beneficiary's right to receive all current income results in a $15,000 capital gain to the trust ($40,000 − $25,000). The basis of the stock to Hillary is the price she is deemed to have paid for it ($40,000).

Different rules apply for property distributions from complex trusts and estates.

Effect of Depreciation Reserve

If the trust instrument requires or permits the trustee to retain a reasonable reserve for depreciation, retention of current income for that purpose will not prevent the trust from being a simple trust. Funding an annual reserve decreases the amount of cash flow to the income beneficiaries of a simple trust, since depreciation expense reduces trust accounting income when reserves are funded.

Computing the Distribution Deduction for a Simple Trust

Once a trust has been classified as a simple trust, the tax return preparer will need to determine the amount of the income distribution deduction. This determination can be broken down into four distinct steps:

1. Determine fiduciary accounting income, the amount required to be distributed currently.

2. Calculate distributable net income (DNI), which is the upper limit on the amount of the distribution deduction.

3. Compute the actual distribution deduction, in light of steps 1 and 2 above, after adjusting for nontaxable income and related expenses.

4. Determine the character of the income distributed to the beneficiaries (e.g., interest, dividends, etc.).

Example 1E-5 Simple trust's distribution deduction: Step 1—trust accounting income.

The Jack Jones Testamentary Trust is required to distribute currently all its income to Janice Jones. Capital gains are allocated to principal by the trust instrument. The trust instrument and state law neither require nor permit a depreciation reserve.

During 2010, the trust had the following income and expenses:

Business income	$ 25,000
Qualified dividends	50,000
Tax-exempt interest income	25,000
Long-term capital gain	15,000
Tax depreciation expense	(5,000)
Other business expenses	(5,000)
Trustee fee allocated to income	(2,600)
Trustee fee allocated to principal	(1,300)
Subtotal	101,100
Adjustments to calculate fiduciary accounting income:	
Eliminate capital gains allocable to principal	(15,000)
Add back depreciation expense	5,000
Add back trustee fee allocated to principal	1,300
Fiduciary accounting income	$ 92,400

Capital gains are not part of fiduciary accounting income because the trust instrument specifies that capital gains are allocable to principal. Similarly, the trustee fee allocated to principal is not deducted in reaching fiduciary accounting income. Depreciation expense is not allowed as a deduction in reaching fiduciary accounting income since the trust document neither requires nor permits a reserve for depreciation. The tax depreciation will be allocated to the beneficiary (because all income is required to be distributed) directly on Schedule K-1, bypassing Form 1041 entirely. The preparer confirms from the records that $92,400 was distributed to Janice Jones.

Fiduciary accounting income must be calculated to determine a simple trust's distribution deduction, since fiduciary accounting income, not DNI, is the amount required to be distributed. If fiduciary accounting income is less than DNI, not all DNI would be distributed, limiting the distribution deduction and causing the simple trust to be subject to tax. Such excess DNI is sometimes referred to as "phantom income."

Once fiduciary accounting income has been determined, the second step is to compute DNI, the maximum amount that can be deducted.

Example 1E-6 Simple trust's distribution deduction: Step 2—DNI.

Assuming the same facts as in Example 1E-5, the preparer calculates the trust's DNI as:

Business income		$ 25,000
Qualified dividends		50,000
Tax-exempt interest income	$ 25,000	
Less: expenses allocated to tax-exempt income ($25,000 ÷ $100,000) × $3,900	(975)	24,025
Other business expenses		(5,000)
Deductible trustee fees ($3,900 − $975)		(2,925)
Distributable net income		$ 91,100

Capital gains are excluded from DNI. The $3,900 amount is the total trustee fees from Example 1E-5 since both components of the fee are deductible for tax purposes (to the extent not allocated to tax-exempt income). Since capital gains are excluded from DNI, they are also excluded from the denominator of the fraction used to allocate a portion of the trustee fee to tax-exempt income ($100,000 is the total of all income items included in DNI).

Since all of the income of the trust is required to be distributed currently, the tax depreciation expense is directly allocated to the beneficiary, and no depreciation deduction is allowable in calculating DNI (in the absence of provisions in the governing instrument requiring depreciation reserves to be maintained).

After fiduciary accounting income and distributable net income have been computed, the third step is to determine the deduction for distribution of current income. Schedule B (Form 1041) is again used for reporting purposes.

Example 1E-7 Simple trust's distribution deduction: Step 3—"taxable" DNI.

Using the facts in Examples 1E-5 and 1E-6, the simple trust will receive a deduction for the taxable portion of DNI, that is, DNI less tax-exempt income, net of the expenses allocated to it:

DNI (determined in Example 1E-6)		$ 91,100
Less:		
Tax-exempt interest income (TEI)	$ 25,000	
Expenses allocated to TEI (Example 1E-6)	(975)	(24,025)
Taxable DNI		$ 67,075

Since fiduciary accounting income, less net tax-exempt income ($92,400 − $24,025 = $68,375), exceeds taxable DNI ($67,075), the distribution deduction is limited to the taxable portion of DNI (although $92,400, the fiduciary accounting income, will actually be distributed to the beneficiary).

Finally, the fourth step is to determine how distributions are characterized to beneficiaries.

Amounts Taxable to Beneficiaries of Simple Trusts

The beneficiary of a simple trust must include in gross income the amount of fiduciary accounting income required to be distributed to the extent of the taxable portion of DNI, i.e., the lesser of fiduciary accounting income required to be distributed or taxable DNI. This is true whether or not it is actually distributed. A beneficiary of a simple trust is never taxed on more than the fiduciary accounting income required to be distributed, but could be taxed on less if DNI is less.

Distribution Deduction for Estates and Complex Trusts

Overview of Allowable Distribution Deduction Rules

Estates and complex trusts are allowed to deduct distributions to beneficiaries. All trusts that are not simple trusts are classified as complex trusts. Thus, if a trust is allowed to accumulate income, claims a charitable contribution deduction, or makes a distribution of principal in excess of required income, it is a complex trust.

A trust instrument may authorize distribution of principal under certain circumstances or at the trustee's discretion (perhaps limited by specific standards). In those years the trust distributes principal in excess of required income, it is a complex trust, even if it is a simple trust in other years.

Schedule B, the income distribution deduction schedule on page 2 of Form 1041, in keeping with the statutory scheme of IRC Sec. 661, specifies that income required to be distributed currently is stated separately from any other amounts paid, credited, or required to be distributed. The sum of these two components is the total distribution, which is deductible up to the amount of taxable distributable net income (DNI).

Example 1F-1 Complex trusts and estates may accumulate income.

ABC Trust's current year DNI and fiduciary accounting income both equal $35,000 and consist of $15,000 in dividends, $25,000 of taxable interest income, and $5,000 of trustee fees chargeable to trust income. There were no distributions.

The trust instrument states that distributions of income are subject to the trustee's discretion. The trust is a complex trust, since all income is not required to be distributed currently. Thus, it was entirely permissible for the trustee to accumulate the entire $35,000 the current year, distributing nothing to the income beneficiary. Alternatively, the trust could have distributed the entire $35,000 or some lesser amount.

The trust instrument of a complex trust can require any amount to be distributed to the beneficiary each year, even if that amount exceeded the trust's income. The trust instrument can also give the trustee discretion to distribute or accumulate any fiduciary accounting income in excess of the stated amount. The distribution powers that can legally be granted a trustee are very flexible. Note, however, that different powers have different income or transfer tax consequences associated with them.

The distribution deduction on Schedule B should not include amounts paid to a charitable organization. This is because amounts distributed to a charity from income or principal are deducted on Schedule A of Form 1041, to the extent they are included in DNI. If the amounts paid to charity are not included in DNI, neither a charitable contribution nor distribution deduction is available. Thus, an estate or trust should not issue a Schedule K-1 to a charitable organization to report a distribution of income or principal.

Two Tiers of Distributions Exist for Complex Trusts and Estates

Estates and complex trusts are allowed a deduction in computing taxable income equal to the sum of two components after adjusting for tax-exempt income and related expenses:

1. the amount of income required to be distributed currently under the terms of the governing instrument or local law (whether distributed or not), plus

2. any other amounts properly paid or credited to, or required to be distributed to, the beneficiaries for the tax year, to the extent the total deduction does not exceed the taxable portion of distributable net income (DNI).

Tier 1 Distributions. Distributions of the first component are called *Tier 1* distributions and include any amount required to be distributed that may be paid out of income or principal (such as an annuity), to the extent it is actually

paid out of income for the tax year. The deductible amount of a Tier 1 distribution is limited to the taxable portion of DNI, computed without any deduction for charitable contributions.

Tier 2 Distributions. Distributions of the second component are called *Tier 2* distributions and generally include "proper" payments of income not required to be distributed currently and distributions of principal, whether required or discretionary. Distributions from estates are nearly always Tier 2 distributions, since the executor has discretion in distributing income and principal, paying debts and claims, and marshaling estate assets. Tier 2 distributions are referred to on Schedule B of Form 1041 as "other amounts paid, credited, or required to be distributed" (OAPC). Determining whether an amount was "properly" paid or credited is made according to local law.

Impact of Tier 1 vs. Tier 2 Distributions. The distinction between Tier 1 and Tier 2 distributions governs the taxability of distributions to the two corresponding classes of beneficiaries. DNI is first carried out (via the distribution deduction) by Tier 1 distributions and, to the extent there is DNI remaining, it is carried out by Tier 2 distributions. Therefore, the deduction for Tier 2 distributions is limited to the amount of taxable DNI remaining after Tier 1 distributions. If more than one beneficiary receives Tier 2 distributions of the remaining DNI, it is allocated among the Tier 2 beneficiaries on the basis of the relative amount of Tier 2 distributions made to each.

A Tier 1 beneficiary (entitled to a mandatory distribution of income) will be both a Tier 1 and Tier 2 beneficiary if Tier 2 amounts are also distributed to him or her.

Charitable Contributions. Charitable deductions are often referred to as "Tier 1½ distributions" because they are not deducted from the amount distributed to Tier 1 beneficiaries, but will take precedence over Tier 2 distributions, if any exist.

When a distribution made to a charitable organization qualifies for the charitable deduction under IRC Sec. 642(c), the distribution is ignored when computing the Tier 1 and Tier 2 distributions to that charity, and DNI is not allocated to the charitable beneficiary. The deduction for amounts of income paid or permanently set aside for charitable purposes is deducted as a charitable contribution on Schedule A of Form 1041, rather than a distribution deduction on Schedule B of Form 1041.

Computing the Distribution Deduction for a Complex Trust or Estate

Once a trust has been classified as a complex trust, the return preparer must determine the income distribution deduction. This determination, also applicable for estates, can be broken down into five distinct steps:

1. Determine fiduciary accounting income, upon which Tier 1 distributions (income required to be distributed currently, if any) are based.

2. Determine the amount of other amounts paid, credited, or required to be distributed (the Tier 2 distributions).

3. Calculate distributable net income (DNI), which is the upper limit on the amount of the distribution deduction.

4. Compute the actual distribution deduction, which is the sum of amounts determined in Steps 1 and 2 above, limited to the amount determined in Step 3, after adjusting for tax-exempt income and related expenses.

5. Determine the character of the income distributed to the beneficiaries (e.g., interest, dividends, etc.).

Example 1F-2 Complex trust's distribution deduction: Step 1—fiduciary accounting income and Step 2—other amounts paid or credited.

In 2010, the Bill Baker Testamentary Trust had tax-exempt income, made a mandatory distribution to charity and a discretionary distribution to an individual beneficiary. Thus, the trust is a complex trust.

The trust instrument requires the trust to pay $10,000 out of its income to a specific charity each year. The remaining income may, at the trustee's discretion, be accumulated or distributed to Allen Baker. Therefore, Allen is a Tier 2 beneficiary since there are no mandatory distributions of income to him.

According to the trust instrument, all expenses are allocable against income, and a reserve for depreciation is required (and is actually maintained). Tax and book depreciation expense are equal. During 2010, the trustee makes the $10,000 distribution to the charity and a discretionary distribution of $15,000 to Allen.

The trust has the following items of income and (expense) for 2010, which the preparer uses to calculate fiduciary accounting income, as shown:

Qualified dividends	$ 10,000
Taxable interest	10,000
Tax-exempt interest	10,000
Business income	20,000
Business depreciation expense	(3,000)
Other business expenses	(2,000)
Trustee fee (allocated to income)	(5,000)
Fiduciary accounting income	$ 40,000

There are no required distributions to individual beneficiaries. Therefore, the $15,000 distributed to Allen is a Tier 2 distribution (i.e., other amounts paid or credited).

The third step in computing the distribution deduction for estates and complex trusts is to calculate distributable net income (DNI).

Example 1F-3 Complex trust's distribution deduction: Step 3—DNI.

The preparer of the 2010 Form 1041 for the trust in Example 1F-2 calculates the trust's DNI in the following manner:

Qualified dividends		$ 10,000
Taxable interest		10,000
Tax-exempt interest	$ 10,000	
Less allocable expenses ($10,000 ÷ $50,000[a]) × $5,000	(1,000)	
Less allocable charitable deduction ($10,000 ÷ $50,000[a]) × $10,000	(2,000)	7,000
Business income		20,000
Total income		47,000
Other business expenses		(2,000)
Business depreciation expense		(3,000)
Trustee fee (net) ($40,000 ÷ $50,000[a]) × $5,000		(4,000)
Charitable contribution (net) ($40,000 ÷ $50,000[a]) × $10,000		(8,000)
Distributable net income (DNI)		$ 30,000

Note:

[a] This amount consists of the total income of the trust (dividends, taxable interest, tax-exempt interest, and business income) before expenses.

The next step is to determine the portion of DNI allowed as an income distribution deduction.

Example 1F-4 Complex trust's distribution deduction: Step 4—apportion taxable DNI between fiduciary and beneficiaries.

DNI is $30,000 as calculated in Example 1F-3. The taxable portion of DNI is $23,000, which is the $30,000 DNI reduced by the $7,000 adjusted tax-exempt interest income. However, the trust's allowable distribution deduction is not equal to the entire taxable portion of DNI because the total of the Tier 1 and Tier 2

distributions ($15,000) is less than total DNI ($30,000); in other words, not all of the DNI was distributed. Thus, the distribution will carry out only a portion of DNI to the beneficiaries.

The $15,000 distribution to beneficiary Allen (from Example 1F-2) is half of the $30,000 DNI. Therefore, the distribution deduction equals $11,500, $15,000 distribution reduced by half the amount of the tax-exempt component of DNI ($7,000 × 1/2 = $3,500).

The fifth and final step is to determine the character of amounts distributed to beneficiaries.

Amounts Taxable to Beneficiaries of Complex Trusts and Estates

The beneficiary of a complex trust or estate must include distributed amounts in gross income. Up to a maximum amount equal to the trust's taxable DNI, the beneficiary must include—

1. The amount of fiduciary accounting income required to be distributed currently, whether or not it is actually distributed, and

2. All other amounts paid, credited, or required to be distributed to such beneficiary, except for amounts not deductible by the fiduciary, such as a specific bequest.

Amounts Distributed to Satisfy "Support" Obligation

If trust income is used, or required to be used to discharge a grantor's legal obligation to provide support or maintenance of a beneficiary, the grantor will be taxed on the current income of the trust used (or required to be used) to provide the support (as defined under local law) under the grantor trust rules. However, to the extent principal or accumulated income is used to discharge a grantor's support obligation, the support payments are treated as "other amounts paid or credited," deductible by the trust and taxable to the grantor as Tier 2 distributions. Parallel rules apply to a trustee of a trust (i.e., a person other than the grantor) who makes distributions in satisfaction of his own support obligations.

To the extent an amount, pursuant to a trust instrument, is used to discharge a support obligation of a person who is neither a grantor nor a trustee (e.g., a beneficiary), the amount so used is treated as a distribution from a complex trust directly to that person.

Payments made by an estate to provide support for the decedent's widow or dependents for a limited time during the administration of the estate are considered Tier 1 or Tier 2 distributions, as appropriate, if paid or required to be paid during the tax year pursuant to a court order or local law.

Example 1F-5 Payments used to discharge grantor's support obligation.

George Jones established the Jones Children's Trust to accumulate funds for the college education of his children. The agreement also permits the trustee to pay the children's medical expenses to the extent not covered by insurance. In George's state of residence, the provision of medical care for one's minor children is a parent or guardian's legal obligation of support, but paying for a college education is not. In 2010, one of George's children was hospitalized and incurred $5,000 of expenses not covered by insurance. The expenses were paid by the trust. Fiduciary accounting income and DNI were each $3,000 for the year.

The trust is not a grantor trust simply because of a provision that trust assets could potentially be used to pay the children's medical bills. However, the actual payment of the medical bills by the trust in 2010 is support, and therefore, the trust is considered a grantor trust for 2010 to the extent of current trust income ($3,000) used to provide the support. The income is reported directly by George on his Form 1040. The additional $2,000 in excess of current income paid in discharge of George's support obligation is an "other amount paid or credited," or a Tier 2 distribution under IRC Sec. 661. However, since there is no DNI remaining to be carried out, the trust receives no distribution deduction for (and George is not taxed on) the additional $2,000.

Amounts Distributed to Fund a Charitable Remainder Trust

Normally, an income distribution made directly to a charitable organization, pursuant to the terms of the governing instrument, is deductible under IRC Sec. 642(c) and does not qualify as a distribution deduction under IRC

Sec. 661. Thus, amounts paid to a charity are not reported on Schedule K (Form 1041) if the distribution qualifies for the charitable income tax deduction under IRC Sec. 642(c). However, the tax treatment for distributions to charitable remainder trusts (CRTs), when they are residual beneficiaries of estates and trusts, is not clear since the distributions are made to split-interest trusts, with a required annual payment payable to noncharitable beneficiaries and the remainder to qualified charities.

To be deductible as a charitable income tax deduction under IRC Sec. 642(c), the possibility of amounts being insufficient to distribute to the charity must, under the terms of the governing instrument and circumstances of a particular situation, be so remote as to be negligible. If there is a possibility that principal will be needed to make the required CRT annuity or unitrust amount, no charitable income tax deduction is allowed under IRC Sec. 642(c). In that case, a Section 661 distribution deduction should be available for the amount of income used to fund a CRT. When a charitable remainder annuity trust (CRAT) was a beneficiary of the residuary estate, the IRS has ruled that the estate could not claim a charitable deduction under IRC Sec. 642(c) for amounts used to fund the CRT, but a Section 661 distribution deduction was allowed.

If the amounts distributed to the CRT are paid from the estate or testamentary trust's gross income, DNI is allocated to the CRT as if the CRT were a regular noncharitable beneficiary. In other words, Schedule K-1 should be issued to the CRT upon funding, to the extent of the CRT's share of DNI. The character of DNI allocated to the CRT will be accounted for under the CRT's four-tier system and available for future allocation to the CRT's noncharitable beneficiary.

Amounts Other Than Current Income

Determining Other Amounts Paid, Credited, or Required to Be Distributed

When an estate or complex trust distributes amounts, including property, in excess of "income required to be distributed currently" to beneficiaries, the return preparer must determine if the distribution is included in "other amounts properly paid or credited or required to be distributed" (OAPC) under IRC Sec. 661(a)(2). If the distributions are OAPC, they are Tier 2 distributions and carry out DNI to beneficiaries to the extent of taxable DNI remaining after Tier 1 distributions.

As a practical matter, actual payments or credits to beneficiaries are "proper" unless they are not in accordance with the terms of the governing instrument as interpreted by state law.

The word "credited" is intended to encompass the concept of constructive receipt by the beneficiaries. That is, if the fiduciary "credits" an amount via a bookkeeping entry to the beneficiary's account and there is actual or implied notice to the beneficiary that the fiduciary is legally bound to pay the beneficiary on demand, then there is constructive receipt of the amount by the beneficiary. "Credited" would also include funds over which the beneficiary had control, whether or not the beneficiary opted to collect the funds from the entity. Effectively, "credited" prevents the beneficiary from avoiding an income allocation by merely refusing to accept a distribution from the fiduciary or choosing to accept the distribution at another time. The trust or estate may therefore claim the appropriate distribution deduction. A mere entry on the fiduciary's books is likely insufficient unless it places the amount legally beyond the reach of the fiduciary.

All distributions are considered OAPC unless they are—

1. income required to be distributed currently, or

2. specific gifts and bequests under IRC Sec. 663(a).

Example 1G-1 Other amounts properly paid, credited, or required to be distributed.

The Mae Daye Trust does not require all income to be distributed currently. However, the trust instrument permits the trustee to distribute principal. The return preparer calculates the DNI and fiduciary accounting income both to be $100,000 for 2010. The trustee distributed $250,000 to the beneficiary during the year.

The entire $250,000 is an "other" amount paid, credited, or required to be distributed consisting of $100,000 of income (a Tier 2 income distribution since all income is not required to be distributed) and a $150,000

distribution of accumulated income from a prior year or of principal. The return preparer reports the $250,000 on Schedule B (Form 1041), line 10.

An estate's distribution of real estate is not considered OAPC if title to the real estate vests in the distributee immediately upon the death of the decedent.

Exception for Specific Gifts and Bequests

A gift or bequest of a specific sum of money or of specific property that is properly paid or credited to a beneficiary under the terms of the governing instrument is not deductible by the fiduciary or taxable to the beneficiary, unless the gift or bequest is payable in more than three installments or is paid from income. Such specific gifts and bequests have no income tax consequences.

The amount of money or the identity of the specific property must be ascertainable under the testator's will at the date of death, or under the terms of an *inter vivos* trust instrument at the date of the trust's inception. For example, a decedent's bequest to his or her surviving spouse of money or property, to be selected by the executor, and expressed as a fraction of the "adjusted gross estate" is not a specific bequest (and is therefore an OAPC that carries out DNI). Similarly, a distribution of the residuary estate or principal of a trust is not a specific gift or bequest and thus, carries out DNI.

Determining Amount of Property Distribution

When OAPC takes the form of property other than cash, the amount taken into account in computing the fiduciary's distribution deduction and the amount taxable to the beneficiary is generally the lesser of:

1. the basis of the property to the beneficiary, which is a carryover basis from the fiduciary, adjusted for any gain or loss recognized by the fiduciary on the distribution; or

2. the fair market value of the property.

However, the fiduciary can elect to recognize gain on the distribution under IRC Sec. 643(e)(3), in which case the distribution deduction/income inclusion amount is the property's fair market value. However, because of the related party rules, an estate or trust is not allowed to deduct a loss except for pecuniary bequests made by an estate.

Payments to Third Parties for Beneficiary's Personal Expenses

Sometimes it is more efficient for the fiduciary to make a payment on a beneficiary's behalf than to make a distribution to the beneficiary and then have the beneficiary make the payment. Often, a trust is used to manage property for a beneficiary who is incapable of managing the property personally. Therefore, the trust will pay the beneficiary's personal expenses directly rather than make a distribution to the beneficiary. If the payment is for the beneficiary's personal benefit, the payment is classified as an OAPC.

Example 1G-2 Trust's payment of personal expenses considered other amounts properly paid, credited, or required to be distributed.

A testamentary trust was established for the decedent's incapacitated daughter, Jana. The trustee had total discretion as to whether any distributions could be made. Due to Jana's poor health, the trustee paid all of her personal expenses, such as food, medical bills, and clothing. During the current year, the trustee made payments on Jana's behalf totaling $35,000. The entire $35,000 is classified as a Tier 2 distribution, and DNI is allocated to Jana for the lesser of DNI or $35,000.

If the trust is required to make income distributions (Tier 1), the payment of personal expenses would be treated as part of the required income distribution. However, when payments for personal expenses are made that discharge a grantor's support obligation, the grantor will be subject to taxation.

When an estate or trust maintains a personal residence for the beneficiary, the fiduciary's payment of the residence expenses are subject to a different set of rules. Since the residence is an asset of the estate or trust and the

expenses are necessary to maintain the property, such payments are not allocated as income to the beneficiary, even if the beneficiary received some benefit from the expenditures. However, except for interest and taxes, the expenses are not deductible by the fiduciary since the residence is not an income-producing asset. Any residential expenses are nondeductible expenses of the fiduciary, and thus, the estate or trust must pay income taxes on the taxable income used to pay the residential expenses.

In *Du Pont*, a trust was required to maintain the property as the surviving spouse's personal residence. Although the spouse's health caused her to remain in the residence, the expenses were not attributable to her since she could have moved. Regardless of whether the spouse lived in the house, the trust was required to maintain the property, and thus, the residence expense payments were made to maintain the trust's assets rather than for the spouse's benefit. The Tax Court held that the payments could not be allocated to the spouse via the income distribution deduction of IRC Sec. 661. Although a deduction is allowed for "the management, conservation, and maintenance of property held for the production of income," the administrative expenses must be directly connected or proximately related to the management, conservation, or maintenance of the property. Because a residence is not an income-producing asset, any expenses other than interest or taxes is nondeductible by the trust.

SELF-STUDY QUIZ

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

14. In which scenario below would a simple trust become a complex trust?

    a. The Wright Family Trust distributes property to Julia, satisfying her right to receive all current income.

    b. The trust instrument of the Lane Children's Trust grants the fiduciary the power to accumulate income.

    c. The Zucker Trust has a remainder due to charity, but in 2010 it does not claim a charitable deduction.

    d. The Hill Trust retains current income for its depreciation reserve, as permitted by the trust instrument.

15. The Michael Halford Testamentary Trust is a simple trust with the following income and expenses in 2010:

Business income:	$	75,000
Qualified dividends:		100,000
Tax-exempt interest income:		25,000
Long-term capital gain (allocated to principal):		30,000
Tax depreciation expense:		7,000
Other business expenses:		4,000
Trustee fee allocated to income:		1,500
Trustee fee allocated to principal:		500

    Compute the trust's fiduciary accounting income.

    a. $194,500.

    b. $217,000.

    c. $224,500.

    d. $243,000.

16. Assume the same details as in the question above, and compute the trust's available distribution deduction.

    a. $24,750.

    b. $169,250.

    c. $194,000.

    d. $199,750.

17. Which of the following statements best describes the two tiers of distributions allowed for complex trusts and estates?

    a. Income required to be distributed currently is a Tier 2 distribution.

b. Annuities and discretionary distributions of principal are both Tier 1 distributions.

c. DNI is first carried out to Tier 1 distributions; any remaining is carried out to Tier 2 distributions.

d. Charitable contribution deductions are called Tier 3 distributions.

18. The Larson Testamentary Trust is a complex trust. The trust instrument requires an annual $20,000 income distribution to a specific charity, and allows any remaining income to be distributed to Janine at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2010, the trustee distributes $20,000 to the charity and $30,000 to Janine. The trust also has the following items of income and expense:

Qualified dividends:	$	20,000
Taxable interest:		20,000
Tax-exempt interest:		20,000
Business income:		40,000
Business depreciation expense:		6,000
Other business expenses:		4,000
Trustee fee (allocated to income):		10,000

Calculate the trust's DNI for 2010.

a. $14,000.

b. $60,000.

c. $80,000.

d. $94,000.

19. The Kinch Children's Trust was established by David Kinch to accumulate funds for Arthur and Joshua's college education. The trust agreement also permits the trustee to pay their medical expenses to the extent that they are not covered by insurance. In David's state of residence, paying for college education is not a legal obligation of support, but paying for one's minor children's medical care is. In 2010, Joshua was hospitalized, and $7,000 of expenses not covered by insurance were incurred. These expenses were paid by the trust. Fiduciary accounting income and DNI were both $4,000 for the year. Which of the following will occur in this scenario?

a. The trust will always be considered a grantor trust.

b. The $4,000 of income will be reported by the trust on Form 1041.

c. David must pay taxes on the entire $7,000 as a support obligation.

d. $3,000 is considered an "other amount paid or credited" to David.

20. Which of the following statements accurately describes estates and trusts?

a. Estates and trusts are not allowed to make payments to third parties on behalf of beneficiaries. They can only distribute funds to the beneficiaries themselves.

b. If an estate or trust maintains a personal residence for a beneficiary and pays expenses related to the residence, the payments are considered income to the beneficiary.

c. A payment made by an estate or trust for the beneficiary's benefit is considered "other amounts properly paid or credited or required to be distributed" (OAPC).

d. Payments of personal expenses on the behalf of a beneficiary made by a trust will always be considered a Tier 1 income distribution.

SELF-STUDY ANSWERS

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

14. In which scenario below would a simple trust become a complex trust? **(Page 137)**

    a. The Wright Family Trust distributes property to Julia, satisfying her right to receive all current income. [This answer is incorrect. As long as it does not distribute an amount that exceeds the year's fiduciary accounting income, the trust may distribute property in this instance and still retain its simple trust status.]

    b. The trust instrument of the Lane Children's Trust grants the fiduciary the power to accumulate income. [This answer is correct. Even if not exercised, this power will make the Lane Children's Trust a complex trust. However, if the trust merely had the power to distribute amounts in excess of required income, it would only become a complex trust if that power was utilized in the current year.]

    c. The Zucker Trust has a remainder due to charity, but in 2010 it does not claim a charitable deduction. [This answer is incorrect. A trust that is entitled to a charitable deduction in the current year is, for that year, not classified as a simple trust. However, as long as the charitable deduction is not claimed, it generally will not be disqualified from its simple trust status.]

    d. The Hill Trust retains current income for its depreciation reserve, as permitted by the trust instrument. [This answer is incorrect. Funding a depreciation reserve reduces the amount of cash flow to a simple trust's beneficiaries, but if the trust instrument requires or permits the reserve, retaining current income for that purpose will not cause the trust to lose its simple trust status.]

15. The Michael Halford Testamentary Trust is a simple trust with the following income and expenses in 2010:

Business income:	$	75,000
Qualified dividends:		100,000
Tax-exempt interest income:		25,000
Long-term capital gain (allocated to principal):		30,000
Tax depreciation expense:		7,000
Other business expenses:		4,000
Trustee fee allocated to income:		1,500
Trustee fee allocated to principal:		500

    Compute the trust's fiduciary accounting income. **(Page 137)**

    a. $194,500. [This answer is correct. To calculate fiduciary accounting income, take $217,000 (the subtotal of all the trust's income minus all the trust's expenses), subtract $30,000 (the capital gains, which are allocable to principal), and add $7,000 (add back the depreciation expense) and $500 (add back trustee fees allocated to principal).]

    b. $217,000. [This answer is incorrect. This is the subtotal of the trust's income and expenses ($230,000 in income minus $13,000 of expenses). Further adjustments are needed to arrive at the trust's fiduciary accounting income.]

    c. $224,500. [This answer is incorrect. To arrive at this total, the capital gain was not dealt with correctly. It must be subtracted from the subtotal before the fiduciary accounting income can be determined.]

    d. $243,000. [This answer is incorrect. This is the total of all the trust's expenses ($230,000) plus all the trust's expenses ($13,000). Ordinarily, the expenses must be subtracted from the income to begin the calculation.]

16. Assume the same details as in the question above, and compute the trust's available distribution deduction. **(Page 141)**

    a. $24,750. [This answer is incorrect. This is the tax-exempt interest income ($25,000) minus the expenses allocated to it ($250). This is a portion of the calculation, but further calculations are needed to arrive at the trust's taxable DNI.]

    b. $169,250. [This answer is correct. To calculate the trust's taxable DNI, first the DNI must be calculated ($194,000) and then the tax-exempt interest income minus any allocated expenses ($24,750) must be subtracted. Assuming the trust distributed this much or more to beneficiaries, it is entitled to a deduction of this amount.]

    c. $194,000. [This answer is incorrect. This is the trust's DNI ($75,000 + $100,000 + $24,750 – $4,000 – 1750), but one more calculation is necessary to determine the trust's taxable DNI.]

    d. $199,750. [This answer is incorrect. This is the business income ($75,000) plus the qualified dividends ($100,000) plus the tax-exempt interest income minus allocated expenses ($24,750). This is the first part of the calculation of DNI. Further calculations are needed to determine the DNI and then the taxable DNI.]

17. Which of the following statements best describes the two tiers of distributions allowed for complex trusts and estates? **(Page 141)**

    a. Income required to be distributed currently is a Tier 2 distribution. [This answer is incorrect. According to IRC Sec. 661(a), this type of distribution is defined as a Tier 1 distribution. The requirement can come from the trust or estate's governing document or local law.]

    b. Annuities and discretionary distributions of principal are both Tier 1 distributions. [This answer is incorrect. According to IRC Sec. 661(a), an annuity paid out of principal would be a Tier 1 distribution, but discretionary distributions of principal would be considered Tier 2 distributions.]

    c. DNI is first carried out to Tier 1 distributions; any remaining is carried out to Tier 2 distributions. [This answer is correct. The purpose of defining Tier 1 and Tier 2 distributions is to determine how the taxability of the distributions will be governed. The deduction for a Tier 2 distribution will always be limited to the amount of DNI left after the Tier 1 distributions are accounted for.]

    d. Charitable contribution deductions are called Tier 3 distributions. [This answer is incorrect. According to IRC Sec. 661(a), such distributions can be called Tier 1½ distributions. Charitable distributions take precedence over Tier 2 distributions, but they are not deducted from the amount distributed to Tier 1 beneficiaries.]

18. The Larson Testamentary Trust is a complex trust. The trust instrument requires an annual $20,000 income distribution to a specific charity, and allows any remaining income to be distributed to Janine at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2010, the trustee distributes $20,000 to the charity and $30,000 to Janine. The trust also has the following items of income and expense:

Qualified dividends:	$	20,000
Taxable interest:		20,000
Tax-exempt interest:		20,000
Business income:		40,000
Business depreciation expense:		6,000
Other business expenses:		4,000
Trustee fee (allocated to income):		10,000

    Calculate the trust's DNI for 2010. **(Page 141)**

    a. $14,000. [This answer is incorrect. This is the trust's taxable interest after the allocable expenses ($2,000) and allocable charitable deduction ($4,000) are taken into account.]

    b. $60,000. [This answer is correct. The trust has a fiduciary accounting income of $80,000. Once the allocable expenses ($2,000) and the allocable charitable deduction ($4,000) have been subtracted

from the taxable interest (leaving $14,000), the other business expenses, business depreciation expenses, net trustee fee, and net charitable contribution must be subtracted to arrive at the DNI ($94,000 – $4,000 – $6,000 – $8,000 – $16,000 = $60,000).]

c. $80,000. [This answer is incorrect. This amount reflects the trust's fiduciary accounting income.]

d. $94,000. [This answer is incorrect. This is the trust's total income once the allocable expenses and allocable charitable deduction ($2,000 and $4,000, respectively) have been taken into account in regards to the taxable interest.]

19. The Kinch Children's Trust was established by David Kinch to accumulate funds for Arthur and Joshua's college education. The trust agreement also permits the trustee to pay their medical expenses to the extent that they are not covered by insurance. In David's state of residence, paying for college education is not a legal obligation of support, but paying for one's minor children's medical care is. In 2010, Joshua was hospitalized, and $7,000 of expenses not covered by insurance were incurred. These expenses were paid by the trust. Fiduciary accounting income and DNI were both $4,000 for the year. Which of the following will occur in this scenario? **(Page 141)**

a. The trust will always be considered a grantor trust. [This answer is incorrect. The trust will only be considered a grantor trust in 2010. The potential that trust assets could be used in a support obligation does not make the trust a grantor trust into perpetuity. It will only be a grantor trust when assets are actually used for support.]

b. The $4,000 of income will be reported by the trust on Form 1041. [This answer is incorrect. The income will be reported by David on his Form 1040 because it was used by the trust to provide support to his minor children.]

c. David must pay taxes on the entire $7,000 as a support obligation. [This answer is incorrect. David only has to pay taxes on the $4,000 of the medical expenses that are allocated to the current trust income.]

d. $3,000 is considered an "other amount paid or credited" to David. [This answer is correct. This is a Tier 2 distribution under the guidance found in IRC Sec. 661. Because there is no remaining DNI to carry out, the trust receives no distribution deduction for this $3,000, and David is not taxed on it.]

20. Which of the following statements accurately describes estates and trusts? **(Page 141)**

a. Estates and trusts are not allowed to make payments to third parties on behalf of beneficiaries. They can only distribute funds to the beneficiaries themselves. [This answer is incorrect. Sometimes it can be more efficient for an estate or trust to make a payment to a third party on behalf of a beneficiary instead of distributing the income to the beneficiary so he or she can make the payment. For example, often, trusts are used to manage property for beneficiaries that are not capable of personally managing the property.]

b. If an estate or trust maintains a personal residence for a beneficiary and pays expenses related to the residence, the payments are considered income to the beneficiary. [This answer is incorrect. The residence is actually an asset of the trust or estate and the expenses are necessary to maintain the property; therefore, even if the beneficiary received benefit from the property, the payments would not be allocated to him or her as income. Except for interest and taxes, though, the payments will not be deductible by the estate or trust, as the residence does not produce income.]

c. A payment made by an estate or trust for the beneficiary's benefit rather than a required income distribution is considered "other amounts properly paid or credited or required to be distributed" (OAPC). [This answer is correct. When the payment is for the personal benefit of said beneficiary, the payment will be considered OAPC. However, if the trust is required to make income distributions, the payment of personal expenses are treated as part of the required income distribution.]

d. Payments of personal expenses on the behalf of a beneficiary made by a trust will always be considered a Tier 1 income distribution. [This answer is incorrect. If the trust is required to make income distributions, any payments of personal expenses would be part of that Tier 1 distribution. However, payments made to discharge a grantor's obligation of support would be taxed to the grantor.]

The Separate Share Rule for Multiple Beneficiaries

If a single complex trust or an estate has two or more beneficiaries who have substantially separate and independent shares, their shares are treated as separate trusts or estates for the sole purpose of determining the amount of DNI allocable to each beneficiary. When separate shares exist (in either estates or trusts), DNI must be computed separately for each share. Thus, all income, deductions, gains or losses attributable to that share will not be allocated to any other share.

When Separate Shares Exist

Separate shares exist when the governing instrument of the trust or estate and applicable local law create separate economic interests in one beneficiary or class of beneficiaries in such a way that their economic interests neither affect nor are affected by the economic interests of another beneficiary or class of beneficiaries. The rule applies when distributions must be made to the beneficiaries as if each beneficiary had his or her own substantially separate and independent share of the trust or estate. The language of the instrument determines whether the separate share rule applies. A separate share generally exists only if it includes both principal and the income attributable to that principal, and it is independent from any other share. Thus, if the beneficiary is not entitled to income on the principal, separate share treatment will generally not apply.

Separate shares are often found in trusts, which typically provide shares for more than one beneficiary. However, separate shares are often found in estates as well, particularly where each beneficiary is to receive a fraction of the residuary estate. Additionally, a separate share may have more than one beneficiary, and one beneficiary may be a beneficiary of more than one separate share. Furthermore, it does not matter whether the principal or accumulated income of each share is distributed to the beneficiary of that share, to the beneficiary's heirs, or to any other beneficiaries designated to receive his or her share upon termination of the interest, or simply added to the shares of other estate or trust beneficiaries.

Example 1H-1 Separate shares exist for multiple beneficiaries with different amounts of distributable income and/or principal.

Martha creates a trust for the benefit of her two granddaughters, Kelly and Amy, providing that the trust income is to be divided into two equal shares, one for each granddaughter. Each beneficiary's share of the income is to be accumulated until she becomes age 21. Upon becoming age 21, the beneficiary is entitled to either receive her share of the income or have the income accumulated and later distributed to her at the trustee's discretion. The trustee also has discretion to invade principal for the benefit of either Kelly or Amy (or both) to the extent of her share of the trust assets. Upon attaining age 35, each beneficiary is entitled to receive her share of the trust assets. If either Kelly or Amy dies before attaining age 35, her interest is to be distributed to her heirs, or if none, to be allocated entirely to the other beneficiary.

The trust is subject to the separate share rules under IRC Sec. 663(c) since different amounts of income and/or principal are distributable to different beneficiaries, and a distribution to one beneficiary cannot affect the other beneficiary's proportionate share. Thus, the DNI must be calculated separately for Kelly and Amy's shares to determine the amount of the total distribution deduction (i.e., the total of the distributions made to each beneficiary, as limited by her separate share of DNI).

Separate share treatment will not apply if the executor or trustee has the discretionary power to distribute, apportion, or accumulate income or distribute principal among beneficiaries. Nor will the separate share treatment apply if a distribution to one beneficiary can affect the proportionate share of any income, accumulated income, or principal of another beneficiary's share, and no adjustment is required to compensate for such distributions.

Example 1H-2 Separate shares do not exist if income may be distributed to or accumulated for any beneficiary.

Assume the same facts as in Example 1H-1 , except that the trustee has the power to make discretionary distributions of income and principal for Kelly and/or Amy, and these distributions will reduce the proportionate share available to both Kelly and Amy.

The separate share rules do not apply since the trustee has the discretionary power to distribute or accumulate income or distribute principal to Kelly or Amy, and the distribution to one beneficiary will affect the proportionate share of any income, accumulated income, or principal of the other beneficiary's share.

For the separate share rule to apply, it is not required that each beneficiary's share be separately and independently maintained in the accounting records of the trust or estate. No physical segregation of assets is required. However, separate share treatment is mandatory, not elective, and will continue unless an event occurs that, under the terms of the trust instrument or will, causes different treatment to be required (e.g., a beneficiary reaching a certain age).

Purpose of the Separate Share Rule

Under the separate share rule, a beneficiary is taxed only on the amount of income that belongs and is distributed to that beneficiary's separate share, based upon the amount to which that separate share is entitled under the terms of the governing instrument or local law. Without this provision, a beneficiary could be taxed on all the DNI being distributed, which may represent income accumulated for future distribution to another beneficiary. The rule is mandatory where separate shares exist.

Example 1H-3 Consequences of distributions without the separate share rule.

Nancy and Bob are each entitled to receive 50% of an estate created before the separate share rules applied to estates. In the first taxable year, the estate had DNI of $60,000. The executor decided to make a distribution of $100,000 to Nancy on the last day of the taxable year, postponing distributions to Bob until some later time. Because the deduction for distributions is limited to DNI, the estate can only deduct $60,000. The estate income is carried out to Nancy to the extent of total DNI, so that she will include the full $60,000 in her income.

Estate income and principal will ultimately be distributed equally to Nancy and Bob, after taking into account the disproportionate distribution made to Nancy in the first year. However, Nancy will have paid tax on a portion of Bob's share of the estate's income, which Bob will receive tax-free in a later year.

Example 1H-4 Consequences of distributions with the separate share rule.

Assume the same facts as in Example 1H-3, except that the estate was created when the mandatory separate share rules applied to estates. Nancy and Bob have separate shares of DNI of $30,000 each ($60,000 combined DNI $\times$ 50%) for the first taxable year. Thus, the estate will only be entitled to a deduction of $30,000 for the distribution made to Nancy, and Nancy need only include $30,000 in her income for the distribution she received. However, tax will be generated at the estate level on the amount of Bob's share of DNI ($30,000) not distributed to him.

Because estate income and principal is to be distributed equally to Nancy and Bob, after taking into account Nancy's larger distribution in the first year, neither will be taxed on more than his or her share of DNI.

Allocating DNI of Separate Shares

The general rule of allocating DNI requires that DNI be allocated to the beneficiaries based on the amount of cash or other property distributions (whether from income or principal). Under the separate share rule, each share of DNI is determined as if it were a separate estate or trust. DNI is allocated to the various beneficiaries according to their respective shares of income, which is based upon their right to fiduciary accounting income according to local law or the governing instrument. To the extent that beneficiaries are entitled to fiduciary accounting income included in DNI, the DNI is to be allocated among them. Distributions in excess of a beneficiary's share of DNI are not deductible by the estate or trust or taxable to the beneficiary. DNI allocated to a beneficiary but not distributed to that beneficiary is taxable to the estate or trust, rather than to the beneficiary. Once the DNI is allocated to each share, the distribution deduction is computed per each share, based on the respective distributions and DNI per share. The deductions per share are then combined into a total distribution deduction for the estate or trust.

Example 1H-5 Application of the separate share rule.

According to the trust document of the Ben Wheeler Family Trust, a trust was created and funded at the beginning of 2010 with two equal beneficiaries, Bob and Bill. Each beneficiary's share of income and principal may be distributed to the beneficiary of that share or it may be accumulated for his future benefit. Upon age 35, each beneficiary is entitled to receive his share of the remaining trust assets.

In 2010, the trust has $100,000 of DNI, requiring $50,000 to be allocated to each share. The trustee distributed $60,000 to Bob and nothing to Bill, charging $50,000 of the distribution to Bob's share of trust income and $10,000 to Bob's share of trust principal.

Since the separate share rule applies, the trust's distribution deduction is limited to $50,000 even though $60,000 was actually distributed in a year the taxable portion of DNI exceeded $60,000. The extra $10,000 is a nontaxable distribution of trust principal to Bob. The trust will owe tax on the undistributed $50,000 of DNI.

Variation: If the separate share rule had not applied, the entire $60,000 would have been gross income to Bob, and the trust would have had a $60,000 distribution deduction. The remaining $40,000 would have been taxed to the trust, accumulated for the benefit of Bob and Bill, and would not have been specifically earmarked for either beneficiary.

Example 1H-6: Reporting DNI allocable to each separate share.

Assume the same facts as in Example 1H-5 and the application of the separate share rule. A statement, such as the following, is attached to the trust's Form 1041:

Ben Wheeler Family Trust	91-1515155
Form 1041	2010
DNI Allocable to Separate Shares	
Robert Wheeler (534-90-1279)	$ 50,000
William Wheeler (527-39-6426)	0
Income distribution deduction (Sched. B, line 15)	$ 50,000

Separate Share Rule and Charities

Although a charity may have a separate economic interest in the assets of an estate or trust and, in that sense, be considered a *separate share*, the separate share rule of IRC Sec. 663(c) should not apply to charities. Since charities are not allocated DNI [i.e., amounts distributed to them are deductible as charitable contributions under IRC Sec. 642(c) rather than as income distribution deductions under IRC Sec. 661], the separate share rule should not apply to them.

The regulations explaining the separate share rule include one example with a charity as a beneficiary of income during the estate administration. The example illustrates that each noncharitable beneficiary has a separate share together with the charity, rather than the charity having its own separate share.

Disproportionate Distributions

Disproportionate distributions to the separate share beneficiaries can change the relative portions of the separate shares after the distributions are made. Thus, numerous distributions of principal, which are common to estates, may create an accounting nightmare, particularly if they are made throughout the year rather than at once, typically the year-end. In that case, it may be necessary to make interim allocations of DNI to properly adjust the values of the separate shares. However, the fiduciary must use a "reasonable and equitable method" in determining the value of each separate share and the allocation of taxable income to each share. This gives the fiduciary flexibility in applying the separate share rules. The most logical approach, however, would be to either make only proportionate

distributions or none until distributions upon termination are made. In the case of a trust, separate trusts should be considered for each of the beneficiaries.

Example 1H-7 Disproportionate distribution may require interim allocation.

Kim died on January 1, 2010, with a gross estate of $2 million. Her will contains a fractional formula bequest bequeathing 60% of her residuary estate to her surviving spouse, Bryan, and 40% to a trust for their children. A calendar year was elected for the estate's taxable year. On August 1, 2010, the executor made a distribution of $400,000 to partially fund the children's trust, but made no payment to Bryan. The estate's DNI was $50,000 in 2010. If the distribution had occurred on December 31, 2010, it would seem most correct to allocate the DNI based upon the 60/40 ratio. However, an interim allocation seems more reasonable and equitable for a funding on August 1. The executor makes the allocation as follows:

	January 1		(after funding) August 1		Weighted Average Percentage
Bryan	$ 1,200,000	60 %	$ 1,200,000	75 %	66.29 %[a]
Children's Trust	800,000	40 %	400,000	25 %	33.71 %[b]
Total	$ 2,000,000	100 %	$ 1,600,000	100 %	
Allocation of DNI ($50,000) to the separate shares as follows:					
Bryan	$ 33,145[c]				
Children's Trust	16,855[d]				

Notes:

[a] (212 ÷ 365 × 60%) + (153 ÷ 365 × 75%) = 66.29%

[b] (212 ÷ 365 × 40%) + (153 ÷ 365 × 25%) = 33.71%

[c] Since no distributions were made to Bryan in 2010, no distribution deduction will be allowed for his share of DNI. Instead, the estate will be subject to income tax on the undistributed DNI ($33,145).

[d] $50,000 × 33.71%.

Impact of Distribution Type on Separate Share Rule

The general rule of separate share treatment is that a separate share exists if the economic interest of the beneficiary or class of beneficiaries neither affects nor is affected by the economic interests accruing to another beneficiary or class of beneficiaries. For example, separate shares exist in the following situations:

1. income on bequeathed property if the recipient of the specific bequest is entitled to such income,

2. a surviving spouse's elective share that under local law is entitled to income and appreciation/depreciation, and

3. a qualified revocable trust. In addition to the general rule, the final regulations provide special rules for certain types of shares.

Specific Bequests. A bequest of a specific sum of money or specific property payable in three or fewer installments is not considered a specific share because such bequests do not carry out DNI. However, if the recipient of the specific bequest is entitled to the income on the property, the income on the bequeathed property is a separate share.

Residuary Estate Bequest. The residuary estate, or a portion of the residuary estate, is a separate share if the bequest is entitled to income and to share in appreciation/depreciation under the governing instrument or local law.

Pecuniary Formula Bequest. A pecuniary bequest that can be determined as of the decedent's death (e.g., specific property or sum of money) is considered a specific bequest and is thus excluded from separate share treatment except for any right to income from the bequest. In contrast, a pecuniary formula bequest that is not determinable based on facts known on the decedent's death and is entitled to income *and* to share in appreciation/depreciation under the governing instrument or local law is a separate share. Thus, the share is subject to DNI carryout, limited to the separate share of income.

Under a special rule, a pecuniary formula bequest that is not entitled to income *or* to share in appreciation/depreciation is also considered a separate share if the will or trust instrument does not provide that the bequest is to be paid or credited in more than three installments. However, even though the pecuniary formula bequest is considered a separate share according to this special rule, no DNI is allocated to the share for the funding of the bequest with principal. DNI is only carried out if the bequest is entitled to income or to share in appreciation/depreciation of the assets, and even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI.

The same result would occur if a pecuniary disclaimer (a disclaimer of a specific dollar amount) was made. While not a specific bequest, the disclaimed amount would be considered a separate share since it would not be entitled to any income or to share in any appreciation/depreciation. No DNI would be allocated to the disclaimed amount to the extent it is funded with principal.

If a pecuniary bequest is funded with appreciated assets under a true worth (date of distribution value) funding clause, all gain must be recognized by the estate, rather than being carried out to the beneficiaries.

Example 1H-8 Allocating DNI between a pecuniary bequest and the estate residue.

John Booth died in 2009. His will provides for a bypass trust to be funded with a pecuniary amount to fully use his applicable credit amount. The remainder of his estate is to fund a marital trust for his wife, Beth. The bypass trust is not entitled to income and does not share in any appreciation or depreciation in estate assets. In 2010, the estate transfers $3.5 million to the bypass trust but does not make a distribution to the marital trust. Funding the bypass trust generates a $25,000 long-term capital gain. The estate's taxable income is $149,400 ($150,000 DNI − $600 personal exemption), which includes the $25,000 long-term capital gain recognized upon funding the pecuniary bequest.

The estate has two separate shares, one for the bypass share and another for the marital share. Since the bypass share does not share in income, the amount of the DNI allocated to the bypass share is zero. The estate is not entitled to any deduction for the $3.5 million distributed to the bypass share, since it is a pecuniary bequest. Although the estate has DNI of $150,000, nothing is allocated to the marital share, since it did not receive any distributions during the current year. The estate must pay taxes on the entire $149,400 of taxable income.

If the estate's taxable income had included pass-through income from an S corporation or partnership, the result would have been the same, since no income is allocated to the pecuniary bequest. However, the result would have been different if the separate shares of the pecuniary bequest had been funded with IRD (see Example 1H-10, below).

Fractional Formula Bequest. A fractional formula bequest that divides the residuary estate is subject to the separate share rules.

Example 1H-9 Allocating DNI based on a fractional formula.

Joan Curry's will divides her estate between a bypass trust and an outright gift to her husband based on a fractional formula. Under the fractional formula, Joan's husband's share is 60% of the estate, and the bypass trust is to receive 40% of the estate. During the current year, the estate distributed $2.5 million ($1.5 million to Joan's husband and $1 million to the bypass trust). DNI for the year was $100,000, comprised of $240,000 of

taxable interest and $140,000 of deductions. Since the gift to Joan's husband and the bypass trust are separate shares, the estate must allocate $60,000 of the DNI ($100,000 × 60%) to Joan's husband and $40,000 of the DNI ($100,000 × 40%) to the bypass trust. Since distributions to each share exceed the DNI allocated to that share, the estate will have zero taxable income, and the spouse and bypass trust will have income of $60,000 and $40,000, respectively.

Allocating Non-cash Income among Separate Shares. The portion of gross income includible in DNI that is not attributable to cash received by the estate (e.g., original issue discount, a distributive share of partnership tax items and the pro rata share of an S corporation's tax items) is allocated among the separate shares according to the amount of accounting income that each share is entitled to receive from that source.

Allocating IRD among Separate Shares. Income in respect of a decedent is allocated among the separate shares that could potentially be funded with these amounts, regardless of whether a share is entitled to receive any income under the terms of the governing instrument or local law. The amount allocated to each share is based upon the relative value of each of the shares that could potentially be funded with such amounts.

Example 1H-10 Pecuniary formula bequest not required to, but could potentially, be funded with IRD.

Donald dies in 2009, survived by his wife, Rita, and their daughter, Mandie. Donald's will provides for a pecuniary formula bequest to be paid to a trust for Mandie's benefit in the largest amount that can pass free of federal estate taxes and a bequest of the residuary to Rita. The date of death value of the estate after payment of debts and expenses is $3.9 million. The estate was the designated beneficiary of Donald's IRA, and in 2010, the estate received a distribution of $500,000 from the IRA, which is included in the estate's gross income as IRD, under IRC Sec. 691(a). The entire $500,000 is allocated to principal according to local law.

The estate has two separate shares consisting of a pecuniary formula bequest to the bypass trust valued at $3.5 million and a residuary bequest to Rita, valued at $400,000. Both the separate share for Mandie's trust and the separate share for Rita may potentially be funded with the IRA proceeds. Thus, a portion of the $500,000 gross income must be allocated to each separate share. The amount allocated must be based upon the relative values of the two separate shares using a reasonable and equitable method. The executor allocates $448,718 to the trust for Mandie's benefit [$500,000 × ($3.5 million ÷ $3.9 million)] and $51,282 to Rita [$500,000 × ($400,000 ÷ $3.9 million)].

To the extent that DNI is allocated and distributions are made to the trust and/or Rita, the estate is entitled to a distribution deduction, and the distributee must include this amount in income for 2010.

Example 1H-11 Fractional share funding with requirement to be funded first with IRD.

Assume the same facts as in Example 1H-10, except that Donald's will bequeaths his entire residuary estate to his two nephews, Huey and Dewey. According to the will, the executor is to fund Huey's share first with the proceeds of Donald's IRA.

The estate has two separate shares, one for the benefit of Huey and one for Dewey's benefit. If any distributions are made to either Huey or Dewey during the taxable year, the entire $500,000 of IRD must be allocated to Huey's share when determining the DNI for each separate share.

To the extent that DNI is allocated and distributions are made to each share, the estate is entitled to a distribution deduction and the distributee must include this amount in income for 2010.

Electing Qualified Revocable Trusts. A revocable trust electing under IRC Sec. 645 to be treated as part of the estate is always a separate share of the estate and may itself contain two or more separate shares. Therefore, if the estate or qualified revocable trust makes a distribution during the year, the DNI of the distributing share must be allocated separately to that share. Additionally, if the distributing estate or trust share has separate and independent shares, its DNI must be further allocated among such shares. According to the Preamble to the separate share regulations, a qualifying revocable trust is subject to the estate separate share rule even if the Section 645 election is not made.

A separate share making a distribution to another share must calculate its distribution deduction without reducing it by the amount of income excluded from gross income under IRC Sec. 661(c), e.g., net tax-exempt interest

income. The share receiving the distribution must increase its gross income by the same amount when calculating DNI. The distribution will have the same character in the hands of the recipient share as in the hands of the distributing share.

Example 1H-12 Allocating DNI between the estate and an electing trust.

During his life, Sam Chambers created a revocable trust but failed to transfer all of his assets to the trust before his death. Sam had a pourover will requiring all of his probate estate to be transferred to his trust. The estate and trust elected to be a combined estate under IRC Sec. 645. During the year following Sam's death, the assets in his probate estate generated taxable interest income of $15,000, $10,000 of tax-exempt interest (TEI), and $5,000 of deductions. The estate distributed $20,000 to the trust, which had $25,000 of taxable interest income and $5,000 of deductions before receiving the distribution from the estate. The trust had one beneficiary, Nancy, who received $50,000 from the trust.

The estate's DNI for the year is $20,000 [$15,000 interest income − $3,000 deductions ($5,000 deductions reduced by the portion allocable to TEI) + $8,000 adjusted tax-exempt interest ($10,000 reduced by allocable deductions). The estate's income distribution deduction of $20,000 to the trust reduces its taxable income to zero.

After the estate's distribution, the trust has taxable interest income of $40,000 [the amount from the estate ($15,000) and trust ($25,000)], TEI of $10,000 (from the estate), and $10,000 of combined estate and trust expenses. The trust's taxable income before the distribution deduction and personal exemption is $32,000 [$40,000 taxable interest income − $8,000 ($10,000 deductions reduced by the portion allocable to tax-exempt interest income)]. The trust's DNI is $40,000 ($32,000 + $8,000 adjusted tax-exempt interest) and its distribution deduction is $32,000, which is reported on the Schedule K-1 for Nancy, in addition to the $8,000 of net tax-exempt interest.

Since the character of the estate distribution to the trust is determined at the estate level, the trust must allocate a portion of its expenses to tax-exempt income. This is consistent with the combined estate concept, in which adjusted total income is computed on an aggregate basis, but DNI is allocated between the shares. The combined estate will have gross income of $50,000 and tax-deductible expenses of $8,000. Expenses of $2,000 must be allocated to tax-exempt interest, using the gross income method to determine the allocation of expenses between taxable and tax-exempt income.

Application to Spousal Elective Shares. The separate share rule may apply to a spouse who exercises his/her elective share allowed by local law (because he or she is disinherited or dissatisfied with the will bequest or other inheritance). A spouse's elective share is a separate share of the estate for the sole purpose of determining the amount of DNI in applying IRC Secs. 661(a) and 662(a) if the surviving spouse's elective share is entitled, under local law, to income and appreciation/depreciation. Thus, the amount of DNI carried out to the surviving spouse will be limited to that share's income under state law. Further, under a special rule, a surviving spouse's elective share that is determined under local law as of the date of the decedent's death is also treated as a separate share, even though it is not entitled to income or any appreciation/depreciation. However, if the elective share is not entitled to income, distributions do not carry out DNI to the surviving spouse. Instead, the estate must bear any tax liability for the DNI not allocated and distributed to the other beneficiaries' shares.

An elective share entitled to interest only (rather than to income or appreciation/depreciation) is subject to the separate share rules. However, the elective share does not carry out DNI (because its share of DNI is zero) and the interest payment is considered nondeductible personal interest.

Electing to Treat Distributions Paid or Credited within the First 65 Days as Made in the Prior Year

General Rule

Any amount properly paid or credited to a beneficiary within the first 65 days following the close of the tax year of an estate or complex trust is considered paid or credited on the last day of the immediately prior tax year, if the

fiduciary elects such treatment in accordance with the regulations. Any amount considered under IRC Sec. 663(b) as having been distributed in the immediately prior tax year shall be so treated for all purposes.

Although there can be little doubt as to whether an amount has been properly paid to a beneficiary within 65 days of the prior tax year-end, the regulations are unclear as to what it means to be "properly credited." The Tax Court held that a distribution was treated as "properly credited" even though the actual payment had not been made within the 65-day period. In that case, the executor had instructed the estate's accountants to credit the earnings to the beneficiaries, there was enough cash available to make the distribution, and the distribution was allowable under local law.

The Maximum Election Amount

The maximum amount covered by the election is limited to the greater of fiduciary accounting income or DNI for the immediately prior tax year, reduced by any amounts paid, credited, or required to be distributed in such tax year, other than any amounts considered paid or credited to the tax year preceding the tax year in question by reason of a prior Section 663(b) election.

Flexibility and Planning Opportunity

The fiduciary may designate some or all of the distributions made in the first 65 days of the tax year as covered by the election, limited to the greater of fiduciary accounting income or DNI of the immediately prior tax year, as discussed previously. Administratively, this provision allows a fiduciary to determine the income of the estate or complex trust for the year just ended, while there is still time to make distributions that can be treated as having been made at the end of that year. The election may also present an opportunity to minimize the combined income tax burden of the trust or estate and the beneficiaries.

Example 1l-1 The 65-day election.

On February 10, 2011, the preparer completes the 2010 Form 1041 for a calendar-year complex trust that had $100,000 of fiduciary accounting income and $95,000 of DNI. The workpapers indicate the trustee paid $50,000 to the beneficiary, Al, on January 31, 2010, and $60,000 on July 31, 2010. A copy of the prior year Form 1041 indicates a valid Section 663(b) election treating the $50,000 distribution as paid on December 31, 2009. A handwritten memo in the 2010 trust records indicates a distribution of $45,000 on January 31, 2011.

The maximum amount available for the Section 663(b) election on the 2010 Form 1041 is $40,000 ($100,000 fiduciary accounting income less the $60,000 distribution on July 31, 2010). The $50,000 distribution on January 31, 2010 does not reduce the maximum amount to which the 2010 election may apply because that amount was properly treated on the 2009 Form 1041 as distributed on December 31, 2009.

Since $5,000 in excess of the $40,000 maximum potential 2010 Section 663(b) election has already been distributed within the first 65 days of 2011, there is no reason to consider making another distribution before the end of the 65-day window. The question is how much, if any, of the $40,000 maximum should be designated as a Section 663(b) election for 2010. This decision may be made as late as the due date (including extensions) of the Form 1041 for 2010.

Distribution Deduction for Tax-exempt Income

Limiting the Distribution Deduction

The income distribution deduction for estates and trusts, and the amount of distributions taxable to beneficiaries, are limited to the amount of the fiduciary's distributable net income (DNI) for a particular year. For purposes of the distribution deduction, DNI is computed only with items of income and allocable deductions included in the entity's gross income for tax purposes.

Example 1J-1 Effect of tax-exempt DNI on distribution deduction.

The preparer of a Form 1041 for 2010 determines that DNI consists of $50,000 of taxable interest income and $30,000 of tax-exempt interest income. The individual trustee did not charge a fee and there are no other trust expenses. The trustee distributed $80,000 to the beneficiary in 2010.

The distribution deduction for 2010 is limited to $50,000, the taxable portion of DNI, even though $80,000 of trust income was distributed. Since the $30,000 of tax-exempt interest was not included in the fiduciary's taxable income, it is not included in distributable net income, for purposes of the limitation on the distribution deduction.

No Deduction for Expenses Directly Related to Tax-exempt Income

No deduction is allowed for expenses directly attributable to tax-exempt income. If a fiduciary has both taxable and tax-exempt income, and the only expenses relate directly to the taxable income, all the expenses are fully deductible. Conversely, if the only expenses relate directly to tax-exempt income, none of the expenses are deductible.

Mandatory Allocation of Indirect Expenses

When an expense is indirectly attributable to both taxable and tax-exempt income, the fiduciary must make an allocation of the expense to ensure an appropriate portion is not deducted. The allocation must be "reasonable" in light of all the facts and circumstances. The regulations often use a proration based upon total income, but this method of allocating indirect expenses to tax-exempt income is not required. When making the allocation of indirect expenses, no part of the deductions would be allocable to amounts not included in DNI (e.g., capital gains allocated to principal).

Example 1J-2 Allocating indirect expenses to tax-exempt income.

In 2009, the Ames Family Trust, a simple trust, had $25,000 of taxable interest income, $5,000 in fiduciary fees allocable to income for fiduciary accounting purposes, and no other income or expenses. Gross income is therefore $25,000. DNI and trust accounting income equal $20,000. The trust's distribution deduction also is $20,000, and the beneficiary must include $20,000 in taxable income.

If half the $5,000 of fiduciary fees had been allocable to principal under state law, fiduciary accounting income would increase to $22,500, the cash distribution would increase to $22,500, but DNI (and the distribution deduction) would remain $20,000, as would the amount included in the beneficiary's gross income.

In 2009, the Jones Family Trust is an identical trust, except that in this case the trust's $25,000 of interest income is composed of $15,000 of taxable interest income and $10,000 of tax-exempt interest income. A reasonable proration of the fiduciary fee must be made to tax-exempt income. An examination of the trust records reveals that none of the $5,000 fiduciary fees is directly related to either component of the interest income. Thus, the fees are entirely indirect expenses. The preparer determines that $2,000 ($10,000 ÷ $25,000 × $5,000) of the $5,000 fiduciary fees should be allocated to the tax-exempt interest income.

Taxable DNI for the Jones Family Trust equals $12,000 ($15,000 of taxable interest, less $3,000 of deductible trustee expenses). The tax-exempt component of DNI equals $8,000 ($10,000 of tax-exempt income less $2,000 of indirect expense allocable to tax-exempt income). Therefore, even though DNI and fiduciary accounting income both are $20,000, and the cash distributed to the beneficiary is $20,000, the distribution deduction and the amount the beneficiary includes in gross income is $12,000, the taxable portion of DNI ($8,000 of the distribution being tax exempt).

Charitable Contribution Deduction Reduced by Portion Deemed Paid from Tax-exempt Income

When a fiduciary makes a charitable contribution, the portion of the contribution deemed paid from tax-exempt income is not deductible. See the "Distribution Deduction for Estates and Complex Trusts" section of this lesson for an example and illustration of the reporting implications when the entity has tax-exempt income and a charitable contribution in the same year.

Interest Expense in Connection with Tax-exempt Income

A deduction for interest expense is disallowed for debt "incurred or continued to purchase or carry" municipal bonds or other investments for which the income is exempt from tax.

Example 1J-3 Interest expense allocable to tax-exempt interest income.

The preparer of a 2010 Form 1041 for a simple trust reviews the trust records provided by the fiduciary, a close friend of the grantor who does not take a trustee fee. The trust document reveals the settlor has granted the fiduciary unusually broad discretion to manage the trust's investments.

The preparer determines the trust received only two types of income in 2010: $70,000 in cash dividend on ABC growth stock and $30,000 in tax-exempt interest income from long-term municipal bonds. A call from the trustee to confirm the preparer had received the tax data also reveals the trustee's belief that the long-term municipal bond market rate will fall during 2010, producing a handsome capital gain for the trust when the bonds are sold (as the trustee projects) around the end of 2011.

The trust's only expense for 2010 was $28,000 in interest. The trustee was able to borrow the entire amount necessary to purchase the municipal bonds by pledging the bonds and the ABC stock as collateral for an interest-only, two-year loan with a balloon payment due in January 2011.

Since the proceeds from the loan can be traced directly to the funds used to purchase the bonds, and the bonds are the primary collateral for the loan, it is clear to the preparer that the entire interest expense of $28,000 was used to "purchase or carry" the bonds and is therefore not deductible as investment interest expense.

DNI and fiduciary accounting income both equal $72,000 ($100,000 − $28,000), and $72,000 was distributed to the income beneficiary. The beneficiary of this simple trust will include $70,000 in his or her gross income from the trust, classified as dividend income, in addition to $2,000 of tax-exempt interest income ($30,000 − $28,000). The trust will have no taxable income after the distribution deduction.

"Phantom" Taxable Income

Unless otherwise provided in Subchapter J of the Internal Revenue Code, estates and trusts compute taxable income in the same manner as individuals. However, Congress routinely fails to consider the effects of individual tax law revisions on the income taxation of fiduciaries, which can produce unpleasant surprises for clients.

When the creator of an estate or trust directs all income to be distributed currently to beneficiaries, "income" is fiduciary accounting income, which may be quite different from taxable income. To compute fiduciary accounting income, receipts and disbursements are classified as "income" or "principal" transactions in accordance with the wishes of the creator, as expressed in the governing instrument. Without explicit directions in the governing instrument, a Principal and Income Act or other legislation adopted by the state will govern the classification.

Deductions for Fiduciary Accounting Income May Differ for Taxable Income

Fiduciary accounting income may be reduced by certain expenses or losses charged against income for accounting purposes but not currently deductible (i.e., do not reduce DNI) for tax purposes. As a result, the amount of income required to be distributed currently and the income distribution deduction are reduced by these items, but taxable income is not reduced, causing the entity to incur tax even though the creator directed all income to be distributed currently. This effectively causes the remainder beneficiaries to bear the tax burden for the "phantom" income they never received. New York law allows trustees to make a discretionary adjustment, referred to as the "Holloway adjustment" that will reduce fiduciary accounting income and reimburse principal (on behalf of the remainder beneficiaries) for the income taxes paid. If the adjustment is required by state law when the governing instrument is silent, the trust's current fiduciary accounting income is reduced for the amount of the adjustment.

Some of the items that can reduce fiduciary accounting income but not DNI include the following:

1. Losses suspended at the fiduciary level under the passive activity loss rules, if such losses are charged against fiduciary accounting income under the terms of the governing instrument or applicable local law.

2. Expenses subject to the 2% of AGI floor at the fiduciary level.

3. Interest expense subject to the investment interest limitation at the fiduciary level.

4. Interest expense, such as that paid to the IRS on income tax deficiencies, that is nondeductible interest at the fiduciary level.

5. The addition to the accounting reserve for depletion under the original or revised Uniform Principal and Income Acts in excess of depletion allowed for tax purposes.

6. The addition to the accounting reserve for depreciation in excess of tax depreciation.

Example 1K-1 Rental loss creates phantom taxable income.

The trust agreement for the Merle Jones Family Trust requires a reserve for depreciation to be maintained. Additions to the reserve are to equal depreciation computed for tax purposes. All trust income is to be distributed currently. In 2010, the trust received $20,000 in taxable interest income and $6,000 of rental income. The trust incurred $5,000 of direct rental expenses, and the addition to the depreciation reserve was $4,000. Rental losses are charged against income under the terms of the trust agreement.

Fiduciary accounting income is computed as follows:

Interest income	$ 20,000
Rental income	6,000
Rental expenses	(5,000)
Addition to depreciation reserve	(4,000)
Trust accounting income	$ 17,000

Since all income is required to be distributed currently, the trustee distributed $17,000. However, the passive loss rules cause the net rental loss to be suspended at the trust level for tax purposes. DNI is therefore $20,000, since none of the $3,000 rental loss is currently deductible.

The distribution deduction for a simple trust is the amount of income required to be distributed currently, which is the $17,000 of fiduciary accounting income. The trust will be taxed on the remaining $3,000 of DNI (less the $300 personal exemption). This excess of DNI over accounting income is sometimes referred to as "phantom income."

Potentially Caused by Pass-through Income

A trust or estate that owns an interest in a partnership or S corporation (i.e., a pass-through entity) reports taxable income for the fiduciary's share of partnership or S corporation income reported on the pass-through entity's Schedule K-1. However, fiduciary accounting income is generally based upon distributions from the partnership or S corporation. Since the distributions from these entities usually do not equal the taxable income passed through to the owners, "phantom" income is created for the fiduciary if the taxable income reported on Schedule K-1 exceeds the actual distributions from the pass-through entity.

Reporting on the Generation-skipping Transfer Tax

Generation-skipping Transfers (GSTs)

The GST tax is normally imposed on direct transfers to beneficiaries more than one generation below that of the transferor and on transfers involving trusts having beneficiaries in more than one generation below that of the transferor. However, at the time of this publication, the GST tax is repealed in 2010 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This means that direct skip transfers, taxable terminations, and taxable distributions, which are generation-skipping transfers, are not subject to the GST tax in 2010. Thus, there is no reporting requirement for GST taxable distributions from trusts in 2010.

In years other than 2010, the trustee of any trust that makes a taxable distribution, as defined in the next paragraph, is required to file Form 706-GS(D-1) to report the distribution to the distributee and the IRS. The distributee, who is liable for the tax, uses the information to compute the GST tax due on the distribution.

Taxable Distribution (for Years Other than 2010)

A *taxable distribution* is any distribution of income or principal (other than a taxable termination or a direct skip) from a trust to a skip person in a year other than 2010. Generally, skip persons are individuals who are two or more generations below the transferor.

A trust can be a skip person in two instances. First, a trust can be a skip person if all interests in the trust are held by skip persons. A trust can also be a skip person if (1) no person holds an interest in the trust, and (2) at no time after the transfer may a distribution (including distributions on termination) be made to a nonskip person.

The amount of the taxable distribution is the value of the property received by the transferee (recipient) reduced by any expense incurred by the recipient in connection with the determination, collection, or refund of the GST tax imposed on the distribution.

The recipient of a distribution is liable for the GST tax on includable taxable distributions. If the trust pays any of the GST tax, the tax payment is treated as an additional taxable distribution. The trustee is required to report the inclusion ratio of the taxable distribution, as explained in the following paragraphs.

Inclusion Ratio

The *inclusion ratio* is defined as one minus the *applicable fraction*. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust. (For 2010, each transferor is allowed a $1 million lifetime exemption indexed for inflation.) The denominator of the applicable fraction is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax recovered from the trust attributable to the transfer, and (2) the gift or estate tax charitable deduction, if any, allowed for the property. When computing the inclusion ratio, the applicable fraction must be rounded to the nearest one-thousandth (.001) before subtracting it from one.

Partial Terminations of a Trust (for Years Other than 2010)

If a property interest (e.g., an income interest) in a trust terminates because of the death of a lineal descendant of the transferor, and a specified portion of the trust's assets are distributed to at least one skip person (or at least one trust for the exclusive benefit of a skip person), the distribution is considered a *taxable termination* in a year other than 2010.

SELF-STUDY QUIZ

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

21. Larry and Joe are the beneficiaries of the Louisa Mae Estate. They each are entitled to 50% of the estate, and the separate share rule applies. In the first year, the estate has $50,000 of DNI. The executor decides to distribute $75,000 to Larry and postpone distributions to Joe until the next year. What are the resulting tax consequences?

    a. The estate is entitled to a $75,000 deduction.

    b. Larry includes $50,000 in his net income.

    c. Joe will receive his portion tax-free.

    d. Larry and the estate must each pay tax on $25,000.

22. Which of the following qualifies as a separate share?

    a. A charitable donation.

    b. Disproportionate distributions.

    c. A specific bequest.

    d. A pecuniary bequest determined as of the decedent's death.

23. Upon Robert's death, his wife, Martha, finds that she has been disinherited under the terms of Robert's most recent will. Martha invokes her spousal elective share. Under local law, the spousal elective share is interest only. Which of the following is true about Martha's inheritance?

    a. Martha's portion of the estate does not qualify as a separate share.

    b. Martha's share is considered a separate share but does not carry out DNI.

    c. The amount of Martha's DNI is equal to that distributed to the other beneficiaries.

    d. Martha's spousal elective share may contain two or more separate shares.

24. If an estate elects to use the 65-day rule, which of the following applies?

    a. Funds must be received by the beneficiary for the distribution to qualify.

    b. An amount under this election is considered made in the prior tax year for all purposes.

    c. The election is limited to the estate's amount of fiduciary accounting income.

    d. If the election is made, all distributions made by the estate will be affected.

25. The Jefferson Family Trust has $25,000 of taxable interest income and $15,000 of tax-exempt interest income. The trust has $8,000 in fiduciary fees, which are determined to be indirect expenses. The trust distributes all of the current income to the beneficiary. Calculate the distribution deduction for the trust using a reasonable method for allocating the indirect expenses.

    a. $12,000.

    b. $17,000.

c. $20,000.

d. $32,000.

26. Which of the following items will reduce fiduciary accounting income but not DNI, thus, creating "phantom" income for the beneficiaries?

a. All losses subject to the passive activity loss rules.

b. All interest expenses that are considered nondeductible interest.

c. All interest expenses that are subject to the investment interest limitation.

d. An addition to the accounting reserve for depreciation in excess of tax depreciation.

27. In the context of the generation-skipping transfer (GST) tax, define *taxable distribution*.

a. One minus the applicable fraction (numerator: a trust's allotted amount of the GST tax exemption; denominator: the value of the transferred property with certain reductions).

b. A trust's property interest terminates because of the death of a lineal descendent of the transferor and a specified portion of the estate transfers to a skip person.

c. Any distribution of income or principal from a trust to a skip person (other than a taxable termination or a direct skip).

d. "Proper" payments of income that are not required to be distributed currently and both discretionary and required distributions of principal.

28. When can a trust be a skip person?

a. When a skip person holds all interests in the trust.

b. When interests in the trust are held by at least one individual.

c. When a distribution is made to a nonskip person after the transfer.

SELF-STUDY ANSWERS

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

21. Larry and Joe are the beneficiaries of the Louisa Mae Estate. They each are entitled to 50% of the estate, and the separate share rule applies. In the first year, the estate has $50,000 of DNI. The executor decides to distribute $75,000 to Larry and postpone distributions to Joe until the next year. What are the resulting tax consequences? **(Page 154)**

    a. The estate is entitled to a $75,000 deduction. [This answer is incorrect. The distribution deduction is limited to DNI. Under the separate share rule, DNI must be calculated separately for each beneficiary.]

    b. Larry includes $50,000 in his net income. [This answer is incorrect. This would be true if the estate was not subject to the separate share rule.]

    c. Joe will receive his portion tax-free. [This answer is incorrect. If the estate was not subject to the separate share rule, Joe would receive his portion tax-free in the next year because Larry would be liable for the taxes currently on the entire distribution.]

    d. Larry and the estate must each pay tax on $25,000. [This answer is correct. Under the separate share rules, Larry will incur tax on $25,000 and the estate will incur tax on the $25,000 not distributed.]

22. Which of the following qualifies as a separate share? **(Page 154)**

    a. A charitable donation. [This answer is incorrect. Charities are not allocated any DNI; thus, the separate share rule does not apply to charitable donations.]

    b. Disproportionate distributions. [This answer is correct. Though disproportionate distributions can be problematic to account for, beneficiaries that receive them can still qualify as separate shares. The fiduciary must use a "reasonable and equitable method" to determine the value of each share and the allocations of income to each.]

    c. A specific bequest. [This answer is incorrect. The bequest of a specific property or a specific sum of money that is payable in three installments or less does not carry out DNI and, therefore, is not considered a separate share.]

    d. A pecuniary bequest determined as of the decedent's death. [This answer is incorrect. This type of pecuniary bequest is not a separate share, but one that is not determinable based on all the facts known at the decedent's death could be a separate share, if it is entitled to income and a share of appreciation/depreciation.]

23. Upon Robert's death, his wife, Martha, finds that she has been disinherited under the terms of Robert's most recent will. Martha invokes her spousal elective share. Under local law, the spousal elective share is interest only. Which of the following is true about Martha's inheritance? **(Page 154)**

    a. Martha's portion of the estate does not qualify as a separate share. [This answer is incorrect. Martha's spousal elective share will be subject to the separate share rules in this situation.]

    b. Martha's share is considered a separate share but does not carry out DNI. [This answer is correct. Because it is entitled to neither income nor appreciation/deprecation, Martha's spousal elective share does not carry out DNI. The initial payment of the share is considered nondeductible personal interest.]

    c. The amount of Martha's DNI is equal to that distributed to the other beneficiaries. [This answer is incorrect. Martha's share's portion of DNI is zero.]

    d. Martha's spousal elective share may contain two or more separate shares. [This answer is incorrect. This is true of a revocable trust that elects to be treated as part of the estate, not a spousal elective share.]

24. If an estate elects to use the 65-day rule, which of the following applies? **(Page 160)**

    a. Funds must be received by the beneficiary for the distribution to qualify. [This answer is incorrect. Funds must only be "properly credited" by the 65-day time limit to be considered made in the prior tax year under the election. Funds do not necessarily need to have been received by the beneficiary.]

    b. An amount under this election is considered made in the prior tax year for all purposes. [This answer is correct. Under IRC Sec. 663(b), the amount elected to be treated as if in the prior tax year will be treated as such for all purposes.]

    c. The election is limited to the estate's amount of fiduciary accounting income. [This answer is incorrect. According to IRC Sec. 663(b), the maximum amount of the election is limited to the greater of the estate's fiduciary accounting income or DNI reduced by amounts that were paid, credited, or required to be distributed during the tax year.]

    d. If the election is made, all distributions made by the estate will be affected. [This answer is incorrect. Either some or all of the distributions made in the first 65 days of the tax year can be designated as covered by the election by the estate per IRC Sec. 663(b).]

25. The Jefferson Family Trust has $25,000 of taxable interest income and $15,000 of tax-exempt interest income. The trust has $8,000 in fiduciary fees, which are determined to be indirect expenses. The trust distributes all of the current income to the beneficiary. Calculate the distribution deduction for the trust using a reasonable method for allocating the indirect expenses. **(Page 161)**

    a. $12,000. [This answer is incorrect. This is the tax-exempt portion of DNI (the tax-exempt interest income, $15,000, minus a portion of the indirect fees determined by a reasonable method, $3,000).]

    b. $17,000. [This answer is incorrect. To get this result, all of the indirect fees were allocated to the taxable portion of DNI ($20,000). This is not a reasonable method of allocating the indirect fees—some of the fees must also be allocated to the tax-exempt interest income.]

    c. $20,000. [This answer is correct. The portion of the fiduciary fees allocated to taxable income as an indirect expense is $5,000 using the following method: $8,000 − ($15,000/$40,000 × $8,000). Therefore, the trust's distribution deduction is $20,000, which is the taxable portion of DNI minus the taxable portion of the fees ($25,000 − $5,000).]

    d. $32,000. [This answer is incorrect. This is the entire available DNI amount ($40,000 − $8,000), but the tax-exempt must be taken into account to determine the trust's distribution deduction.]

26. Which of the following items will reduce fiduciary accounting income but not DNI, thus, creating "phantom" income for the beneficiaries? **(Page 163)**

    a. All losses subject to the passive activity loss rules. [This answer is incorrect. Losses that are suspended at the fiduciary level under the passive activity loss rules will reduce fiduciary accounting income without reducing DNI. This can occur if the losses are charged against the fiduciary accounting income under the terms of local law or the fiduciary's governing instrument.]

    b. All interest expenses that are considered nondeductible interest. [This answer is incorrect. Only nondeductible interest expenses at the fiduciary level will reduce fiduciary accounting income without reducing DNI. An example of such expenses is a payment to the IRS on income tax deficiencies.]

    c. All interest expenses that are subject to the investment interest limitation. [This answer is incorrect. Only such expenses at the fiduciary level will reduce fiduciary accounting income without reducing DNI. Another item that is a concern in this area is expenses that are subject to the 2% of AGI floor at the fiduciary level.]

    d. An addition to the accounting reserve for depreciation in excess of tax depreciation. [This answer is correct. Another item that can reduce fiduciary income without reducing DNI is an addition to the

accounting reserve for depreciation under the Uniform Principal and Income Acts (new or revised) in excess of depreciation allowed for tax purposes.]

27. In the context of the generation-skipping transfer (GST) tax, define *taxable distribution*. **(Page 165)**

    a. One minus the applicable fraction (numerator: a trust's allotted amount of the GST tax exemption; denominator: the value of the transferred property with certain reductions). [This answer is incorrect. In the context of the GST tax, this is the definition of the *inclusion ratio*. Trustees are required to report the inclusion ratio of a taxable distribution.]

    b. A trust's property interest terminates because of the death of a lineal descendent of the transferor and a specified portion of the estate transfers to a skip person. [This answer is incorrect. This is the definition of a *taxable termination*.]

    c. Any distribution of income or principal from a trust to a skip person (other than a taxable termination or a direct skip). [This answer is correct. Generally, a skip person is an individual that is two or more generations below the transferor. In two instances, a trust can be a skip person.]

    d. "Proper" payments of income that are not required to be distributed currently and both discretionary and required distributions of principal. [This answer is incorrect. This is the definition of a *Tier 2 distribution*, which can be made by an estate or a complex trust.]

28. When can a trust be a skip person? **(Page 165)**

    a. When a skip person holds all interests in the trust. [This answer is correct. According to the Internal Revenue Code, a trust can be a skip person in certain situations. One of which is when all interests in the trust are held by a skip person.]

    b. When interests in the trust are held by at least one individual. [This answer is incorrect. The trust can be a skip person if no individual holds an interest in the trust per the Internal Revenue Code.]

    c. When a distribution is made to a nonskip person after the transfer. [This answer is incorrect. According to the Internal Revenue Code, at no time after the transfer may a distribution (including distributions on termination) be made to a nonskip person.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T41TG102)

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

1. What is the Internal Revenue Code's term for the maximum amount of taxable income required to be included in the beneficiaries' gross income and the maximum amount a fiduciary can claim as an income distribution deduction?

   a. Fiduciary accounting income.

   b. Distributable net income.

   c. Tax-exempt income.

   d. Taxable income.

2. The Charleston Family Trust is set up to pay Sue Charleston's college expenses. In 2010, the trust pays $10,000 for Sue's tuition and $7,000 for Sue's room, board, and textbooks. The trust's DNI for 2010 is $13,000. There was no tax-exempt trust income. What is the trust's distribution deduction for 2010?

   a. $7,000.

   b. $10,000.

   c. $13,000.

   d. $17,000.

3. Logan's will specifically states that a cash sum of $50,000 should be distributed to his granddaughter, Cleo, within two years of his death (2010). In 2010, the estate has taxable DNI of $125,000. The trustee distributes the $50,000 to Cleo in 2010. No other distributions were made during the year. How will the distribution deduction be affected?

   a. The estate can deduct $50,000.

   b. Cleo can deduct $50,000.

   c. The estate can deduct $75,000.

   d. No distribution deduction is allowed.

4. The Baker Trust requires all income to be distributed currently. Additionally, it makes no distributions of principal in excess of a given year's required income, and it is not allowed a charitable contribution deduction. What type of trust is it?

   a. A simple trust.

   b. A complex trust.

   c. A simple trust with Tier 1 distributions.

   d. A complex trust with Tier 1 and 2 distributions.

5. The Wood Family Trust is a complex trust. In 2010, it received dividend income of $9,000 and taxable interest income of $20,000. The trust paid a fiduciary fee of $6,000. Calculate the trust's DNI for 2010.

   a. $20,000.

   b. $23,000.

   c. $29,000.

   d. $35,000.

6. Assume the same details as the question above. In 2010, the trustee made a $29,000 discretionary distribution to the beneficiary, which was permitted by the trust instrument. Calculate the trust's 2010 DNI.

   a. $20,000.

   b. $23,000.

   c. $29,000.

   d. $35,000.

7. Which of the following modifications would be made to an estate's taxable income to compute DNI?

   a. All capital gains would be excluded from DNI.

   b. No deduction would be allowed for distributions to beneficiaries.

   c. Net tax-exempt interest would be excluded from DNI.

   d. Gains from disposing of qualified small business stock would be excluded from DNI.

8. In 2010, the Levenweld Estate's fiduciary accounting income is greater than its DNI. Who receives the deduction for principal expenses in this situation?

   a. The income beneficiary.

   b. The estate.

   c. The executor.

   d. Under these circumstances, the deduction is lost.

9. A trust receives the following in 2010:

Interest income:	$	20,000
Qualified dividends:		40,000
Long-term capital gains:		80,000
Trustee's fees:		60,000

   Under the trust document, the trustee's fees are allocated to principal. Calculate the total amount of DNI, the total allocated to income, and the total allocated to principal.

   a. DNI: $0; Income: $60,000; Principal: $20,000.

   b. DNI: $0; Income: $120,000; Principal: $100,000.

   c. DNI: $40,000; Income: $100,000; Principal: $40,000.

   d. DNI: $60,000; Income: $0; Principal: $20,000.

10. The Thompson Testamentary Trust is a complex trust. The trust instrument states that $30,000 must be provided to Anne each year and any remaining income can be distributed to Alan, given to charity, or accumulated. The trust had $50,000 of taxable interest income in 2010. There are no other income items or trust expenses. The trustee distributes $30,000 to Anne, and, at his discretion, also distributes $10,000 to Alan and $45,000 to charity. What is the total amount of Tier 1 distributions?

    a. $10,000.

    b. $30,000.

    c. $40,000.

    d. $55,000.

11. The Thompson Testamentary Trust is a complex trust. The trust instrument states that $30,000 must be provided to Anne each year and any remaining income can be distributed to Alan, given to charity, or accumulated. The trust had $50,000 of taxable interest income in 2010. There are no other income items or trust expenses. The trustee distributes $30,000 to Anne, and, at his discretion, also distributes $10,000 to Alan and $45,000 to charity. What amount of the distributions would be tax-free?

    a. $0.

    b. $10,000.

    c. $30,000.

    d. $40,000

12. In which of the following instances would capital gains be included in DNI?

    a. When the capital gains are not permanently set aside, paid, or used for charitable purposes.

    b. When the capital gains are allocated to principal under the governing instrument's terms.

    c. When the capital gains are not credited, paid, or required to be distributed to a beneficiary.

    d. When the capital gains are distributed by the fiduciary as allowed by the governing instrument.

13. The Brinkman Family Trust terminates in 2010. All the stocks are sold, and all funds from the year's income and the capital gains are distributed equally to the two beneficiaries, Erin and Jamie. The capital gain was allocated to principal. What is the result of this action?

    a. The capital gain is included in DNI and taxed to the trust.

    b. The capital gain is excluded from DNI and taxed to the trust.

    c. The capital gain is included in DNI and taxed to Erin and Jamie.

    d. The capital gain is excluded from DNI and taxed to Erin and Jamie.

14. Alicia is the beneficiary of a simple trust. The trust agreement specifies that all income must be distributed currently to Alicia during her lifetime. In 2010, the trustee contacted Alicia as a notification of current available funds, but the trustee never actually distributed the funds. What are the consequences of this scenario?

    a. The trust is rendered ineligible for an income distribution deduction.

    b. The trust will lose its status as a simple trust.

c. Alicia must file a protest to ensure that she eventually receives the distribution.

d. Alicia must report income from the missed distribution on her Form 1040.

15. When the word *income* is unmodified in the Internal Revenue Code in conjunction with the income taxation of estates and trusts, what type of income is being referred to?

a. Taxable income.

b. Distributable net income.

c. Gross income.

d. Fiduciary accounting income.

16. Which of the following statements about *fiduciary accounting income* is most accurate?

a. It is contributed directly to the trust or estate by a donor.

b. Expenditures associated with it are charged to principal.

c. It is a common law, not an income tax concept.

d. Its provisions can never depart fundamentally from local law.

17. The Hershfield Testamentary Trust is a simple trust with the following income and expenses in 2010:

Business income:	$	15,000
Qualified dividends:		45,000
Tax-exempt interest income:		30,000
Long-term capital gain (allocated to principal):		10,000
Tax depreciation expense:		2,000
Other business expenses:		7,000
Trustee fee allocated to income:		2,000
Trustee fee allocated to principal:		1,000

Compute the trust's available distribution deduction.

a. $30,000.

b. $51,000.

c. $80,000.

d. $81,000.

18. The Allen Trust is a complex trust. Its trust document allows income distributions subject to the trustee's discretion. In 2010, the trust has DNI and fiduciary accounting income of $15,000 consisting of dividends worth $5,000, $12,000 of taxable interest income, and $2,000 of trustee fees. Which of the following actions would be allowed in this scenario?

a. The trustee can elect to accumulate the $15,000.

b. The trust takes a $19,000 deduction.

c. The trustee is required to distribute $15,000 to the beneficiaries.

d. The trust becomes a simple trust for the year.

19. The Jade Bell Trust is a complex trust. Under the trust instrument, a $5,000 income distribution is required for a specific charity each year, and any remaining income can be distributed to Allison at the trustee's discretion. A reserve for depreciation is allowed and maintained. Tax and book depreciation expenses are equal. During 2010, the trustee distributes $5,000 to charity and $7,500 to Allison. The trust also has the following items of income and expense:

Qualified dividends:	$	5,000
Taxable interest:		5,000
Tax-exempt interest:		5,000
Business income:		10,000
Business depreciation expense:		1,500
Other business expenses:		1,000
Trustee fee (allocated to income):		2,500

Calculate the trust's taxable portion of DNI for 2010.

a. $20,000.

b. $15,000.

c. $11,500.

d. $3,500.

20. Which of the following distributions would **never** be considered "other amounts properly paid or credited or required to be distributed" (OAPC) for an estate or trust?

i. Income required to be distributed currently

ii. Support obligation payments

iii. A charitable distribution

iv. Specific gifts and bequests under IRC Sec. 663(a)

v. A discretionary distribution made by a trustee

a. i. and iv.

b. ii. and v.

c. ii., iii., and iv.

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

21. Which of the following is true about the separate share rule?

a. Only trusts can be subject to the separate share rules; estates do not qualify.

b. Trustees have the ability to apportion income to beneficiaries at their discretion.

c. Each separate share can only have one beneficiary.

d. A beneficiary can be the beneficiary of multiple shares.

22. Tabitha's will divides her estate between an outright gift to her husband, Calvin, and a bypass trust. Cal receives 75% of the estate, and the bypass trust receives the other 25%. In the current year, the estate distributes $4 million—$3 million to Calvin and $1 million to the bypass trust. DNI for the year was $120,000 ($250,000 of taxable interest and $130,000 of deductions). Calculate the amount of taxable income of the estate for the year.

    a. $0.

    b. $30,000.

    c. $90,000.

    d. $120,000.

23. Aaron designates his estate as the beneficiary of his IRA. He dies in 2010. The date of death value of his estate after payment of debts and expenses is $1.7 million. The $300,000 from the IRA is included in the estate's gross income and allocated to principal. The estate consists of two separate shares for Esther and Ethan. Aaron's will specifies that Ethan's share must be funded first by the IRA. Both Esther and Ethan receive a distribution of $100,000 in 2010. How should the income in respect of a decedent (IRD) from the IRA be allocated?

    a. To the estate.

    b. To Esther.

    c. To Ethan.

    d. Split between Esther and Ethan.

24. Under IRC Sec. 663(b), an estate elects to have all distributions considered credited or paid on the last day of the tax year immediately prior. When must distributions have been made to qualify for this election?

    a. Within 65 days following the close of the estate's tax year.

    b. Within 90 days of the decedent's date of death.

    c. Within 30 days following the close of the beneficiary's tax year.

    d. Within 45 days of the beneficiary's receipt of the funds.

25. In 2009, the Keith Clinton Estate had $30,000 of taxable interest income and $20,000 of tax-exempt interest income. There were no executor fees or other trust expenses. The executor distributed $60,000 to the sole beneficiary during the year. Compute the estate's distribution deduction for the year.

    a. $20,000.

    b. $30,000.

    c. $50,000.

    d. $60,000.

26. When could an estate have "phantom" income (i.e., income that beneficiaries never receive, but that they must pay taxes on)?

    a. When the estate makes a "Holloway adjustment" to fiduciary accounting income.

    b. When a portion deemed paid from tax-exempt income reduces a charitable deduction.

    c. When the estate has a mandatory allocation of indirect expenses.

    d. When fiduciary accounting income is reduced by certain expenses/losses but DNI is not.

27. When the estate's creator directs all income to be distributed currently to beneficiaries, "income" is considered which of the following?

    a. Taxable income.

    b. Fiduciary accounting income.

    c. Net income.

    d. Tax-exempt income.

28. Where should an estate that owns interest in a S corporation report taxable income for the fiduciary's share of S corporation income?

    a. Schedule A (Form 1041).

    b. Schedule B.

    c. Schedule D (Form 1041).

    d. Schedule K-1.

Lesson 2: Property Distributions

INTRODUCTION

Property distributions are also called "in-kind" distributions and are governed by different rules than those prescribed for cash distributions. Although cash is generally considered property, for purposes of this discussion, property distributions consist only of non-cash, or "in-kind" distributions. Lesson 1 covered the general rules for dealing with distributions.

This lesson distinguishes between distributions of specific property (i.e., specific bequests) and distributions of property that are not specific bequests. This is important because specific bequests are governed by IRC Sec. 663(a)(1), rather than IRC Secs. 661 and 662 (the general distribution rules). Thus, the estate or trust is not entitled to an income tax deduction for the distribution, and the beneficiary does not include the distribution in his or her income. In contrast, property distributions that are not considered specific bequests are subject to the general distribution rules of IRC Secs. 661 and 662, entitling the estate or trust to a distribution deduction and requiring the inclusion of income for the beneficiary.

Practitioners should be familiar with the amount of the distribution deduction to the estate or trust, the amount of income recognition by the beneficiary, the recipient's basis in the property distributed, the holding period of the property in the recipient's hands, and the rules for gain recognition by the estate or trust upon distributing appreciated property.

Estates make three types of distributions: (1) specific, (2) pecuniary, and (3) residuary. Specific bequests are those that are specifically identified in the governing instrument and payable to a beneficiary in three or fewer installments. Pecuniary bequests include gifts of a specific dollar value, which can be based on either a fixed dollar amount or a formula. Residuary bequests refer to the particular fraction or percentage of the estate after the payment of the specific and pecuniary bequests, any debts, and expenses. Trusts make two types of distributions: (1) income and (2) principal.

Fiduciaries may make a variety of in-kind distributions, depending on the circumstances. Some examples include:

1. A fiduciary may be required under the terms of the governing instrument to distribute a specific asset.

2. A fiduciary may distribute property to satisfy a requirement to distribute a certain monetary (pecuniary) value to a beneficiary. The pecuniary amount in question could be explicit (e.g., $100,000 of value) or based on a variety of formulas (e.g., the minimum marital distribution amount necessary to reduce the taxable estate to zero).

3. A fractional amount of trust principal or a fraction of the residuary estate may be involved (e.g., "One-half of the remaining trust principal is to be distributed to my son, John, upon reaching the age of 40").

4. The fiduciary may have the discretion to distribute property in-kind as he or she sees fit or under powers granted in the governing instrument.

The property being distributed may have appreciated (fair market value greater than tax basis) or depreciated (fair market value less than tax basis). The property may be subject to some form of cost recovery (depreciation, depletion, amortization). If depreciable property is distributed, it may have depreciation recapture potential that is carried over to the beneficiary.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the tax effects of property distributions and determine when distributions of specific property are considered specific bequests and, thus, are not eligible for the distribution deduction.
- Develop a strategy for dealing with distributions of property that are not specific bequests.

- Assess and compute gain or loss recognition related to distributions in lieu of specific property or dollar amounts, distributions of property in lieu of income, and distributions of depreciated property.
- Determine the tax implications of distributions of installment obligations, partnership interests, and S corporation stock.

An Overview of the Tax Effects Related to Property Distributions

Generally, no gain or loss is recognized when a fiduciary distributes property (an "in-kind" distribution) to beneficiaries. For estates and complex trusts, the value of property distributed (i.e., paid, credited, or required to be distributed) is the smaller of the (1) fiduciary's adjusted basis in the property immediately before the distributions, plus any Section 643(e)(3) gain elected to be recognized by the fiduciary on the distribution or (2) fair market value of the property. The beneficiaries receive property with carryover basis and holding period. This general rule applies to bequests of specific property, discretionary distributions, and distributions to satisfy the rights to a share of trust principal or a share of a residuary estate. Discretionary distributions are usually treated as "other amounts paid or credited" on Schedule B of Form 1041.

The exceptions to this general rule include the following:

1. Distributions of property in satisfaction of a pecuniary bequest (e.g., specific dollar amount based on an estate tax formula). These distributions require recognition of gain and, for estates, loss.

2. Distributions of property in satisfaction of the beneficiary's right to receive a specific dollar amount or a specific asset other than the asset distributed. These distributions trigger gain, but not loss.

3. Distributions of property in lieu of income. These distributions result in recognition of gain, but not loss.

4. Distributions of property when the fiduciary elects to recognize gain under IRC 643(e)(3). When the election is made, gain is recognized by the estate or trust, causing a step-up in basis to the beneficiary, as if the property had been sold to him or her at FMV.

5. For estates of decedents dying in a year other than 2010, distributions of special-use valuation property (for which a lower-than-FMV valuation was claimed on Form 706) to qualified heirs. In that case, the gain is limited to the difference between the FMV (without regard to the special-use valuation) as of the date of transfer and the FMV (without regard to the special-use valuation) as of the decedent's death (or alternate valuation date, if elected).

In each of the above situations, there are also specific rules regarding whether DNI is carried out to the beneficiary causing him or her to recognize income and allowing the estate or trust to claim an income distribution deduction.

SELF-STUDY QUIZ

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

29. Define *residuary distribution*.

    a. An in-kind distribution made by the fiduciary as he/she sees fit.

    b. Distribution of a fraction of the estate after all other debts and bequests are settled.

    c. Distribution of property that is specifically identified by the estate's governing instrument.

    d. Distribution of gifts of a specific dollar value, either a fixed amount or a formula.

30. The value of property distributed by an estate (other than in satisfaction of a pecuniary bequest) is the smaller of the estate's adjusted basis in the property immediately before distributions are made plus Section 643 gain the fiduciary elects to recognize, or which of the following?

    a. The fair market value (FMV) of the property.

    b. The FMV of the property as of the decedent's death.

    c. The carryover basis of the property.

    d. The value recorded on Schedule B of Form 1041.

SELF-STUDY ANSWERS

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

29. Define *residuary distribution*. **(Page 179)**

    a. An in-kind distribution made by the fiduciary as he/she sees fit. [This answer is incorrect. This is an example of the types of in-kind distributions that fiduciaries may be required to make; however, this is not the definition of a residuary distribution.]

    b. Distribution of a fraction of the estate after all other debts and bequests are settled. [This answer is correct. After the payment of specific bequests, pecuniary bequests, and any expenses or debts, the bequest of a percentage or fraction of the remaining estate is called a residuary distribution.]

    c. Distribution of property that is specifically identified by the estate's governing instrument. [This answer is incorrect. This is a *specific distribution*, which is one of the other types of distributions that fiduciaries make.]

    d. Distribution of gifts of a specific dollar value, either a fixed amount or a formula. [This answer is incorrect. Fiduciaries make three types of distributions. This is the definition of a *pecuniary bequest*.]

30. The value of property distributed by an estate (other than in satisfaction of a pecuniary bequest) is the smaller of the estate's adjusted basis in the property immediately before distributions are made plus Section 643 gain the fiduciary elects to recognize, or which of the following? **(Page 180)**

    a. The fair market value (FMV) of the property. [This answer is correct. The value of property paid, credited, or required to be distributed by an estate or a complex trust is the smaller of the property's FMV or the value listed above.]

    b. The FMV of the property as of the decedent's death. [This answer is incorrect. The difference between FMV as of the date of transfer and FMV as of the decedent's death is the amount of gain recognized on distributions of special-use valuation property.]

    c. The carryover basis of the property. [This answer is incorrect. However, beneficiaries of an estate will receive property with both the carryover basis and the holding period.]

    d. The value recorded on Schedule B of Form 1041. [This answer is incorrect. Discretionary distributions made by an estate are generally treated on Schedule B of Form 1041 as "other amounts paid or credited."]

Considerations for Distributing Specific Property

General Rules

A gift or bequest of specific property or a specific sum of money explicitly required by the terms of a will or trust instrument to be paid or credited to a beneficiary in three or fewer installments is generally not allowed as a distribution deduction to an estate or trust and is not included in the beneficiary's gross income. To qualify as a gift or bequest of specific property or sum of money, the amount of money or the identity of the property must be ascertainable under the terms of the decedent's will as of the date of death or under the terms of an *inter vivos* trust instrument at its inception. An amount that, under the terms of the governing instrument, can be paid only from the income of the estate or trust is not a specific bequest (since the amount of estate or trust income cannot be determined as of the date of the decedent's death or for *inter vivos* trusts, at the time of the trust inception).

No gain or loss is recognized on the distribution of the specific property, unless (1) the distribution is in satisfaction of a right to receive a specific dollar amount or (2) the property distributed is substituted for the specific property bequeathed. The election to recognize gain under IRC Sec. 643(e)(3) does not apply to specific bequests. However, if under the terms of the will or trust instrument, the gift or bequest is to be paid or credited in more than three installments, the distribution is treated under the general distribution rules of IRC Sec. 643(e)(2) (i.e., distribution deduction at the fiduciary level and income inclusion to the beneficiary equal to the lesser of the adjusted basis or FMV of the property).

Example 2B-1 Distribution of specific property has no tax effect.

Bill Parker died in 2008. Bill's last will and testament bequeathed his Rolls Royce to his great niece, Bonnie. In 2010, the executor distributed the Rolls Royce to Bonnie, but made no distributions of cash or other property. The estate has taxable DNI of $100,000 for 2010. The Rolls Royce had a basis to the estate of $150,000 and a FMV of $175,000 at the time of distribution.

The $25,000 appreciation between the date of death (or alternate valuation date) and the date of distribution is not taxed to the estate or Bonnie in 2010. Bonnie receives the Rolls with a basis of $150,000 and a long-term holding period. No income distribution deduction is allowed to the estate, and the receipt of the auto does not increase Bonnie's gross income for 2010, even though the estate had undistributed taxable DNI for that year. The distribution is not required to be reported on Schedule B (Form 1041).

Interest Paid on Distributions. If a specific bequest of money is not distributed promptly, some state laws require the estate to pay interest. If interest is paid under these circumstances, the interest income should be reported to the recipient by the estate. Issuing a Form 1099-INT to the recipient is this course's recommendation for reporting the interest. The IRS's position is that such interest expense is nondeductible by the estate. In certain jurisdictions, however, statutory interest (required by the governing instrument or local law) may be deductible as an administration expense under IRC Sec. 2053(a)(2), rather than an income distribution deduction under IRC Sec. 661. Interest paid to a surviving spouse is not deductible in a will contest when the spouse elects against the will to receive the fraction of the estate allowed by the state's elective share statute. The electing spouse is not entitled to receive any estate income, but must receive interest income on the elective share from the date the court order directed that the elective share be paid. Such interest is considered nondeductible personal interest expense of the estate.

Property or Property Value Must Be Specifically Identified

For a property transfer to be considered a specific bequest, the identity of the specific property or the specific amount of the property value must be ascertainable in the governing instrument as of the date of death or the inception of the trust. If the will or trust instrument provides that the bequest of money or property is to be based upon a fraction of the decedent's adjusted gross estate, the bequest does not qualify as a specific bequest since the identity of the property and the amount of money are subject to administration expenses and other charges, which cannot be known as of the decedent's death. For example, if a will bequeaths a personal residence to an individual, the distribution of the residence qualifies as a specific bequest since the property can be specifically

identified at the date of death. In contrast, if the will bequeaths sales proceeds of the residence to a beneficiary, the distribution would not be a specific bequest since neither the sales price nor the sales expenses would be known at the date of death. A bequest of specific property is not disqualified solely because the distribution is subject to a condition, such as the beneficiary reaching a certain age.

Distributions of the following items are *not* considered specific bequests and are subject to the general distribution rules discussed later in this lesson:

1. An amount that can be paid or credited only from the income of an estate or trust, whether from income for the year of payment or from income accumulated from a prior year.

2. An annuity or periodic gifts of specific property in lieu of or having the effect of an annuity.

3. A residuary estate or trust principal.

4. A gift or bequest that is required to be paid in more than three installments under the terms of the governing instrument, regardless of the actual number of installments actually made.

A bequest of unspecified assets with a fair market value specified in a decedent's will is considered a bequest of a "specific sum of money" under IRC Sec. 663(a). Consequently, the estate is not allowed a distribution deduction when it pays the bequest, and the beneficiary does not include any amount in gross income. In addition, the distribution of unspecified property with a specific dollar amount (i.e., a pecuniary bequest) causes the estate to recognize gain or loss on the distribution.

Assets Acquired from Decedents Who Die Before or After 2010. An estate distributing unspecified property to satisfy a pecuniary bequest will recognize gain or loss in an amount equal to the difference between the property's fair market value (FMV) at the time of distribution and its adjusted basis to the estate. The losses will be allowed under IRC Sec. 267(b)(13) because the related party rules for estates and beneficiaries do not apply to property distributions in satisfaction of pecuniary bequests.

Assets Acquired from Decedents Who Die in 2010. Although individuals who die in 2010 are not subject to estate tax, the bases of their assets are subject to the modified carryover basis rules rather than the step—up basis rules. Without some type of relief provision, the required gain recognition for pecuniary bequests of appreciated property could be significantly higher than under the traditional rules, even if the assets have not appreciated from the date of the decedent's death to the date of distribution. To prevent this inequitable result, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) provides that gain is recognized by the estate only to the extent that the FMV of the property at the time of the transfer exceeds the FMV of the property (not the property's carryover basis) on the date of the decedent's death [IRC Sec. 1040(a), effective for estates of decedents dying after December 31, 2009 and before January 1, 2011].

If the distribution results in a loss, the loss will not be disallowed because the related party rules do not apply to property distributions in satisfaction of pecuniary bequests.

Example 2B-2 Distribution of unspecified property in satisfaction of a beneficiary's right to receive a specific dollar amount (pecuniary bequest).

Karla Wiliow died in 2009. The Karla Willow Estate bequeaths $100,000 to Joyce Willow, payable in cash or property. The executor distributes shares of stock to Joyce in 2010 when the stock was valued at $100,000. Karla acquired the stock in 1978 for $30,000. The stock's FMV on the date of Karla's death was $80,000. The estate's basis in the stock is $80,000, the value on Karla's date of death.

Because the distribution was of unspecified property (either cash or property was distributable), the estate must recognize a capital gain of $20,000 ($100,000 FMV − $80,000 basis) on the satisfaction of Joyce's bequest with appreciated property. However, no distribution deduction is available to the estate upon paying the bequest, and Joyce does not include any amount from the distribution in her gross income since it falls within the specific bequest exception to the normal distribution rules of IRC Secs. 661 and 662.

Variation: Karla died in 2010, and none of Karla's $1.3 million aggregate basis increase (see Key Issue 5E) was allocated to the stock. Thus, the estate's basis in the stock is $30,000. The estate recognizes $20,000 ($100,000 FMV on date of distribution − $80,000 FMV on date of death) capital gain on the distribution rather than $70,000 ($100,000 FMV on date of distribution − $30,000 carryover basis on date of death) because the gain recognized is limited to post-death appreciation.

Note: Whether or not the executor elects to increase the basis for the aggregate basis increase (or, for decedents who were married at the time of death, spousal property basis increase) makes no difference in the amount of gain recognition for distributions of appreciated property in satisfaction of pecuniary bequests. If the executor had elected to increase the basis of the stock to the $80,000 FMV on Karla's date of death, the required gain recognition on the distribution to Joyce is still $20,000 ($100,000 FMV on date of distribution - $80,000 FMV on date of death).

Bequests Payable in Installments

To be treated as a specific bequest, the distribution must be *required* to be paid in three or fewer installments. Thus, if the bequest is required to be paid in four or more installments, each payment will be an "other amount paid or credited," which carries out DNI to the distributee. If no time of payment or crediting is specified in the instrument, the bequest is considered as required to be paid in a single installment. In addition, all gifts and bequests payable at any one specified time (e.g., when the beneficiary turns 35) are taken into account as a single installment.

Personal-use property, such as household effects and automobiles, are disregarded for purposes of the three-or-fewer-installments rule. Specifically devised real property, the title to which passes directly to the devisee under state law, is also disregarded.

When determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust are treated as separate entities.

Example 2B-3 Property bequeathed in three or fewer installments.

Joe Johnson died in 2010. Under the terms of Joe's will, $10,000 cash, household furniture, a watch, an automobile, 100 shares of IBM stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to his son, Sam, under local law) are bequeathed or devised outright to Sam. The will also provides for the creation of a trust for the benefit of Sam, the terms of which require the trustee to distribute $50,000 cash and 100 shares of AT&T stock to Sam when he reaches 25 years of age, $100,000 cash and 200 shares of AT&T stock when he reaches 30 years of age, and $200,000 cash and 300 shares of AT&T stock when he reaches 35 years of age.

The furniture, watch, automobile, and farm are excluded in determining whether any gift or bequest is required to be paid or credited to Sam in more than three installments. These items qualify for the exclusion for specific bequests under IRC Sec. 663(a)(1), regardless of the treatment of the other items of property bequeathed to Sam.

The $10,000 cash, the IBM stock, the grain, and the cattle bequeathed outright to Sam are considered paid in a single installment. Likewise, the assets required to fund the trust are considered as required to be paid or credited (to the trust) in a single installment, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The cash and stock required to be distributed by the trust to Sam when he is 25 years old are considered as required to be paid in one installment under the trust. Likewise, the distributions to be made by the trust to Sam when he is 30 and 35 years old are each considered as one installment under the trust.

Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under IRC Sec. 663(a)(1). Similarly, the three distributions by the trust also qualify as specific bequests. However, if the recipient of the specific bequest is entitled to the income on the property, such income (not principal) on the bequeathed property is considered a separate share and is subject to DNI carryout.

Example 2B-4 Property bequeathed in more than three installments.

Assume the same facts as in Example 2B-3, except another distribution of a specified sum of money is required to be made by the trust to Sam when he turns 40. This distribution would also qualify as an installment, totaling four installments under the terms of the trust agreement. None of the gifts to Sam under the trust would qualify for the specific bequest exclusion under IRC Sec. 663(a)(1). However, the distributions from the estate (i.e., the furniture, watch, automobile, and farm) would still qualify for the exclusion.

Example 2B-5 Property bequeathed in more than three installments, but paid all at once.

Sarah Jones died on March 19, 2010. According to the terms of her will, 5,000 shares of XYZ stock was to be paid to her niece, Kate, over five years after Sarah's death. However, because she needed the funds for college, the executor distributed all 5,000 shares to Kate on December 10, 2011.

Although the property is specifically identified, Sarah's will does not require the distribution to be payable in three or fewer installments, and thus, the distribution does not qualify as a specific bequest under IRC Sec. 663(a)(1). The fact that the executor actually distributed the stock in three or fewer installments is irrelevant. Thus, the distribution is not excluded from the DNI carryout rules of IRC Secs. 661and 662.

Because the will provides that the bequest is payable in more than three installments, the bequest is subject to DNI carryout regardless of whether the bequest is entitled to income.

SELF-STUDY QUIZ

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

31. Which of the following distributions would be considered a bequest of specific property or sum of money, assuming all are explicitly required by the terms of the trust instrument or will?

    a. George receives a sum of money from his father's estate that is paid out in three installments.

    b. Bob receives a sum of money from an *inter vivos* trust that must be paid from the trust's income.

    c. Charlie receives a boat from his mother's estate instead of an equivalent specified sum of money.

    d. Reggie elects to recognize gain on a distribution under IRC Sec. 643(e)(3).

32. Harold died in 2008, and in his will, he left his vacation home to his grandson, Carl. The vacation home is distributed to Carl by the executor in 2010. No other property or cash distributions were included. The estate has taxable DNI of $150,000 in 2010. The vacation home had a basis to the estate of $200,000 and a FMV of $275,000 when it was distributed to Carl. Which of the following best illustrates one of the consequences of this distribution?

    a. The estate takes an income distribution deduction of $275,000 to offset DNI.

    b. Carl must pay taxes on the $75,000 of appreciation on the property.

    c. The estate must pay taxes on the $75,000 of appreciation on the property.

    d. Carl has a basis of $200,000 in the vacation home.

33. Assume the same details as in the question above. Must Harold's estate pay interest on the vacation home because it was not distributed promptly upon Harold's death?

    a. Yes.

    b. No.

    c. It depends on the state in which Harold's estate is based.

34. Assume the same details, but with these additions. Harold bequeaths $25,000 to his nephew, Mark, to be paid out in four installments. Upon Mark's request, the executor pays the bequest in one installment. Harold bequeaths an additional $25,000 to his niece, Shelia, but Shelia takes the payments in the four installments. Considering all of the bequests, which of Harold's beneficiaries meets the installment requirements for treatment as a specific bequest?

    a. Carl.

    b. Shelia.

    c. Mark.

SELF-STUDY ANSWERS

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

31. Which of the following distributions would be considered a bequest of specific property or sum of money, assuming all are explicitly required by the terms of the trust instrument or will? **(Page 183)**

    a. George receives a sum of money from his father's estate that is paid out in three installments. [This answer is correct. Property or cash distributions required by the will must be paid to a beneficiary in three installments or less to qualify for tax treatment as a distribution of specific property. If the payment were made in more than three installments, the general distribution rules of IRC Sec. 643(3)(2) would apply.]

    b. Bob receives a sum of money from an *inter vivos* trust that must be paid from the trust's income. [This answer is incorrect. The amount of income cannot be determined as of the date of the *inter vivos* trust's inception; therefore, this is not a specific bequest per IRC Sec. 643.]

    c. Charlie receives a boat from his mother's estate instead of an equivalent specified sum of money. [This answer is incorrect. Because the boat was not the specific property bequeathed to Charlie by the will, this distribution does not qualify for the favorable tax treatment of distributions of specific property per IRC Sec. 643.]

    d. Reggie elects to recognize gain on a distribution under IRC Sec. 643(e)(3). [This answer is incorrect. The election to recognize gain on a distribution under IRC Sec. 643(e)(3) is not allowable for specific bequests.]

32. Harold died in 2008, and in his will, he left his vacation home to his grandson, Carl. The vacation home is distributed to Carl by the executor in 2010. No other property or cash distributions were included. The estate has taxable DNI of $150,000 in 2010. The vacation home had a basis to the estate of $200,000 and a FMV of $275,000 when it was distributed to Carl. Which of the following best illustrates one of the consequences of this distribution? **(Page 183)**

    a. The estate takes an income distribution deduction of $275,000 to offset DNI. [This answer is incorrect. Because this is a distribution of specific property, the estate cannot claim a distribution deduction, despite the undistributed taxable DNI.]

    b. Carl must pay taxes on the $75,000 of appreciation on the property. [This answer is incorrect. The appreciation amount will not be taxed to Carol in 2010.]

    c. The estate must pay taxes on the $75,000 of appreciation on the property. [This answer is incorrect. The estate is not responsible for paying taxes in 2010 on the property's appreciation.]

    d. Carl has a basis of $200,000 in the vacation home. [This answer is correct. Neither Carl nor the estate must pay taxes on the $75,000 of appreciation on the vacation home. However, Carl's basis in the vacation home is limited to the basis that it had to the estate at the time of Harold's death.]

33. Assume the same details as in the question above. Must Harold's estate pay interest on the vacation home because it was not distributed promptly upon Harold's death? **(Page 183)**

    a. Yes. [This answer is incorrect. However, if the estate did have to pay interest on the vacation home, the estate must report it to Carl.]

    b. No. [This answer is incorrect. Any interest paid by the estate can be reported on Form 1099-INT.]

    c. It depends on the state in which Harold's estate is based. [This answer is correct. State law governs interest in this situation. The IRS maintains that such interest is not deductible by the estate.]

34. Assume the same details, but with these additions. Harold bequeaths $25,000 to his nephew, Mark, to be paid out in four installments. Upon Mark's request, the executor pays the bequest in one installment. Harold bequeaths an additional $25,000 to his niece, Shelia, but Shelia takes the payments in the four installments. Considering all of the bequests, which of Harold's beneficiaries meets the installment requirements for treatment as a specific bequest? **(Page 183)**

    a. Carl. [This answer is correct. The bequest of the vacation home is personal-use property and is disregarded for the three-installments-or-fewer rule. Because an estate and a trust are considered separate entities when determining the number of installments to a beneficiary, his trust qualifies under the installment rule.]

    b. Shelia. [This answer is incorrect. A bequest taken in more than three installments does not qualify to be treated as a specific bequest.]

    c. Mark. [This answer is incorrect. It is Harold's will and not the executor of the estate that determines if the bequest is specific or not. Even though Mark received his bequest in one installment, it will not be treated as a specific request.]

Considerations for Property Distributions That Are Not Specific Bequests

General Rules

Unless a property distribution from an estate or trust qualifies as a gift or bequest of specific property, a property distribution is generally treated as an "other amount paid or credited" on Schedule B of Form 1041. Therefore, such distributions carry out DNI to the beneficiaries, resulting in an income distribution deduction at the fiduciary level and an income inclusion amount for the beneficiary, subject to the DNI limitations of the separate shares.

Simple Trusts. For simple trusts, the distribution deduction and income inclusion amount equal the income required to be distributed currently, and the trust must recognize gain on the distribution for the excess of FMV of the property over its adjusted basis. This rule also applies to Tier 1 distributions of complex trusts.

Estates and Complex Trusts. For in-kind distributions, the amount considered distributed for an estate or a complex trust's distribution deduction and the beneficiary's income inclusion generally is the lesser of the adjusted basis of the property in the hands of the beneficiary (usually the carryover basis from the estate or trust) or the fair market value (FMV) of the property at the time it was distributed. The estate or trust generally does not recognize gain or loss on the distribution unless the property is distributed in satisfaction of a pecuniary bequest. However, if a Section 643(e)(3) election (discussed later in this lesson) is made, gain but not loss is recognized, and the distribution deduction, income inclusion amount, and the basis of the property to the beneficiary is equal to the property's FMV.

Example 2C-1 Discretionary distribution of property.

In 2010, the Samuel Smith Family Trust generated $30,000 of taxable DNI for the year. Fiduciary accounting income was also $30,000. The trust instrument follows the general rule that capital gain is excluded from fiduciary accounting income. The only distribution to a beneficiary during the year was a discretionary distribution to Al Smith of 100 shares of BT&T common stock. The trust had a tax basis of $1,000 for these shares, and the FMV of the shares on the date of distribution was $25,000.

Since the distribution is not a mandatory income distribution or a distribution of a stated dollar amount, no gain or loss is recognized by the trust on the distribution of the stock. The basis in the shares to Al is $1,000. The trust's holding period "tacks on" to Al's. The trust's distribution deduction is $1,000 since basis is less than FMV. Al will include $1,000 in gross income.

Variation: If the FMV of the shares had been $500, the tax basis of the shares in Al's hands would still have been $1,000 (a carryover basis since the trust recognizes no gain or loss on the distribution). Similarly, the trust's holding period carries over to Al. However, Al will include $500 in gross income (instead of $1,000), and the trust is entitled to a $500 distribution deduction, i.e., the lesser of the stock's basis to the beneficiary or FMV.

Pecuniary (specific dollar amount) bequests based on a formula are not considered specific bequests. (See the discussion of pecuniary formula bequests later in this lesson.) Additionally, the distribution of a residuary estate or principal of a trust is not considered a specific bequest, and as such, is generally deductible by the estate or trust and taxable to the beneficiary (up to its separate share of taxable DNI).

An estate's distribution of real estate will not carry out DNI if title to the real estate automatically vests in the distributee immediately upon the death of the decedent, which is typically the case in most states.

Distributions of Property with Recapture Potential

When the fiduciary distributes depreciable property to beneficiaries for which no gain or loss is recognized and the basis carries over, any depreciation recapture potential remains with the property.

Example 2C-2 No depreciation recapture when basis carries over to beneficiary.

Assume the same facts as in Example 2C-1, except the discretionary distribution consisted of Section 1245 recapture property with a basis of $1,000, a FMV of $25,000, and potential Section 1245 recapture of $24,000.

The distribution does not trigger the recapture amount, since no gain or loss is recognized. However, the recapture potential remains with the property in the hands of the beneficiary.

Election to Recognize Gain on Property Distributions

Estates and trusts generally may elect to recognize gain (but not loss) on the distribution of property (except for specific bequests), causing a step-up in basis to the beneficiary as if the property had been sold to the distributee at FMV. Losses are disallowed according to the related party rules of IRC Secs. 267(b)(6) and (13). Although the related party rules do not disallow losses of an *estate* upon distributions in satisfaction of pecuniary bequests, gain or loss recognition is *required* rather than *elective* for pecuniary bequests. Thus, the election under IRC Sec. 643(e) does not apply for such gains or losses. Gains and disallowed losses must be determined for each separate property distributed.

The election to recognize gain generally covers *all* distributions of property other than specific bequests made during the tax year and distributions in satisfaction of pecuniary obligations, such as rights to income. However, the election is not available for the distribution of claims to receive IRD. When the election is made, the distribution deduction and income inclusion amounts are the FMV of the property distributed.

Example 2C-3 Election to recognize gain upon distribution of property.

The facts are the same as in Example 2C-1, in which stock with a FMV of $25,000 and a basis of $1,000 was distributed, except the trustee elects under IRC Sec. 643(e)(3) to recognize gain on the stock distribution as if the shares were sold.

As a result of the Section 643(e)(3) election, the trust will recognize a capital gain of $24,000 (FMV − basis). The beneficiary will have a $25,000 (trust's $1,000 basis plus $24,000 gain recognized) basis in the shares, and the trust is allowed a distribution deduction of $25,000 (not to exceed DNI). Since capital gains are allocated to principal, DNI does not include the $24,000 gain on this discretionary distribution. The beneficiary would include $25,000 in gross income from the trust (not to exceed DNI) even though he received no cash. Because there has been a deemed sale of the trust property, the trust's holding period is not tacked onto to the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquisition (i.e., date of distribution).

In reporting the deemed sale, the gain can be reported on Schedule D (Form 1041), since it pertains to capital gain assets, along with a description of the property and a Section 643(e)(3) election notation. To avoid IRS matching problems [since the Section 643(e)(3) gains will not be reported on a Form 1099], some practitioners prefer to report the gain on an attached statement, rather than on Schedule D, with the amount carried to the appropriate line on page 1 of Form 1041 (line 4 for capital gains). A disclosure statement regarding the election to recognize the gain should be attached to the return.

Variation: If the trustee had been required by the governing instrument to sell the stock and distribute the proceeds to the beneficiary, the gain would be included in DNI.

Example 2C-4 Discretionary distributions of appreciated and depreciated property in the same year.

On June 30, 2010, the Agerton Family Trust made the following discretionary property distribution to Bee:

Description	Basis	FMV	Gain/Loss
100 shares ABC Corp stock	$ 2,000	$ 2,500	$ 500
50 shares XYZ Corp stock	2,200	1,500	(700)
250 shares LQ Corp stock	1,500	3,000	1,500
Total	$ 5,700	$ 7,000	$ 1,300

The trustee makes the Section 643(e)(3) election. Capital gains are allocated to principal. The trust has $20,000 of DNI (all taxable) for 2010. Bee is one of the two beneficiaries of the Family Trust entitled to receive

50% of the value of the trust property. Because there is more than one beneficiary and the separate share rule of IRC Sec. 663(c) applies, the maximum amount of DNI that can be reported to Bee for 2010 is $10,000 ($20,000 x 50%). Bee was the only beneficiary to receive a distribution in 2010, and the property distribution is the only distribution for the year.

Although the trust has a realized net gain of $1,300, it must recognize gain of $2,000 ($500 from ABC Corp and $1,500 from LQ Corp). The $700 loss from XYZ Corp is not recognized due to the related party rules. Since capital gain is allocated to principal, the trust will pay the tax on the $2,000 gain and will charge them against Bee's share of the trust. The trust will have a distribution deduction of $7,000 for the FMV of the property distributed.

Bee will include $7,000 in gross income and receive a tax basis of:

ABC Stock	$ 2,500
LQ Stock	3,000
XYZ Stock:	
For gain purposes:	2,200
For loss purposes:	1,500

If Bee sells XYZ stock for an amount between $1,500 and $2,200, no gain or loss is recognized. The fiduciary should provide the basis information and holding period to Bee as a memo item on Schedule K-1 and in a separate letter to make sure the beneficiary and the preparer, if any, of the beneficiary's income tax return have this basis information. Since the Section 643(e)(3) election was made, there has been a deemed sale of the trust property, which results in a new holding period Bee, beginning on the date of acquisition (distribution of the stock).

Variation: If the Section 643(e)(3) election is not made, the trust would not recognize the $2,000 gain. The trust would have a distribution deduction of $5,000 ($2,000 + $1,500 + $1,500). Bee would include $5,000 in gross income and will have the following basis:

ABC Stock	$ 2,000
XYZ Stock	2,200
LQ Stock	1,500

Because the Section 643(e)(3) election was not made, there is no deemed sale. Thus, the trust's holding period of the stock will tack onto Bee's holding period.

Example 2C-5 Election to recognize loss on discretionary property distributions is not available.

In 2010, the James Harlan Estate made a discretionary distribution of property with a $5,000 basis and a $3,000 FMV. The estate cannot make a Section 643(e)(3) election to recognize a $2,000 capital loss on the distribution since the election is only to recognize gains.

Variation: If the distribution had been made in satisfaction of a pecuniary bequest, rather than a discretionary distribution, a Section 643 election would still not have been available because gains or losses of estates making pecuniary distributions are *required* rather than *elective*. In that case, such losses are not disallowed by the related party rules.

Making the election to recognize gain is beneficial if the fiduciary has a capital loss carryforward with no other opportunity to use it in the near future, or if the fiduciary sold a capital asset at a loss in the current year and would otherwise be limited to an annual $3,000 capital loss deduction. Because capital gains are generally principal and thus, not carried out to the beneficiary (except in the final year), the election is usually not appropriate if the beneficiary has a current year capital loss (or a capital loss carryforward) with which to offset the gain from the beneficiary's sale of the distributed asset. Therefore, a prudent fiduciary will not make the election without consulting with the income beneficiary, or others as necessary, to obtain all information relevant to the decision whether to elect.

Since the result of the election is to treat the property as if it were sold, any gain (but not loss) on the distribution of depreciable property from a trust or an estate to a beneficiary would be ordinary income. However, if the distribution

of the depreciable property was made in satisfaction of a pecuniary bequest, the gain would be Section 1231 gain, rather than ordinary income, since the related party rules do not apply to an estate's distributions in satisfaction of pecuniary bequests.

The election to recognize gain under IRC Sec. 643(e)(3) does not apply to specific bequests.

Formula Pecuniary Clauses

A *pecuniary bequest* is a fixed dollar amount (e.g., "I bequeath $100,000 to my daughter, Beth") and is often expressed in terms of a formula. A formula pecuniary clause in the governing instrument is a common technique using a verbal description to determine the amount of money or value of property to be distributed to a beneficiary (such as a formula designed to fund a marital deduction bequest). A formula pecuniary bequest is a bequest for which neither the identity of the property nor the amount to be distributed is ascertainable under the terms of the decedent's will as of the date of death or under the terms of an *inter vivos* trust instrument at its inception. Thus, pecuniary formula bequests do not qualify as specific bequests under IRC Sec. 663(a)(1) and, as such, are governed by the general distribution rules of IRC Secs. 661 and 662.

The same provisions apply to disclaimed amounts of pecuniary formula bequests, even if the disclaimer results in a specific dollar amount being disclaimed. Since the amount being disclaimed cannot be ascertained at the date of death, it cannot qualify as a specific bequest.

When appreciated property is used to fund the pecuniary formula clause, the estate or trust generally recognizes gain; however, the estate's or trust's distribution deduction and the beneficiary's income inclusion are limited by the beneficiary's separate share of DNI. When depreciated property is used to fund a pecuniary formula clause, an estate recognizes loss due to a special exception to the related party rules. Loss recognition is not available to trusts due to related party rules, however.

Under the separate share rule, if the formula pecuniary bequest is not entitled, according to the governing instrument or local law, to share in fiduciary accounting income and appreciation/depreciation of estate assets, there will be no carryout of DNI to the distributee upon funding the bequest. However, if the formula pecuniary clause (or local law) entitles the separate share to receive fiduciary accounting income, the estate or trust receives a distribution deduction under IRC Sec. 661(a), and the beneficiary must include the distribution amount in income under IRC Sec. 662(a)(1), as limited by his or her separate share of DNI.

The actual funding of the formula pecuniary bequest can occur in a variety of ways. Three common funding methods are (1) true worth pecuniary bequests, (2) fairly representative pecuniary bequests, and (3) minimum worth pecuniary bequests. All three funding methods are considered separate shares regardless of whether they are entitled to share in income and appreciation/depreciation of assets. However, actual funding of the bequests with principal is not subject to DNI allocation according to the separate share rule. Distributions of DNI are limited to the bequest's separate share of DNI if the bequest is entitled to share in income.

True Worth Pecuniary Funding. True worth pecuniary funding, the most commonly used method, values assets distributed in kind at their date-of-distribution values, rather than their date-of-death (or for estates created in a year other than 2010, alternate valuation date) values. The fiduciary has the freedom to select particular assets to fund a true worth pecuniary bequest. This method can easily trigger gain or loss since the in-kind asset distribution in satisfaction of a pecuniary bequest is a taxable event. The required gain or loss recognition depends on the amount of appreciation or depreciation in asset values that has occurred between the date of distribution and the date of death. Because these distributions made by the estate are in satisfaction of a pecuniary bequest, the related party rules do not apply and thus, losses must be recognized.

Example 2C-6 True worth pecuniary bequest funding.

Sam Hood died in 2010. His will contained the following provisions:

> If my wife, Anne, survives me, I give to her the lowest pecuniary amount that, if permitted as a federal estate tax marital deduction, would produce the lowest federal estate tax liability for my estate.

The above clause is a formula pecuniary clause. The will further states:

> My executor is directed, using his absolute discretion, to choose the particular assets (including cash if he so decides) to satisfy the marital deduction bequest and to distribute them outright to my wife, Anne, if she survives me. However, my executor may not select any asset for this purpose that does not qualify for the federal estate tax marital deduction. All assets selected are to be valued at their FMV as of the date distributed.

The language in the above clause indicates the marital bequest is a true worth pecuniary bequest since the assets to be distributed are to be measured based on date-of-distribution values. The will further provides that the decedent's son, David, is entitled to all the estate assets remaining after the funding of the marital bequest (the residuary estate). The estate incurred no expenses, and it owed no state inheritance tax. The decedent never made any taxable gifts.

The estate consisted of two assets, undeveloped land valued at $1.6 million and common stock of an international oil company valued at $2.4 million on the date of death. Accordingly, the Form 706 showed no estate tax due. A gross estate of $4 million less a marital deduction of $500,000 equals a taxable estate of $3.5 million. The resulting estate tax of $1,455,800, in the absence of prior taxable gifts, is completely sheltered by the applicable credit amount, producing zero estate tax liability.

The land had not appreciated in value between the Form 706 valuation date and the date of distribution, but the stock was worth $2.55 million on the date of distribution, over a year after the timely Form 706 was filed. The stock paid $29,000 in ordinary dividends prior to its distribution in 2010. The estate tax closing letter, accepting the Form 706 as filed, has been received from the IRS. The executor funded the marital bequest by distributing stock worth $500,000 (date-of-distribution value) to Anne. The balance of the stock, the land, and the $29,000 in cash from the dividends were distributed to David, who inherited the residuary estate.

The preparer of the estate's final Form 1041 for 2010 confirms that the distribution to Anne is not a specific bequest under Reg. 1.663(a)-1(b)(1) because the marital bequest was not of a specific sum of money and the identity of the specific property was not ascertainable as of the date of death. However, because the will did not specify whether the pecuniary bequest was entitled to participate in estate income, state law must be consulted. In Sam Hood's jurisdiction, pecuniary bequests are not entitled to participate in estate income.

The number of shares Anne received was affected by the appreciation or depreciation in value between the Form 706 valuation date and the date of distribution. Since assets in-kind (shares worth $500,000 on the date of distribution) were distributed to Anne in satisfaction of a pecuniary bequest, the distribution of the stock is treated as if the estate had distributed $500,000 cash to Anne, who then used the cash to purchase the stock from the estate. The estate has a long-term capital gain of $29,412 in connection with the stock distribution to Anne [($500,000 ÷ $2.55 million) × $150,000 appreciation].

In addition, the distribution of stock to Anne (a formula pecuniary bequest) and the distribution of the residuary estate to David carry out the estate's DNI of $58,412 ($29,000 from the ordinary cash dividends collected by the estate plus the $29,412 capital gain). [Capital gains and losses are usually not included in DNI, but the gain in this example is included in DNI since the estate terminated and distributed all of its assets in 2009.] The DNI is allocated entirely to David because the distribution made to Anne was in satisfaction of a pecuniary bequest that was not entitled to participate in estate income. Thus, Anne's separate share of DNI was zero. However, if this had not been the estate's final tax year, the $29,412 capital gain realized upon funding Anne's share would be taxed to the estate, rather than to David, reducing his separate share of the residual available for future distribution.

Variation: If Sam's will or local law had entitled Anne, as beneficiary of the pecuniary bequest to participate in the income of the estate, the DNI would have been allocated to both Anne and David according to each separate share.

Fairly Representative Pecuniary Funding. The fairly representative pecuniary funding method values each asset at its income tax basis with the additional requirement that the assets distributed "fairly represent" the appreciation and depreciation in the value of all assets available for distribution that has occurred between the valuation date

and the date the assets are distributed. The requirement that the assets distributed fairly represent the appreciation and the depreciation that has occurred restricts the combination of assets that the fiduciary can select to satisfy the bequest. However, in contrast to the true worth pecuniary method, use of the fairly representative pecuniary funding method does not produce gain or loss. The distribution is a taxable event, but the amount of gain or loss recognized is zero because the amount distributed is measured by the basis (not FMV) of the property.

Example 2C-7 Fairly representative pecuniary bequest funding.

Assume the same facts as in Example 2C-6, except the language in the will describing the marital deduction bequest calls for the "fairly representative" method of funding the marital deduction pecuniary bequest:

> My executor is directed to select and distribute to my wife, Anne, provided she survives me, sufficient assets to fund my estate's federal estate tax marital deduction, using for valuation purposes the adjusted income tax basis of each asset selected. My executor must choose the assets to be distributed in satisfaction of the federal estate tax marital deduction bequest in such a way that they have an aggregate FMV fairly representative of the appreciation or depreciation in value of all assets available for distribution as of the date(s) of distribution.

The preparer of the final 2010 estate income tax return determines that the executor funded the marital deduction bequest in late 2010 by distributing 12.5% [($4 million − $3.5 million applicable exclusion amount) ÷ $4 million] of the land and 12.5% of the stock to Anne. Using (for valuation purposes) the adjusted income tax basis of the assets as shown on Form 706, the executor distributed to Anne land with a basis and FMV at the date of distribution of $200,000 [$1.6 million × ($500,000 ÷ $4 million)] and stock with a basis of $300,000 [$2.4 million × ($500,000 ÷ $4 million)] and a FMV at the date of distribution of $318,750 ($2.55 million × 12.5%). The FMV of the stock distribution to Anne is $18,750 more than basis ($318,750 − $300,000) since the $2.4 million in stock on Form 706 was worth $2.55 million at the date of distribution. In a sense, the marital deduction is overfunded.

David, the residuary beneficiary, received the balance of the land and stock and the $29,000 of dividend income the estate received in 2010.

No gain or loss is recognized on distribution since the assets distributed "fairly represent" the overall appreciation or depreciation in assets after the Form 706 valuation date. Thus, the basis and FMV of the assets distributed reflect the degree of appreciation or depreciation of all the estate assets taken together. Contrast this result with the consequences of the true worth pecuniary funding method of Example 2C-6.

Like the true worth funding method, a formula pecuniary bequest funded using the fairly representative method is a separate share that generally does not carry out DNI unless the bequest is eligible to share in income. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI. However, the amount of DNI is likely to be less than in the case of true worth funding. In this example, DNI is only $29,000 (the dividends received by the estate), as compared to the DNI of $58,412 in Example 2C-6, which included $30,000 of capital gain (since this was the final year of the estate). All $29,000 of DNI is allocated to David since the distribution made to Anne was a pecuniary bequest that was not entitled to participate in estate income. Thus, Anne's separate share of DNI was zero.

Minimum Worth Pecuniary Funding. The minimum worth pecuniary funding method values each asset at the lesser of its date-of-distribution value or its basis for federal income tax purposes. The fiduciary has the freedom to select particular assets to fund a minimum worth pecuniary bequest, in contrast to the restrictions placed on the fiduciary by the fairly representative pecuniary funding method. Since the minimum worth pecuniary funding method values each asset at the lesser of its date-of-distribution value or its basis for federal income tax purposes, the minimum worth pecuniary funding method cannot result in the recognition of gain, but the distribution will cause any loss to be recognized. The losses will be allowed under IRC Sec. 267(b)(13), because the related party rules for estates and beneficiaries do not apply to property distributions in satisfaction of pecuniary bequests.

Example 2C-8 Minimum worth pecuniary bequest funding.

Assume the same facts as in Example 2C-6, except the funding provision in the will for the pecuniary marital deduction has language calling for a minimum worth pecuniary marital deduction bequest:

> My executor shall choose and distribute the assets representing the marital deduction bequest to my wife, Anne, if she survives me, by using for valuation purposes the lesser of the asset's adjusted basis for federal income tax purposes or the value of the asset at the date(s) of distribution.

Using this method, assets cannot be valued higher than their basis. Therefore, no gain can be recognized. However, if a loss (i.e., depreciated asset) exists and is distributed using this funding method, an income tax loss will be recognized. The potential to overfund the marital bequest also exists since an appreciated asset is measured at the lower of its market value or income tax basis. This funding approach, like the true worth pecuniary method, affords complete flexibility in asset selection.

Like the true worth and fairly representative funding methods, the minimum worth funding mechanism does not carry out DNI for funding the bequests with principal. Although the bequest is considered a separate share, it is only subject to DNI allocation if the bequest is entitled to income. Even then, the DNI distribution is limited to the bequest's separate share of income (not principal) included in DNI. The separate share amount of DNI carried out to Anne (-0-) and David ($29,000) is identical to the amount in Example 2C-7, since the distribution of $500,000 is the same, and the estate has no assets that depreciated between the date of death valuation date and the date of distribution, and no capital gain is triggered by the distribution.

Variation: If we assume, in this example, that the stock had depreciated $150,000 (rather than appreciated $150,000) between the date of death valuation date and the date of distribution, stock valued at $500,000 would be distributed to Anne. The remaining stock and the land would be distributed to David. A loss would be recognized based on the decline in value of the stock. The loss would be a long-term capital loss, which would be allocated to David, since this was the final year of the estate.

Fractional Share Clauses

A less commonly used alternative to the formula pecuniary clauses is the fractional share clause. A fractional share clause describes a fraction, rather than an amount in money or value, that must be calculated (such as a fraction of the residuary estate qualifying for the marital deduction) to determine the portion of the residuary estate a particular beneficiary will receive.

A fractional share clause is either funded on a pro rata basis (e.g., 25% of each asset in the residuary estate to pass to a certain beneficiary), or the executor selects particular assets or portions thereof (if a *non-pro rata distribution* is authorized by the will or state law) to be distributed using date-of-distribution values.

Gains are generally not recognized by the fiduciary using a fractional share clause. However, the Section 643(e) election is available to recognize such gains. The fiduciary's distribution deduction (and the beneficiary's income inclusion) is the lesser of the adjusted basis or fair market value of the assets distributed, limited by the beneficiary's separate share of DNI. The beneficiary has a carryover tax basis in the property distributed. However, the fiduciary can elect to recognize gain (but not loss) on the distribution under IRC Sec. 643(e)(3). Losses cannot be recognized by the fiduciary since the distributions are not in satisfaction of pecuniary bequests. Additionally, gain must be determined for each separate asset.

Example 2C-9 Fractional share of estate is not a specific bequest.

Claude Barrow died in 2009. His will provided that, after payment of all taxes, debts, and expenses of administration, half of his adjusted gross estate was to be distributed to his surviving spouse, Maude. In 2010, the executor made distributions of cash and property with a stepped-up basis and FMV of $700,000 in satisfaction of the bequest. Taxable DNI in 2010 was $20,000. No other distributions were made that year.

The distributions of cash and property to Maude do not qualify as specific bequests because the distributions represent a fractional share of the residuary estate. Therefore, the distributions carry out Maude's separate share of DNI on Schedule K-1, and she will include the $10,000 (50% of taxable DNI) in her gross income for 2010. The estate will claim a distribution deduction of $10,000 on Schedule B (Form 1041). The undistributed DNI of $10,000 will be taxed to the estate.

Variation: If Claude had died in 2010, rather than 2009, the results would be the same, regardless of whether the executor elected to allocate any amount of the aggregate basis increase or spousal property basis increase.

Residuary Bequests from an Estate

A *residuary bequest* is a distribution of the remaining estate after the specific and pecuniary bequests have been made. (For trusts, the income beneficiaries receive the trust accounting income while the trust exists. When the trust terminates, the remainder beneficiaries receive the remaining trust principal. These distributions of the remaining trust assets are referred to as Tier 2 distributions, rather than residuary bequests.) Residuary bequests carry out DNI to the beneficiaries under the general rule of IRC Sec. 643(e)(2), as limited by the separate share rule of IRC Sec. 663(c). The estate does not recognize gain or loss on the distribution.

However, if a will divides the residuary of an estate among multiple beneficiaries, distribution to each beneficiary of other than the appropriate fractional share of each asset is treated as a series of taxable exchanges among the beneficiaries unless the executor is given the discretion to make non-pro rata distributions in satisfaction of the fractional shares of the residue to the beneficiaries. A *nonprorata distribution* is an in-kind distribution of 100% of selected estate assets, rather than a pro rata portion of all assets. For example, rather than distributing a one-half interest in each asset to two equal residual beneficiaries, the executor may, if authorized by the governing instrument and local law, exchange one beneficiary's estate assets for a comparable value of the other beneficiary's estate assets.

Example 2C-10 Nonprorata distribution of estate residue.

Josh Montoya and his sister, Bridget, are each the beneficiary of an undivided one-half interest in the residuary estate of their deceased mother, Donna, who died in 2009. Donna's estate terminated in 2010 and issued its final Schedules K-1 to the beneficiaries. Josh's Schedule K-1 and Donna's will, along with a copy of the estate tax closing letter from the IRS, are included with the material Josh sent to his tax return preparer in February 2010.

A review of the will and local law does not indicate the executor had the power to make nonprorata distributions of the residuary assets of the estate, although the preparer locates a provision that states, "I devise my residuary estate to my children, Josh and Bridget, share and share alike." Except for a variety of relatively small items and cash actually divided equally, the residuary estate consisted of two principal assets that were distributed by the estate.

The first asset was a securities portfolio of publicly held stocks valued on the December 15, 2010, date of distribution at $2 million and having an income tax basis of $1.9 million ($100,000 of net appreciation from the FMV used on Donna's Form 706, which was filed in February 2010). The second asset was an unimproved tract of land also valued on the date of distribution at $2 million, but with an income tax basis of only $400,000. (Development of a new industrial park adjacent to the tract was announced shortly after the estate tax closing letter was received from the IRS. On December 1, 2010, the executor received two identical cash offers to purchase the tract for $2 million, one from the developer of the industrial park and the other from a real estate speculator. Both offers are open until March 15, 2011.)

A letter included with Josh's tax organizer material indicates that Josh and Bridget requested, and the executor agreed, that Josh receive 100% of the land and Bridget receive 100% of the securities portfolio. Bridget's stock certificates and Josh's quit-claim deed to the land from the estate were mailed to the new owners on the December 15, 2010, distribution date. Bridget likes the stocks in the portfolio and wants to retain them. Josh intends to arrange a partnership with the developer of the industrial park and to contribute the land to the partnership.

Since the executor had no power to make a nonprorata distribution of the residuary estate, for income tax purposes, Bridget is deemed to have sold her one-half interest in the land for Josh's one-half interest in the securities portfolio on December 15, 2010, and vice versa. Since IRC Sec. 1031 (like-kind exchange treatment) does not apply, Josh has $50,000 of 2010 net long-term capital gain to recognize from his transaction (sale of his half interest in the securities portfolio with a basis of $950,000 for $1 million in value), and Bridget

has $800,000 of 2010 net long-term capital gain to recognize from her transaction in 2010 (sale of her half interest in the land with a basis of $200,000 for $1 million in value).

Due to the deemed sales, Bridget's basis in the stock portfolio is $1,950,000, and Josh's basis in the land is $1.2 million (the combined basis before the transaction, $2.3 million increased by the amount of the $850,000 of total gain recognized by the parties).

Distributions of Property to Satisfy Claims

Gain is recognized at the fiduciary level when an estate or trust distributes property to satisfy other claims against the fiduciary. It does not matter whether the claim is that of a beneficiary or of a third-party creditor.

Example 2C-11 Property distributed to satisfy a claim against the trust.

In 2010, the trustee of the ABC Trust paid off an unfavorable purchase money mortgage on trust real estate held by an unrelated party using stock with a FMV of $1.2 million (the principal amount of the mortgage) and a basis to the trust of $1 million. The trust recognizes a $200,000 gain as if it had sold the stock and used the proceeds to pay the claim. The gain is reported on Schedule D (Form 1041) because the property was distributed to satisfy a claim against the trust.

SELF-STUDY QUIZ

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

35. Which of the following is one of the general rules for property distributions that are not specific bequests?

    a. Such property distributions are treated as "other amounts paid or credited" on Schedule B of Form 1041.

    b. A simple trust's distribution deduction is the lesser of the property's FMV on the distribution date or its adjusted basis in the beneficiary's hands.

    c. An estate's income inclusion and distribution deduction amounts are equal to income that is required to be distributed currently.

    d. When depreciable property is distributed to beneficiaries with no recognized gain or loss and the basis carries over, an estate retains all recapture potential.

36. The Mocha Trust has 150 shares of Chai Corp. stock with an FMV of $10,000. The trust has a $2,000 basis in the stock. In 2010, the trustee distributes the stock to Mike, the sole beneficiary, and makes the IRC Sec. 643(e)(3) election to recognize gain on the distribution as if the stock were sold. The capital gains are allocated to principal. Which of the following most accurately describes one of the consequences of these actions?

    a. The trust recognizes capital gain of $10,000.

    b. Mike will have a $10,000 basis in the stock.

    c. The gain from the transfer is reflected in DNI.

    d. The trust is allowed a distribution deduction of $10,000.

37. What type of pecuniary bequest values assets that are distributed in kind at their date-of-distribution values, not their date-of-death values?

    a. Minimum worth pecuniary bequests.

    b. Fairly representative pecuniary bequests.

    c. True worth pecuniary bequests.

    d. Formula pecuniary bequests.

38. Lawrence's will calls for a *nonprorata distribution* of the assets between his two residuary beneficiaries, Nikki and Jessica. Which of the following best describes how Lawrence's assets will be distributed?

    a. In an in-kind distribution of 100% of selected estate assets to each beneficiary.

    b. By distributing one-half of all the assets to each beneficiary.

    c. After Nikki's bequests are satisfied, Jessica receives remaining principal.

    d. A fractional share of the estate is calculated for each beneficiary.

SELF-STUDY ANSWERS

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

35. Which of the following is one of the general rules for property distributions that are not specific bequests? **(Page 190)**

    a. Such property distributions are treated as "other amounts paid or credited" on Schedule B of Form 1041. [This answer is correct. Unless it is considered a specific bequest, a distribution of property made by an estate or trust would be considered an "other amount paid or credited" and reported as described. This type of distribution carries out DNI to beneficiaries, resulting in a distribution deduction for the estate or trust.]

    b. A simple trust's distribution deduction is the lesser of the property's FMV on the distribution date or its adjusted basis in the beneficiary's hands. [This answer is incorrect. A complex trust, rather than a simple trust, would use this amount for its distribution deduction or its income inclusion amount.]

    c. An estate's income inclusion and distribution deduction amounts are equal to income that is required to be distributed currently. [This answer is incorrect. An estate would not use this amount for its income inclusion amount or its distribution deduction. Among other entities, this amount would be used for a complex trust's Tier 1 distribution.]

    d. When depreciable property is distributed to beneficiaries with no recognized gain or loss and the basis carries over, an estate retains all recapture potential. [This answer is incorrect. In such a situation, any available depreciation recapture would remain with the distributed property.]

36. The Mocha Trust has 150 shares of Chai Corp. stock with an FMV of $10,000. The trust has a $2,000 basis in the stock. In 2010, the trustee distributes the stock to Mike, the sole beneficiary, and makes the IRC Sec. 643(e)(3) election to recognize gain on the distribution as if the stock were sold. The capital gains are allocated to principal. Which of the following most accurately describes one of the consequences of these actions? **(Page 190)**

    a. The trust recognizes capital gain of $10,000. [This answer is incorrect. The trust would recognize capital gain of $8,000 ($10,000 of FMV − $2,000 basis).]

    b. Mike will have a $10,000 basis in the stock. [This answer is correct. Mike's basis in the stock after the distribution is equal to the trust's $2,000 basis in the stock plus the $8,000 gain recognized on the distribution.]

    c. The gain from the transfer is reflected in DNI. [This answer is incorrect. Capital gains would be allocated to principal, so DNI will not reflect the gain from the discretionary stock distribution.]

    d. The trust is allowed a distribution deduction of $10,000. [This answer is incorrect. The trust's distribution deduction is dependent on how much DNI is available. The $10,000 FMV of the stock is the maximum amount of the trust's distribution deduction, but if DNI is less than $10,000, the trust's distribution deduction will be less.]

37. What type of pecuniary bequest values assets that are distributed in kind at their date-of-distribution values, not their date-of-death values? **(Page 190)**

    a. Minimum worth pecuniary bequests. [This answer is incorrect. When this method is used, each asset is valued at the lesser of its date-of-distribution value or its basis for federal income tax purposes. Use of this method cannot result in gain recognition.]

    b. Fairly representative pecuniary bequests. [This answer is incorrect. In this type of bequest, each asset is valued at the income tax basis with an additional requirement that assets are distributed so they "fairly

represent" appreciation and depreciation in the value of all assets available for distribution occurring between the Form 706 valuation date and the date assets are distributed.]

c. True worth pecuniary bequests. [This answer is correct. This is the most common method used to fund formula pecuniary bequests. The fiduciary has freedom to select particular assets to fund the bequest.]

d. Formula pecuniary bequests. [This answer is incorrect. This type of pecuniary bequest is one in which neither the amount nor the identity of the property to be distributed is ascertainable under the terms of the will or trust document. Formula pecuniary bequest is an umbrella term that includes the type of bequest described in the question above.]

38. Lawrence's will calls for a *nonprorata distribution* of the assets between his two residuary beneficiaries, Nikki and Jessica. Which of the following best describes how Lawrence's assets will be distributed? **(Page 190)**

a. In an in-kind distribution of 100% of selected estate assets to each beneficiary. [This answer is correct. When making this type of distribution, the executor of Lawrence's estate has the power to exchange one beneficiary's assets for a comparable value of the other's. Therefore, if Lawrence had a stock portfolio and a piece of real estate with the same value, Nikki could receive the real estate and Jessica could receive the stocks, instead of each receiving one-half of each asset.]

b. By distributing one-half of all the assets to each beneficiary. [This answer is incorrect. This would be a prorata portion of all the proceeds of Lawrence's estate, which is not what is called for by his will in this scenario. When a prorata distribution is used, exchanges of property between Nikki and Jessica would be taxable distributions.]

c. After Nikki's bequests are satisfied, Jessica receives remaining principal. [This answer is incorrect. This would be true if Lawrence bequeathed either specific or pecuniary bequests to Nikki and made a bequest of the residuary of the estate to Jessica. However, that is not the case in this scenario.]

d. A fractional share of the estate is calculated for each beneficiary. [This answer is incorrect. If Lawrence's will stated that a fractional share clause be used to fund pecuniary bequests to Nikki and Jessica, this would be done to determine the portion of the estate each beneficiary would receive. Fractional share formulas can be done on a prorata or a nonprorata basis. However, this is not what Lawrence's will describes in this scenario.]

Considerations for Distributions in Lieu of Specific Property or Specific Dollar Amount

Gain Recognition Rules

If a property distribution is in satisfaction of specific property other than that which is actually distributed or a required dollar amount of income, gain but not loss is recognized at the fiduciary level. (See illustrations in Examples 2D-1 and 2D-2, respectively.) Although Reg. 1.661(a)-2(f) provides the authority for gain and loss recognition, this regulation has not yet been updated for the related party rules in IRC Sec. 267. These rules deny loss recognition for transactions between an estate or trust and its beneficiaries, except in the case of an estate making a property distribution to satisfy a pecuniary bequest. A property distribution substituted for other specific property or a required dollar amount is not considered to be in satisfaction of a pecuniary bequest; thus, loss recognition is denied.

The transfer is treated as a distribution of cash in an amount equal to the property's FMV, followed by a deemed sale of the property to the beneficiary for the cash. In such cases, the beneficiary acquires a basis equal to the FMV of the property on the date of the transfer. However, when a loss is disallowed because of the related party rules, future gain from the sale of the property need be recognized only to the extent such gain exceeds previously unrecognized losses.

If the property distributed to satisfy a specific dollar obligation is a capital asset, the gain will be a capital gain to the fiduciary. If the property is ordinary income property or has an ordinary income component, ordinary income will be generated by the distribution unless it is a distribution made by an estate in satisfaction of a pecuniary bequest. If the property actually distributed is income in respect of a decedent (IRD) or a claim to IRD, IRC Sec. 691 controls.

Even though capital gain or loss or ordinary recapture income is generated, the property distribution generally will not carry out DNI to the beneficiary unless the distribution is made to satisfy a specific dollar obligation of *income* (i.e., a Tier 1 distribution). The fiduciary is not entitled to a distribution deduction nor does the beneficiary recognize income on amounts that, under the terms of the governing instrument, are properly paid or credited as a bequest of a specific sum of money or of specific property and paid or credited in three or fewer installments. Therefore, unless the will provides that a specific bequest is to be satisfied in more than three installments, satisfaction of the bequest with different property than that specified in the governing instrument will not carry out DNI to the beneficiary.

Example 2D-1 In-kind distribution satisfying beneficiary's right to other property.

In 2010, the executor of the A. L. King Estate distributed 100 shares of Acme Corp. common stock, with a basis of $20,000 and a FMV on the date of distribution of $25,000, to satisfy a specific bequest of $25,000 cash. The beneficiary agreed to accept the Acme stock in lieu of cash. There were no other distributions in 2010.

The DNI for 2010 is $75,000. State law requires the estate to follow the common practice of allocating capital gains to principal.

The estate must recognize $5,000 gain on the transaction since the property distribution is in satisfaction of a specific-dollar bequest. The $5,000 gain is a capital gain since the stock distributed is a capital asset and is shown on Schedule D as if the stock had been sold to a third party.

The beneficiary's tax basis in the property received is its FMV ($25,000), which is equal to the $20,000 tax basis of the estate plus the $5,000 of gain recognized by the estate. Because there has been a deemed sale of the estate property, the estate's basis is not tacked onto the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquisition (i.e., date of distribution).

A Schedule K-1 from the estate to the beneficiary is not required because the $25,000 in cash was a specific bequest that does not carry out DNI from the estate. However, the preparer should make sure the beneficiary is informed of his/her tax basis in the shares and the date his/her holding period begins.

If property is distributed in satisfaction of a beneficiary's right to receive a specific dollar amount of income (e.g., a Tier 1 distribution of a complex trust or a required income distribution of a simple trust), which is not the same as a pecuniary bequest, gain (but not loss) must be recognized by the fiduciary.

Example 2D-2 In-kind distribution satisfying beneficiary's right to a specific dollar amount of income.

The Mabel Huffman Trust is to pay $50,000 from current income each year to Cindy (i.e., a Tier 1 distribution). The excess of the annual $50,000 of current income is to be accumulated and distributed to Cindy's younger brother, Todd, when Todd reaches age 21. (Since all income is not required to be distributed currently, this is a complex trust.) The trustee distributes shares of stock worth $50,000 (basis of $25,000) in satisfaction of the specific dollar amount.

The distribution of the stock is treated as if the trustee had distributed $50,000 to Cindy, who in turn purchased the stock from the trustee with the cash at fair market value. The transfer of the stock in satisfaction of the beneficiary's right to receive $50,000 of current income results in a $25,000 capital gain to the trust ($50,000 − $25,000). Cindy's basis in the stock is the price she is deemed to have paid for it ($50,000). The Trust's holding period does not tack onto Cindy's holding period. Instead, it begins on the date of the stock distribution to her. In addition, the trust is allowed an income distribution deduction of $50,000, and Cindy must include $50,000 in gross income on her personal income tax return.

Variation: If the trustee had distributed stock that had depreciated in value to Cindy, the trust would not be allowed to deduct the loss on distribution due to the related party loss rule of IRC Sec. 267(b)(6).

Considerations for Distributions of Property in Lieu of Income

Gain Recognition Rules

If the fiduciary distributes property in satisfaction of the beneficiary's right to receive income, the estate or trust will be treated as having sold the property for its fair market value on the date of distribution. The fiduciary is deemed to have distributed cash in an amount equal to the trust income required to be distributed currently to the beneficiary who, in turn, is deemed to have used the cash to purchase the asset from the fiduciary.

If the property has appreciated in value, gain must be recognized by the estate or trust. However, if the property has depreciated in value, loss recognition by a trust or estate is disallowed by the related party rules except by an estate in satisfaction of a pecuniary bequest. Because distributions of property in substitution of a beneficiary's right to receive income are not considered to be in satisfaction of a pecuniary bequest, loss recognition is disallowed by the related party rules.

Example 2E-1 Property distributed in satisfaction of beneficiary's right to receive income when the property's FMV does not exceed DNI.

The preparer of the 2010 Form 1041 for the William Jefferson Family Trust determines from the trust document that the income beneficiary, George, was entitled to an income distribution of $100,000 in 2010. The trust had ordinary income of $100,000 and no tax-exempt income for that year. Fiduciary accounting income was also $100,000. The trust document allocates all capital gains to principal.

The trustee's records indicated that George was willing to accept 1,000 shares of ABC Corp. common stock with a FMV of $100,000 and a tax basis in the hands of the trust of $80,000 in satisfaction of his right under the trust instrument to receive $100,000 of income for 2010. No other distributions were made that year.

The trust will have a $20,000 capital gain. The capital gain will be reported on Schedule D as if the stock in ABC Corp. had been sold to a third party. George will have a $100,000 tax basis in the stock and a holding period that begins on the date of distribution. In addition, George will report income of $100,000, and the trust will have a distribution deduction of $100,000.

To trigger the gain, the trust does not have to be a simple trust required to distribute $100,000 of trust accounting income. The trust in this example could also have been a complex trust with at least $100,000 of

fiduciary accounting income that was *required* to distribute $100,000 of income in 2010 (i.e., a Tier 1 distribution), the trustee having discretion to accumulate or distribute the excess. The key points are the distributee's *right* to receive income and the distribution of property in satisfaction of that right.

If the asset distributed had been a machine with a basis of $80,000, a FMV of $100,000 and $20,000 of potential Section 1245 recapture, the distribution would have triggered recapture income to the trust which is reported on Form 4797. Satisfaction of the beneficiary's right to $100,000 of income by distributing the machine is treated as a distribution of $100,000 cash to the beneficiary, who in turn is deemed to use the cash to purchase the machine from the fiduciary at its FMV.

When cash is distributed along with property to satisfy a beneficiary's right to income, the property is only considered to satisfy the income distribution to the extent the cash is insufficient to satisfy the required income distribution.

Example 2E-2 Cash and property distributed to satisfy required income distribution.

Assume the same facts as in Example 2E-1 , except the trustee distributes $40,000 cash along with the 1,000 shares of ABC Corp. to George. The $40,000 cash is considered first in satisfying the $100,000 required income distribution, leaving $60,000 of stock value to fulfill the rest of the $100,000 income distribution. The remaining $40,000 of stock value is a distribution of principal. Only the appreciation attributable to the stock used to meet the required income distribution must be recognized by the trust. The $80,000 basis must be allocated between the income and principal distributions. The income distribution would be 60% ($60,000/$100,000) while 40% ($40,000/$100,000) would be allocated to the distribution of principal.

The trust recognizes a gain of $12,000 [$60,000 − $48,000 (60% × $80,000)] on the transfer of stock to George. If the trust does not make a Section 643(e)(3) election, George will have a basis of $92,000 [$60,000 + $32,000 (40% × $80,000)] in the stock. If the trust makes a Section 643(e)(3) election, George will have a $100,000 basis in the stock, but the trust will recognize an additional gain of $8,000 ($40,000 − $32,000).

When gains are included in trust accounting income, using appreciated property to satisfy a required income distribution creates additional problems. The gain recognized will increase accounting income, causing the need for an additional distribution. The required income distribution can only be satisfied by distributing cash or property that does not produce a gain includable in accounting income.

Example 2E-3 Gains included in trust accounting income results in larger required income distribution.

Assume the same facts as in Example 2E-1, except that the trust documents allocate capital gains to income. When the trustee transfers the 1,000 share of stock to George, the $20,000 realized gain increases the accounting income, thus requiring an additional $20,000 distribution to George. Either cash or property that does not generate capital gain should be distributed to George to prevent increasing the accounting income, which will result in additional required distributions.

SELF-STUDY QUIZ

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

39. When Sue dies, she bequeaths a stock portfolio to Bobby. Bobby requests a distribution of an equivalent amount of cash instead, and the executor agrees. Which of the following would occur?

    a. The estate will be able to recognize any loss that results from the transfer.

    b. The transfer is treated as a cash distribution followed by a deemed sale of the property.

    c. Bobby will receive DNI from the resulting distribution.

    d. The fiduciary is entitled to an income distribution deduction on the transaction.

40. Which of the following could occur when property is distributed in lieu of a beneficiary's right to receive income?

    a. If the property has appreciated in value, the beneficiary recognizes the gain.

    b. A complex trust distributes property in lieu of a Tier 2 distribution of income.

    c. A combination of cash and property is distributed in lieu of the income.

    d. The fiduciary is deemed to have purchased the property.

SELF-STUDY ANSWERS

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

39. When Sue dies, she bequeaths a stock portfolio to Bobby. Bobby requests a distribution of an equivalent amount of cash instead, and the executor agrees. Which of the following would occur? **(Page 202)**

    a. The estate will be able to recognize any loss that results from the transfer. [This answer is incorrect. This was not a pecuniary bequest, so loss recognition on the transfer would be denied.]

    b. The transfer is treated as a cash distribution followed by a deemed sale of the property. [This answer is correct. The transfer will be treated as a cash distribution in the amount of the stock portfolio's FMV. This is followed by a deemed sale of the property to Bobby for cash.]

    c. Bobby will receive DNI from the resulting distribution. [This answer is incorrect. Because this distribution was not made to satisfy a specific dollar obligation of income (i.e., a Tier 1 distribution), no DNI will be carried out to Bobby.]

    d. The fiduciary is entitled to an income distribution deduction on the transaction. [This answer is incorrect. Bobby would not recognize income on this distribution, and neither would the fiduciary be entitled to a distribution deduction in this transaction.]

40. Which of the following could occur when property is distributed in lieu of a beneficiary's right to receive income? **(Page 203)**

    a. If the property has appreciated in value, the beneficiary recognizes the gain. [This answer is incorrect. In this situation, the gain would be recognized by the estate or trust. Loss recognition, however, is disallowed by the related-party rules.]

    b. A complex trust distributes property in lieu of a Tier 2 distribution of income. [This answer is incorrect. To make a distribution in lieu of a beneficiary's right to receive income, the trust must be required to distribute fiduciary accounting income to the beneficiary. This is not the case with a Tier 2 distribution of a complex trust. Examples of this situation are (1) a simple trust required to distribute current income and (2) a required Tier 1 distribution made by a complex trust.]

    c. A combination of cash and property is distributed in lieu of the income. [This answer is correct. This can happen; however, in this situation, the property will only be considered to satisfy the income distribution to the extent that the cash does not.]

    d. The fiduciary is deemed to have purchased the property. [This answer is incorrect. When this type of distribution is made, the fiduciary is deemed to have made a cash distribution in an amount equal to the required income, and the beneficiary is then deemed to have used that cash to purchase the asset from the fiduciary.]

Considerations for Distributions of Depreciated Property

Because of the related-party loss limitation rules of IRC Sec. 267, trusts and those estates not selling or exchanging the property in satisfaction of a pecuniary bequest should generally sell loss assets to a third party and obtain immediate recognition of the loss rather than distribute the loss property to a beneficiary, provided there is no desire to retain the specific property indefinitely.

If a trust beneficiary does take a distribution of depreciated property and later disposes of the property in a taxable transaction, gain is recognized only to the extent it exceeds the loss previously disallowed to the trust. If the property is depreciated or declines in value while held by the beneficiary, any subsequent loss is based on the fair market value (FMV) of the property at the time of the original distribution from the trust to the beneficiary.

Example 2F-1 Distribution of loss property by a trust.

The income beneficiary of XYZ Trust had the right to a 2010 income distribution of $100,000. The trustee satisfied that right by distributing stock in ABC Corporation with a value of $100,000 and a tax basis of $130,000. The trust's distribution deduction is $100,000, and the income beneficiary includes $100,000 in gross income (provided there is at least $100,000 in DNI).

Satisfaction of a right to income by distributing property to a beneficiary is treated as if the cash were distributed and the beneficiary used the cash to purchase the property. However, the trust cannot recognize the loss in this situation due to the related party rules. The trust's disallowed loss is $30,000.

If the beneficiary later sells the stock for an amount between $100,000 and $130,000, he or she will recognize no gain or loss since gain is recognized only to the extent it exceeds the loss disallowed the trust. A sale for $140,000 would produce $10,000 of gain to the beneficiary. A sale for $90,000 would produce only $10,000 of loss, based on the property's FMV when the original distribution is made from the trust.

Considerations for Distributions of Installment Obligations

Transfer of Fiduciary's Installment Obligation

If an executor or trustee sells property on behalf of an estate or trust on the installment basis, the installment method of accounting must be used to report the gain, unless the fiduciary affirmatively elects out of installment reporting. If the fiduciary subsequently distributes the installment note to the beneficiary, the distribution is a taxable disposition of an installment obligation, causing accelerated gain recognition at the fiduciary level to the extent the fair market value of the installment obligation exceeds the basis of the obligation.

Example 2G-1 Distribution of installment note to beneficiary.

The trustee of the Ben Lucas Testamentary Trust sold a parcel of appreciated land for $100,000 on the installment basis in 2009. The land had a basis to the trust of $60,000. The trust received a $28,000 down payment and took a note for the remaining $72,000. The note called for 36 monthly payments of $2,000, plus interest at a fair market rate. In 2010, after receiving 10 payments, the trustee distributed the note to Betty, the trust beneficiary.

The distribution of the installment note to Betty is a taxable disposition of an installment obligation to the trust. Therefore, the trust recognizes gain to the extent of the excess of the FMV of the note over its adjusted basis.

The adjusted basis of the note is calculated as follows:

Initial face value of the obligation	$ 72,000
Less payments received ($2,000 × 10)	(20,000)
Face value at time of distribution	52,000
Less income not yet reported ($52,000 × 40%, gross profit percentage)	(20,800)
Basis of the installment obligation at time of distribution	$ 31,200

Assuming the FMV of the note is $45,000, the gain on the distribution is $13,800 ($45,000 − $31,200).

Transfer of Installment Obligation Received from Decedent

When property was sold on the installment method before the decedent's death, any gain unrecognized at death is (IRD) and taxable upon collection. The estate's basis is the same as the decedent's because IRD assets are not eligible for either the basis increase (for decedents dying in 2010) or the step-up in basis to the FMV at death (for decedents dying before or after 2010). The estate will recognize income as payments are made, using the same gross profit percentage the decedent would have used as if the decedent had lived and collected the payments. Unlike the situation discussed in Example 2G-1, transferring the decedent's installment obligation to a beneficiary does not automatically trigger an acceleration of gain recognition.

If the installment obligation is sold, cancelled or transferred to the obligor, the estate will recognize IRD to the extent the FMV of the obligation or the amount received upon sale, whichever is greater, exceeds the decedent's remaining basis. When an installment obligation is transferred to satisfy the right to receive a specific dollar bequest or a Section 643(e)(3) election is made, the transfer is considered a sale, so the estate will recognize IRD to the extent of the excess of the installment obligation's FMV at the time of transfer over the decedent's basis in the item.

The FMV of the installment obligation at the date of transfer may be less than the decedent's basis (due to the discounted value of the right to receive payments over a period of time at the specified interest rate), which will result in a loss on the transfer. In that case, the loss would be deductible if the transfer was to satisfy a pecuniary bequest, but would not be deductible under a Section 643(e)(3) election due to the related party rule. The FMV on the date of transfer is based on the prevalent interest rates on that date, which might be significantly higher than those of the obligation.

Example 2G-2 Transfer of decedent's installment note results in sale treatment if made to satisfy a pecuniary bequest.

Jana sold land for $1.25 million, collecting a 20% down payment and a note for $1 million. The note required 10 annual payments with a stated interest rate of 6%. Jana's basis in the note was $100,000. At her death, she had collected five payments, so her unrecovered basis was $50,000 and the unrecognized capital gain was $450,000 ($1 million − $100,000 × $^{5}/_{10}$). During estate administration, the executor collected two payments, leaving an unrecovered basis of $30,000 and an unrecognized capital gain of $270,000 ($1 million − $100,000 × $^{3}/_{10}$).

If the note was distributed to a residuary beneficiary, the beneficiary would continue receiving payments and recognize capital gains as payments were collected. The beneficiary would take the unrecovered basis of $30,000 and recognize capital gains using Jana's gross profit percentage.

If the estate transferred the note to satisfy a pecuniary bequest or made a Section 643(e)(3) election, the estate recognizes a capital gain to the extent the note's FMV on the date of transfer exceeded the $30,000 unrecovered basis. The beneficiary would take a basis in the note equal to its predistribution basis, increased by any gain recognized by the estate. This is the same result as shown in Example 2G-1.

If the prevalent interest rates on the date of transfer caused the note's FMV to be less than $30,000, the estate could deduct the loss if the transfer satisfied a pecuniary bequest, but not under a Section 643(e)(3) election. The beneficiary's basis in the note would be equal to its FMV on the date of transfer, and he or she could use the disallowed loss to reduce any gain on a subsequent sale of the note.

Considerations for Distributions of Partnership Interests and S Corporation Stock

Distribution of Partnership Interests from an Estate or Trust

When an estate or trust distributes a partnership interest to a beneficiary, the following issues must be addressed:

1. Whether the distribution affects the partnership's existence; and
2. How the income is allocated between the fiduciary (estate or trust) and the beneficiary.

Neither of these issues can be addressed by the preparer of Form 1041. Instead, they are determined at the partnership level and reported on a Schedule K-1 (Form 1065) to the appropriate beneficiary. Before the partnership can correctly address each issue, the estate or trust must provide the relevant information to the partnership. By understanding how the partnership should account for these issues, the fiduciary will be able to collect and submit the necessary information to the partnership. In most cases, the same practitioner will not be preparing both the partnership and fiduciary tax returns, thus requiring communication between the fiduciary and the partnership to ensure proper tax reporting.

Partnership Existence. A partnership terminates for tax purposes if (1) 50% or more of the capital and profits interests are sold or exchanged within a 12-month period; (2) the partnership ceases doing business; or (3) the partnership ceases to have at least two partners. However, a partner's death and the subsequent transfer of the deceased partner's interest to the partner's estate or trust is not treated as a sale or exchange for this purpose. Thus, even a partnership with only two partners will not automatically terminate when a partner dies, since the decedent's estate or another successor-in-interest becomes a partner for tax purposes.

What the executor does with the partnership interest after the decedent's death may cause the partnership to terminate for tax purposes, however, if the decedent owned 50% or more of the partnership, and the executor sells the decedent's interest within a 12-month period, the partnership will terminate. (This is often referred to as a "technical termination.") A sale can occur when the executor sells the interest to a third-party, distributes the interest to satisfy a pecuniary bequest, or makes an election under IRC Sec. 643(e)(3) to recognize gain in the year the interest is distributed. If the partnership liquidates the decedent's interest, no sale is deemed to have occurred. As long as the partnership has at least two partners when the liquidation payments end, the partnership will not terminate for tax purposes. Distributing a partnership interest to satisfy a specific or residuary bequest [without a Section 643(e)(3) election] is not considered a sale, and thus, the partnership will not terminate. The same principles apply when a trust distributes a partnership interest.

Income Allocation. The tax year of a partnership closes with respect to a partner who dies during the year. The deceased partner's share of the partnership's income (or loss) earned up to the date of death is reported on the deceased partner's final individual tax return, and the estate reports the remaining income (or loss) on the estate's income tax return. Note that this Code Section applies only to tax years of a deceased *partner*, rather than to the *partnership* upon the partner's death or upon distributions of the deceased partner's interests made by an estate or trust to a beneficiary. The allocation of partnership income between an estate or trust and a beneficiary who acquires an interest in the partnership from the fiduciary depends on the type of distribution made by the estate or trust.

Specific Bequest. When a person dies, all of the decedent's assets are owned by the estate beneficiaries, subject to estate administration. The beneficiaries are entitled to receive the net assets (i.e., creditors must be paid before any distributions are made). If the estate has more assets than debts, the beneficiaries entitled to specific bequests receive their inheritances first. In addition, the beneficiary of a specific bequest is entitled to all income attributable to the specific bequest property. When the estate has sufficient assets so that a specific bequest is not needed for estate administration or to pay a decedent's debts, the executor can treat the bequest as a direct transfer from the decedent to the beneficiary, thus bypassing probate administration. All of the bequest's income from the decedent's date of death can be reported on the beneficiary's tax return, and none is reported on the estate's income tax return. Since the estate ignores specific bequests when computing its distribution deduction for the year, reporting the specific bequest income directly to the beneficiary and ignoring the income (for Form 1041 purposes) avoids potential DNI allocation issues and simplifies the reporting.

If a partnership interest is specifically bequeathed to a beneficiary, and it is certain that the beneficiary will receive the bequest, the fiduciary should notify the partnership of the beneficiary's address and inheritance. The partnership can contact the beneficiary to obtain the necessary identification information for issuing a Schedule K-1 (Form 1065) to the beneficiary. This will enable the partnership to allocate the partnership's post-death income entirely to the beneficiary, with no Schedule K-1 (Form 1065) issued to the estate.

If the size of debts makes it unlikely that the specific bequests can be made, the executor should notify the partnership of its tax identification number and address so a Schedule K-1 (Form 1065) and all partnership distributions can be sent to the estate, which will then report the partnership income on Form 1041. The estate

should keep accurate records of the distributions received from the partnership, since these amounts belong to the beneficiary entitled to the specific bequest unless the estate needs the funds to pay the decedent's debts. None of these funds can be used by the executor to pay administration expenses or debts if other assets are available, even if other assets must be sold to generate cash. A lack of liquidity does not allow an executor to reduce a specific bequest. If it is later determined that the partnership interest can be distributed to the beneficiary, the executor should account for the distribution in the same manner as a residuary bequest, except that the distribution of the partnership interest itself must be ignored when allocating DNI.

If the transfer of the specific bequest property to the beneficiary is delayed while income from the property is received by the estate, the income is typically accounted for on the estate's Form 1041. A specific bequest is not a separate share or subject to the distribution rules. However, the income from a specific bequest property is a separate share, which is subject to the distribution rule. The income is reported on the estate's Form 1041 and offset by a distribution deduction to the beneficiary. These results are the same as the beneficiary's direct reporting of the income. If specifically bequeathed property is needed by the estate for administration purposes, the income from these assets is accumulated for future distribution under the separate share rules and may be subject to estate income tax during the meantime. Upon eventual distribution of the property and accumulated estate income, the amount distributed to the beneficiary will be tax-free, in accordance with the separate share rules.

For trusts, specific bequests are quite uncommon since such bequests would require immediate distribution of the property. In those uncommon situations of specific bequests by a trust, the trust would assign any of its rights in the property to the beneficiary, thus allowing the beneficiary to own the property directly. Mandatory income distributions are not considered specific bequests.

Pecuniary Bequests. An estate's distribution of noncash property to satisfy a pecuniary bequest is treated as a sale, requiring the estate to recognize gain or loss. When a trust distributes noncash property to satisfy a mandatory income or annuity distribution, the same result occurs except no loss is allowed due to the related party rules.

Since the distribution of noncash property to satisfy a pecuniary bequest is considered a sale, the partner's (i.e., the estate's) tax year ends on the date of the distribution to the beneficiary. The estate will recognize its share of the partnership income and loss from the beginning of the year until the date of distribution, and the beneficiary will report the remaining portion on his or her tax return. The fiduciary must notify the partnership of the pecuniary distribution so the partnership can make the proper allocation.

Residuary Bequests. Under the general rule, the distribution of noncash property as part of a residuary bequest does not result in a sale. However, when a Section 643(e)(3) election is made, a deemed sale results. A distribution of a partnership interest as a residuary bequest when a Section 643(e)(3) election is made would be accounted for in the same manner as a pecuniary bequest (i.e., gain, but not loss recognition). Normally, when a trust terminates and makes a distribution to the remainder beneficiaries, these distributions are accounted for in the same manner as residuary bequests. The same holds true for discretionary distributions of principal during the trust's existence.

The guidance for allocating partnership income when the estate has made a residuary bequest of a partnership interest is not clear. A conflict exists between Reg. 1.706-1(c)(3)(vi), Ex. 3 and Rev. Rul. 72-352, and no guidance has been issued to resolve the inconsistency. Although the entity in Ex. 3 of Reg. 1.706-1(c)(3)(vi) was an estate, in contrast to a trust in Rev. Rul. 72-352, it is unclear whether this entity distinction should account for the difference in how income is to be allocated. Since the ruling was issued after the regulations and referred to the same regulation in which the example is found, it is probably preferable to follow the approach used in the ruling (i.e., Approach Two). In either case, the partnership does not terminate, since no sale occurs. The two approaches are as follows:

1. *Approach One [based on Reg. 1.706-1(c)(3)(vi), Ex. 3].* When the partnership interest is distributed, all partnership allocations for the entire year are allocated to the beneficiary receiving the partnership interest.

2. *Approach Two (based on Rev. Rul. 72-352).* In the year the partnership interest is distributed, the partnership year closes as to the partner. Thus, the partnership must allocate income to the estate for the portion of the year the interest was owned by the estate, and the remaining portion is allocated to the beneficiary who receives the partnership interest.

Example 2H-1 Type of distribution from the estate or trust determines how partnership income is allocated.

Sally Jones was a 30% partner in the Mumford Partnership, a calendar year partnership, at the time of her death on September 30, 2010. All of the partnership's income or losses from January 1 to September 30 are reported on Sally's final Form 1040. The type of bequest determines how the post-death partnership activity is reported:

1. *Specific Bequest.* Sally's will made a specific bequest of her partnership interest to her daughter, Rosie, and there are sufficient other assets to pay estate debts. Sally's executor notifies the Mumford partnership of Sally's death and provides information regarding Rosie's direct inheritance of Sally's partnership interest and Rosie's address. The partnership will contact Rosie to obtain the necessary identification information, and at the end of 2010, will send Rosie a Schedule K-1 (Form 1065) allocating the partnership's income and loss from October 1 through December 31, 2010 to Rosie. The estate will not receive a Schedule K-1 from the Mumford Partnership.

2. *Pecuniary Bequest.* Instead of a specific bequest, Sally's will provided for a pecuniary bequest of $250,000 to be made to her daughter, Rosie. No estate distributions were made to Rosie in 2010, so the partnership income from October 1 to December 31, 2010 is reported on the estate's Form 1041. On April 30, 2011 the interest in Mumford Partnership, which had a fair market value of $250,000 on that date, was distributed to Rosie in satisfaction of her pecuniary bequest. The estate must report the distribution as a sale, with a sales price of $250,000. The estate notifies Mumford Partnership of the distribution. The partnership will allocate the partnership's income from January 1 through April 30, 2011 to the estate and its income from May 1 through December 31, 2011 to Rosie.

3. *Residuary Bequest.* Instead of any specific or pecuniary bequests, Sally's will provided that Rosie and her brother Fred are to be equal residuary beneficiaries. After paying all debts, the executor closes the estate on October 31, 2011 and distributes 50% of the assets to Rosie and 50% of the assets to Fred. Included in these assets is the Mumford Partnership interest. Both Rosie and Fred will hold 15% partnership interests in Mumford Partnership. Since no distributions were made in 2010, the partnership income from October 1 to December 31, 2010 is reported on the estate's Form 1041. In 2011, the estate notifies the partnership of its distribution of partnership interests to Rosie and Fred. The allocation of 2011 partnership income between the estate, Rosie, and Fred depends upon the approach used, as follows:

    a. *Approach One.* None of the partnership income for 2011 is reported by the estate. Instead, the income for the entire year is reported by Rosie and Fred. The estate, Rosie, and Fred should all receive Schedules K-1s from the partnership for 2011. Although the estate's 2011 Schedule K-1 (Form 1065) will not reflect any income or loss for the year, it will report the estate's zeroed out capital account on the capital account reconciliation. Rosie and Fred will each report 15% of the partnership's 2011 income on their individual tax returns.

    b. *Approach Two.* As of October 31, 2011 (the date the estate distributed the partnership interest to Rosie and Fred), the partnership year closes as to the estate. Thus, the partnership reports the estate's distributive share of partnership income earned through October 31, 2011 on a Schedule K-1 (1065) issued to the estate. On its 2011 Schedule K-1 from the partnership, the estate's capital account should be zeroed out on the capital account reconciliation. The partnership will also issue a Schedule K-1 to Rosie and Fred to report their share (15% each) of the income earned by the partnership from November 1 through December 31, 2011. The estate will include the partnership income earned through October 31, 2011 in its DNI for 2011. Since Rosie and Fred each received 50% of the total estate distributions, each would receive their separate 50% share of the estate's DNI.

Variation: Unless the fiduciary has the authority (according to state law and the governing instrument) to make nonprorata distributions, a deemed sale would occur if the executor exchanged the assets being distributed to Rosie and Fred. Assume Sally's estate consisted of the 30% Mumford Partnership interest and a building. Rosie preferred to receive the entire partnership interest, whereas Fred wanted the building. Because Sally's will allowed nonprorata distributions, the executor distributed the 30% partnership interest to Rosie and 100% of the building to Fred on October 31, 2011 and avoided sale treatment. (Effectively, the executor has exchanged Rosie's 50% ownership in the building for Fred's 15% share of Mumford Partnership.)

If Approach One is followed, the entire 30% share of the partnership income for 2011 is reported by the partnership to Rosie, with no allocation to the estate.

Approach Two would allocate 30% of the partnership income earned through October 31, 2011 to the estate and includable in DNI, which would be carried out by the estate to both Rosie and Fred in equal shares. From a cash flow perspective, this method seems unfair to Fred, since he will be subject to income taxes on his half of the estate's DNI for the partnership income even through he did not receive the partnership interest. However, when valuing the estate residue to determine the amount distributable to each beneficiary, the value of the partnership interest should include any taxable income earned by the partnership from January 1, 2011 through October 31, 2011. Because both beneficiaries share in this increase in the estate residue on an equal basis, using Approach Two seems to provide a more equitable allocation of income to both beneficiaries.

Gain Allocation for Liability Relief. When a partnership interest is transferred, the share of partnership liabilities allocable to the transferred interest is treated as a cash payment by the transferee (beneficiary) to the transferor (estate or trust). The debt is treated as part of the "purchaser's" (beneficiary's) cost and is part of the amount realized for determining the transferor's (estate or trust's) gain or loss. Thus, the share of partnership liabilities assumed by the beneficiary increases his or her tax basis in the distributed partnership interest.

If the estate or trust's basis in the partnership interest being distributed is negative (e.g., the partnership liabilities allocable to the interest exceed the estate or trust's share of the partnership basis of its assets), the estate or trust (the deemed "seller") must recognize gain equal to the negative capital account.

Distribution of S Corporation Stock from an Estate or Trust

Estates and certain trusts can be S corporation shareholders. While S corporations are not subject to the same termination rules as partnerships, the same issue of how the income should be allocated between the fiduciary and the beneficiary applies. Although a testamentary trust can own S corporation stock for two years (unless revocation of the S election is desired), the trust will distribute the stock to an eligible shareholder within the two year period to avoid the revocation. The same distribution issue will arise when the sole beneficiary of the QSST trust dies. Assuming no sole successor beneficiary exists to continue the QSST election, the trust must either make an ESBT election or distribute the stock to avoid a revocation.

S corporations pass through items of income or loss to the shareholders based on a per-share, per-day allocation method. In the year of death, the decedent is allocated a pro rata share of the corporation's pass-through items on Schedule K-1 (Form 1120S) for the portion of the corporation's tax year through the date of death. The remainder of the S corporation's tax year is allocated to the successor shareholder(s). Unlike partnerships, any form of transfer that changes share ownership results in a per-share, per-day allocation.

Specific Bequest. If a decedent specifically bequeathed S corporation stock to a beneficiary, and the beneficiary's bequest is certain to be made, the fiduciary should notify the S corporation of the beneficiary's address and inheritance. The S corporation can contact the beneficiary to obtain the necessary information to send the beneficiary a Schedule K-1 (Form 1120S), thus allowing the S corporation to allocate the corporation's after-death income totally to the beneficiary. No Schedule K-1 (Form 1120S) need be issued to the estate.

Pecuniary Bequests. The distribution of noncash property to satisfy a pecuniary bequest is a sale requiring the estate to report any gain or loss. When a trust distributes noncash property to satisfy a mandatory income or annuity distribution, the same result occurs except no loss is allowed under the related party rules (except for qualified revocable trusts electing under IRC Sec. 645 to be treated as part of the estate).

Since the distribution of noncash property to satisfy a pecuniary bequest is a sale, the estate's tax year ends on the date of the distribution. The estate will report its share of the S corporation income and loss from the beginning of the year until the date of distribution, and the beneficiary will report the remaining portion on the beneficiary's tax return. The fiduciary must notify the S corporation of the pecuniary distribution so the corporation can make the proper allocation.

Residuary Bequests. Under the general rule, the distribution of noncash property as part of a residuary bequest does not result in a sale. However, when a Section 643(e)(3) election is made, a deemed sale results. A distribution of S corporation stock as a residuary bequest when a Section 643(e)(3) election is made would be accounted for in the same manner as a pecuniary bequest, as discussed previously. Normally, when a trust terminates and makes a distribution to the remainder beneficiaries, the distributions are accounted for in the same manner as residuary bequests from an estate. (The same holds true for discretionary distributions of principal during the trust's existence.) Unlike distributions of partnership interests, the distribution of stock to a residuary beneficiary changes ownership, requiring a per-share, per-day allocation.

Example 2H-2 Type of distribution from the estate or trust determines how S corporation income is allocated.

Sally Jones owned 30% of the stock in ABC, Inc. (a calendar year S corporation) at the time of her death on September 30, 2010. All of the S corporation's income or losses from January 1 through September 30 are reported on Sally's final Form 1040. The type of bequest determines how the post-death S-corporation activity is reported.

1. *Specific Bequest.* Sally's will made a specific bequest of her stock to her daughter, Rosie, and there are sufficient other assets to pay Sally's debts. Sally's executor notifies ABC, Inc. of Sally's death and provides information regarding Rosie's direct inheritance of Sally's stock and Rosie's address. ABC Inc. will contact Rosie to obtain the necessary identification information, and, at the end of 2010, will send Rosie a Schedule K-1 (Form 1120S) allocating the S corporation's income and loss from October 1 through December 31, 2010 to her. The estate will not receive a Schedule K-1 from ABC, Inc.

2. *Pecuniary Bequest.* Instead of a specific bequest, Sally's will provided for a pecuniary bequest of $250,000 to be made to her daughter, Rosie. No estate distributions were made to Rosie in 2010, so the S corporation's income from October 1 to December 31, 2010 is reported on the estate's Form 1041. On April 30, 2011, the ABC Inc. stock, which had a fair market value of $250,000 on that date, was distributed to Rosie in satisfaction of her pecuniary bequest. The estate must report the distribution as a sale, with a sales price of $250,000. The estate notifies ABC Inc. of the distribution. The S corporation will allocate the S corporation's income from January 1 through April 30, 2011 to the estate and its income from May 1 through December 31, 2011 to Rosie.

3. *Residuary Bequest.* Instead of any specific or pecuniary bequests, Sally's will provided that Rosie and her brother Fred are to be equal residuary beneficiaries. After paying all debts, the executor closes the estate on October 31, 2011 and distributes 50% of the assets to Rosie and 50% of the assets to Fred. Included in these assets is the ABC stock. Both Rosie and Fred will become 15% shareholders in ABC. Since no distributions were made in 2010, the corporation income from October 1 to December 31, 2010 is reported on the estate's Form 1041. In 2011, the estate notifies ABC, Inc. of the distribution. The estate reports its distributive share of S corporation income earned through October 31, 2011, which will be included in its DNI for that year. Since Rosie and Fred each received 50% of the total estate distributions, each would receive 50% of the estate's DNI. They will report their share of income earned by ABC, Inc. from November 1 through December 31, 2011.

Variation: Unless the fiduciary has the authority (according to state law and the governing instrument) to make *nonprorata distributions*, a deemed sale would occur if the executor exchanged the assets being distributed to Rosie and Fred. Assume Sally's estate consisted of 30% of the stock in ABC, Inc. and a building. Rosie preferred to receive all of the stock, whereas Fred wanted the building. Because Sally's will allowed

nonprorata distributions, the executor distributed 30% of the ABC Inc. stock to Rosie and 100% of the building to Fred on October 31, 2011 and avoided sale treatment. (Effectively, the executor has exchanged Rosie's 50% ownership in the building for Fred's 15% share of ABC Inc. stock.) In this case, Rosie would report the full 30% of the income earned by ABC Inc. from November 1 through December 31, 2011 since Fred is never considered an owner of the ABC Inc. stock.

Distribution of Encumbered Property

General Rules

If an estate or trust distributes in-kind property that includes debt for which the beneficiary will remain liable, the general rule of carryover of income tax basis from the fiduciary to the beneficiary applies. The fiduciary will not recognize gain or loss unless it meets any of five exceptions. Furthermore, the beneficiary will not have gain or loss recognition until he or she sells or otherwise disposes of the property. However, if the trust is a grantor trust, any debts of the trust that are secured by property in the trust will be considered an amount realized by the grantor when the trust terminates.

When Debt Exceeds Basis

When an estate or trust distributes in-kind property that includes a debt for which the beneficiary will remain liable, and the amount of debt exceeds the income debt basis, there is debt relief to the fiduciary. However, although partnership distributions of property that generate debt relief to the partnership require recognition of debt relief income under Subchapter K, fiduciary distributions of property generating debt relief do not require similar income recognition under Subchapter J.

Cancellation of indebtedness income need not be recognized by the estate or trust unless (a) there is a debtor/creditor relationship, and (b) the debt has been cancelled. For distributions of estate and trust property, the debt is typically not cancelled. Instead, it is usually assumed by the beneficiary. When that is the situation, the general rules of nonrecognition of gain or loss and carryover of basis and holding periods apply unless any of five exceptions are met. However, if the estate or trust has a debtor/creditor relationship for which the debt is actually cancelled, it will be subject to debt relief income at the fiduciary level under the normal rule of IRC Sec. 61(a)(12).

Reporting the Holding Period for Distributed Property

Upon distribution of in-kind property, fiduciaries should provide the beneficiary with information as to his or her tax basis and holding period of the property.

General Rules

Property Inherited from Decedent Dying Before 2010. The holding period attributed to assets distributed from an estate or testamentary trust is dependent upon the decedent's date of death. For estates of decedents who died before January 1, 2010, the holding period of the property is generally considered long-term, regardless of how long it was held by the decedent. However, this general rule does not apply if there has been a taxable event upon distribution (i.e., a deemed sale of the property). See the discussion that follows.

Property Inherited from Decedent Dying in 2010. The repeal of the step-up in basis rules under IRC Sec. 1014 for decedents dying in 2010 also eliminates the automatic long-term holding period that would otherwise be available to assets inherited from the decedent. A tacked holding period may be available, however, which gives the estate a holding period that includes the period held by the decedent, as well as the period that the estate holds the asset.

Specific Property Distributions from Inter Vivos Trusts. When specific property is transferred from a complex *inter vivos* trust, the distribution is treated as a gift, resulting in a carryover basis from the trust to the beneficiary. Because the beneficiary's basis is determined in whole or in part by referring to the trust's basis, the beneficiary's holding period includes that of the trust. However, if the beneficiary sells the property at a loss, and the trust's basis in the property exceeded its fair market value (FMV) at the date of distribution, the beneficiary's holding period begins on the day after the date of the distribution (IRS Pub. 17).

Specific Bequests from Estates and Testamentary Trusts. The holding period of specific bequests is the same as for inherited property, as described previously.

Discretionary Distributions of Property. The holding period of discretionary distributions of in-kind property is the same as for specific property distributions from *inter vivos* trusts, as described earlier (i.e., trust or estate's holding period is "tacked on" to the beneficiary's. However, this is not the case when an estate or trust elects to recognize gain under IRC Sec. 643(e)(3) on the distribution of property to the beneficiary. In that situation, the distribution is treated as a sale of the property to the beneficiary, causing the beneficiary's holding period to begin on the date of acquiring the property. Because the beneficiary is deemed to have purchased the property, his or her basis is not determined by referring to the estate or trust's basis, and IRC Sec. 1223(2) does not apply to tack on the transferor's holding period onto the beneficiary's.

Distributions Substituted for Specific Property or Dollar Amount. If the estate or trust distributes substituted property (i.e., other than that which is specified in the governing instrument), the transfer is treated as a distribution of cash in an amount equal to the property's FMV, followed by a deemed sale of the property to the beneficiary for the cash. In this situation, the estate or trust's holding period is not tacked onto the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquiring the substituted property (i.e., date of distribution). Because the beneficiary is deemed to have purchased the substituted property, his or her basis is not determined by referring to the estate or trust's basis, and IRC Sec. 1223(2) does not apply to tack the transferor's holding period onto the beneficiary's.

Pecuniary Bequests. The determination of whether the estate or trust's holding period "tacks on" to the beneficiary's is based upon whether there has been a taxable event resulting in a deemed sale by the estate or trust. If so, for example, when an estate satisfies a pecuniary bequest with appreciated property or there is a true worth formula pecuniary bequest funded at date-of-distribution value, the beneficiary's holding period begins upon the receipt of the property.

> **Example 18J-1:** Holding period does not tack onto beneficiary's for distribution in satisfaction of a pecuniary bequest.
>
> The trustee of the Jane Hoover Testamentary Trust transferred stock with a FMV of $10,000 to Robert Hoover, nephew of the decedent, in satisfaction of a specific bequest of $10,000. The stock, acquired by Jane in 2005, had a value of $9,000 on the date of her death in 2010. The transfer was made within one year of Jane's death.
>
> The trust must recognize a $1,000 long-term capital gain, and the basis of the stock to Robert is $10,000. Robert's holding period begins upon receipt of the stock (date of the deemed sale). Thus, if he sells it within 12 months of receiving it, he will report it as a short-term gain or loss on his tax return.

If, on the other hand, there has *not* been a taxable event resulting in a deemed sale (e.g., a fairly representative formula pecuniary bequest or a minimum worth funding pecuniary bequest, the basis in the property carries over to the beneficiary. Because the beneficiary's basis is determined, in whole or in part, by referring to the estate or trust's basis), the estate or trust's holding period tacks onto the beneficiary's.

Residuary or Fractional Bequests. Unless the estate or trust makes a Section 643 election to recognize gain upon distribution, the estate or trust's holding period tacks onto the beneficiary's. However, as discussed previously, a Section 643 election is treated as a deemed sale, which causes the beneficiary's holding period to begin on the date of deemed purchase from the estate or trust.

SELF-STUDY QUIZ

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

41. The Bates Estate sells a parcel of land on the installment method. After collecting 11 payments, the obligation is distributed to one of the estate's beneficiaries, Lena, to satisfy a pecuniary bequest. Due to current interest rates at the time of the distribution, the note's FMV is lower than its unrecovered basis. What are the consequences of these actions?

    a. The estate can deduct the difference between the note's FMV and unrecovered basis.

    b. Lena's basis in the note is limited to the FMV at the time of the distribution.

    c. The estate must recognize income in respect of a decedent (IRD) on the transaction.

    d. The cash method of accounting must be used to report the sale.

42. Which of the following statements best describes the distribution of partnership interests from an estate or trust?

    a. The two issues that must be addressed are whether the partnership's existence is affected and how income will be allocated.

    b. The estate or trust that makes the distribution and the preparer of the Form 1041 will determine how the distribution affects the partnership.

    c. If the interest is specifically bequeathed to the beneficiary and receipt is certain, a Schedule K-1 (Form 1065) must be issued to the estate.

    d. If a trust terminates and distributes partnership interests to the remaindermen, the distributions will be accounted for as pecuniary bequests.

43. Joe owns 55% of the Miller-Stein partnership, a two-person partnership. He dies on March 15, 2010. Which of the following actions would make the partnership terminate for tax purposes?

    a. The transfer of Joe's partnership shares into his estate upon his death.

    b. Closure of the partnership's tax year upon Joe's death.

    c. A distribution of the partnership interest to satisfy a pecuniary bequest.

    d. A distribution of the partnership interest to satisfy a specific bequest.

44. Roy was a 35% partner in the Black Fog Partnership before his death. His will provides for a pecuniary bequest of $300,000 to be made to his son, Hank. No estate distributions were made to Hank in 2010. In 2011, the partnership income, worth $300,000, is distributed to Hank in satisfaction of the pecuniary bequest. How would this distribution be reported?

    a. The estate reports the distribution as a sale and notifies the partnership. Black Fog allocates the partnership income from before the distribution to the estate and after the distribution to Hank.

    b. The estate notifies the partnership. The partnership contacts Hank for identification information. At the end of the year, the partnership sends Hank a Schedule K-1 (Form 1065) allocating partnership income to Hank.

    c. Hank reports all partnership income for the year. Both the estate and Hank receive Schedules K-1 from the partnership, but the estate's reports its zeroed out capital account on the capital account reconciliation.

    d. The estate reports its distributive share of partnership income on a Schedule K-1. The partnership issues a Schedule K-1 to Frank reporting his share of the partnership income, as well. The estate includes partnership income in its DNI.

45. Which of the following statements best describes the relationship estates and trusts may have to S corporation stock?

    a. Only beneficiaries can be S corporation shareholders; estates and trusts cannot.

    b. A testamentary trust can own S corporation stock for five years.

    c. A per-share, per-day allocation results from any transfer that changes share ownership.

    d. S corporation shares can only be transferred by specific bequest.

SELF-STUDY ANSWERS

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

41. The Bates Estate sells a parcel of land on the installment method. After collecting 11 payments, the obligation is distributed to one of the estate's beneficiaries, Lena, to satisfy a pecuniary bequest. Due to current interest rates at the time of the distribution, the note's FMV is lower than its unrecovered basis. What are the consequences of these actions? **(Page 203)**

    a. **The estate can deduct the difference between the note's FMV and unrecovered basis. [This answer is correct. Because this is a pecuniary bequest, the estate can make the deduction. The deduction could not be made under an IRC Sec. 643(e)(3) election.]**

    b. Lena's basis in the note is limited to the FMV at the time of the distribution. [This answer is incorrect. Lena's basis in the note would be equal to its predistribution basis.]

    c. The estate must recognize income in respect of a decedent (IRD) on the transaction. [This answer is incorrect. If property was sold on the installment basis before a decedent's death, unrecognized gain at death is IRD. If the obligation were sold by the estate, the estate would then recognize IRD.]

    d. The cash method of accounting must be used to report the sale. [This answer is incorrect. If an executor sells property on an estate's behalf, the installment method of accounting is used to report the gain, unless the fiduciary elects out of installment reporting.]

42. Which of the following statements best describes the distribution of partnership interests from an estate or trust? **(Page 208)**

    a. **The two issues that must be addressed are whether the partnership's existence is affected and how income will be allocated. [This answer is correct. These two issues (whether the distribution will affect the existence of the partnership and how the income from the distribution will be allocated between the estate or trust and the beneficiary) must be addressed when an estate or trust distributes a partnership interest to a beneficiary.]**

    b. The estate or trust that makes the distribution and the preparer of the Form 1041 will determine how the distribution affects the partnership. [This answer is incorrect. The determination must be made on the partnership level; therefore, the estate or trust will need to provide all relevant information to the partnership.]

    c. If the interest is specifically bequeathed to the beneficiary and receipt is certain, a Schedule K-1 (Form 1065) must be issued to the estate. [This answer is incorrect. In this situation, the estate would notify the partnership of the beneficiary's inheritance and address; then the partnership can contact the beneficiary for any needed identification and issue a Schedule K-1 (Form 1065) directly to the beneficiary. Therefore, the estate would not need a Schedule K-1 (Form 1065).]

    d. If a trust terminates and distributes partnership interests to the remaindermen, the distributions will be accounted for as pecuniary bequests. [This answer is incorrect. In this situation, the distributions would be accounted for as residuary bequests, not pecuniary bequests. Two approaches exist for dealing with this type of distribution.]

43. Joe owns 55% of the Miller-Stein partnership, a two-person partnership. He dies on March 15, 2010. Which of the following actions would make the partnership terminate for tax purposes? **(Page 208)**

    a. The transfer of Joe's partnership shares into his estate upon his death. [This answer is incorrect. Joe's estate will become a partner for tax purposes. The partnership will not terminate because it continues to have at least two partners.]

b. Closure of the partnership's tax year upon Joe's death. [This answer is incorrect. When a partner dies during the year, the partnership's tax year closes with respect to that partner. This does not automatically cause the partnership to terminate.]

c. A distribution of the partnership interest to satisfy a pecuniary bequest. [This answer is correct. Because this distribution was to satisfy a pecuniary bequest it is considered a sale. The partnership will terminate because over 50% was "sold" within a 12-month period.]

d. A distribution of the partnership interest to satisfy a specific bequest. [This answer is incorrect. Since there is no Section 643(e)(3) election, this distribution does not qualify as a sale, so the partnership will not terminate.]

44. Roy was a 35% partner in the Black Fog Partnership before his death. His will provides for a pecuniary bequest of $300,000 to be made to his son, Hank. No estate distributions were made to Hank in 2010. In 2011, the partnership income, worth $300,000, is distributed to Hank in satisfaction of the pecuniary bequest. How would this distribution be reported? **(Page 208)**

a. The estate reports the distribution as a sale and notifies the partnership. Black Fog allocates the partnership income from before the distribution to the estate and after the distribution to Hank. [This answer is correct. When an estate distributes noncash property in the satisfaction of a pecuniary bequest, it is treated as a sale. Thus, the estate recognizes gain or loss.]

b. The estate notifies the partnership. The partnership contacts Hank for identification information. At the end of the year, the partnership sends Hank a Schedule K-1 (Form 1065) allocating partnership income to Hank. [This answer is incorrect. This method would be used if the partnership interest had been given to Hank in a specific bequest.]

c. Hank reports all partnership income for the year. Both the estate and Hank receive Schedules K-1 from the partnership, but the estate's reports a zeroed out capital account on the capital account reconciliation. [This answer is incorrect. There are two approaches for allocating partnership income for a residuary bequest. This is one approach.]

d. The estate reports its distributive share of partnership income on a Schedule K-1. The partnership issues a Schedule K-1 to Frank reporting his share of the partnership income, as well. The estate includes partnership income in its DNI. [This answer is incorrect. This is the second of two approaches used to allocate partnership income for a residuary bequest.]

45. Which of the following statements best describes the relationship estates and trusts may have to S corporation stock? **(Page 208)**

a. Only beneficiaries can be S corporation shareholders; estates and trusts cannot. [This answer is incorrect. Both estates and trusts are allowed to be S corporation shareholders. There will be issues to resolve regarding allocation of income between the beneficiary and the fiduciary.]

b. A testamentary trust can own S corporation stock for five years. [This answer is incorrect. A testamentary trust can only own S corporation stock for two years (unless a revocation of the S election is desired).]

c. A per-share, per-day allocation results from any transfer that changes share ownership. [This answer is correct. The decedent gets a prorata share of the corporation's pass-through items on Schedule K-1 for the corporation's tax year until the date of death. The rest of the corporation's tax year is allocated to the decedent's successor.]

d. S corporation shares can only be transferred by specific bequest. [This answer is incorrect. S corporation shares can also be transferred by a residuary or a pecuniary bequest.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T41TG102)

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

29. The Jensen Mallory Estate distributes all the shares of a certain stock to Jensen's brother, as identified in the will. The estate transfers the stock in one installment. What type of distribution is this?

    a. Specific.

    b. Pecuniary.

    c. Residuary.

    d. Nonprorata.

30. Match the following types of property distributions with the correct tax effects of the distribution.

1. A general in-kind distribution	i. The difference between the fair market value (FMV) on the date of transfer and the FMV on the decedent's death is recognized as gain.
2. Distribution to satisfy a pecuniary bequest	ii. No gain or loss is recognized.
3. Distribution to satisfy the beneficiary's right to receive a specific dollar amount/asset other than the asset distributed	iii. Recognition of gain and, for an estate, loss.
4. Distribution of property in lieu of income	iv. Recognition of gain, but not loss.
5. For estates of decedents dying in a year other than 2010, distribution of special-use valuation property to qualified heirs	

    a. 1., iii.; 2., iv.; 3., ii.; 4. and 5., i.

    b. 1., i.; 2. and 3., ii.; 4., iv.; 5., iii.

    c. 1. and 5., iv.; 2., i.; 3., iii.; 4., ii.

    d. 1., ii.; 2., iii.; 3. and 4., iv.; 5., i.

31. In his will, Jared bequeaths his car to his sister, Samantha. The car is distributed to Samantha by the estate two months after Jared's death. What are the tax effects of the distribution?

    a. The value of the car becomes part of Samantha's gross income, and the estate takes an equivalent distribution deduction.

    b. The value of the car becomes part of Samantha's gross income, but the estate cannot take a distribution deduction.

    c. Samantha does not include the value of the car in her gross income, and the estate does not claim a distribution deduction.

    d. The distribution is treated as required by the distribution rules of IRC Sec. 643(e)(2).

32. Which of the following would be considered a specific bequest if required by a will?

    a. An annuity.

    b. A personal residence.

    c. A residuary estate.

    d. Income from the sale of stock.

33. Maeve's will bequeaths $50,000 to her nephew, Tom. The amount is payable in cash or property. The executor of Maeve's estate distributes stock to Tom to fulfill the request. The stock was valued at $50,000 at the time of the distribution, but the estate's basis in the stock was $40,000. What are the tax effects of this transaction?

    a. Tom includes the $50,000 in gross income.

    b. The estate receives a $50,000 distribution deduction.

    c. Tom recognizes a capital gain of $10,000.

    d. The estate recognizes a capital gain of $10,000.

34. To be treated as a *specific bequest*, a distribution must be required to be paid in how many installments?

    a. Five or fewer.

    b. Four or more.

    c. Three or fewer.

    d. Two or more.

35. Jackson Smith dies in 2010, and his will makes the following bequests. Which of the bequests meet the installment-payment requirement to be treated as a specific bequest?

    i. The distribution of a car, a residence, and piece of family jewelry to his daughter Rose.

    ii. The distribution of $300,000 in cash to a trust that will be distributed to his son, Mike, on his 25, 30, 35, and 40th birthdays.

    iii. The distribution of stock to his niece, Kathy, to be paid in five annual installments, if the executor distributes it all at one time so Kathy can purchase a new home.

    iv. The distribution of two kinds of stock and a sum of cash to a trust to be distributed to his nephew, Bill, on his 25th birthday.

    a. iii.

    b. i. and iv.

    c. i., ii., and iv.

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

36. The Adams Trust generates $45,000 of taxable DNI in 2010. Under the trust instrument, capital gain is excluded from fiduciary accounting income. Fiduciary accounting income for the year was $35,000. One discretionary distribution was made during the year—the trust distributed 50 shares of stock to John. The trust had a tax basis of $2,000 in the stock, and the stock's FMV on the distribution date was $5,000. In this scenario, what is the amount of the trust's distribution deduction?

    a. $2,000.

    b. $5,000.

    c. $30,000.

    d. $35,000.

37. The Alston Family Trust elects to recognize gain on the distribution of property. What are the consequences of this election?

    a. There will be no step-up in basis of the property to the trust.

    b. The trust must also elect to recognize losses on property distributions.

    c. The distribution amount becomes the FMV of the property distributed.

    d. The election includes all distributions of property, including specific bequests.

38. In which scenario would it be prudent for the trustee to make the Section 643(e)(3) election to recognize gain?

    a. The Meyers Trust has capital loss carryforward and several opportunities to use it during the current tax year.

    b. The Baker Trust sold a capital asset for a loss and will be limited to the annual $3,000 capital loss deduction.

    c. The Smith Trust would like the Section 643(e) election to apply to only one distribution of property during the trust's year.

    d. Dee, the beneficiary of the Jones Trust, has a capital loss carryforward that will offset her gain from selling stock distributed by the trust.

39. What type of formula pecuniary bequest is used when the will includes the following clause:

> My executor will choose and distribute the assets that constitute the marital deduction bequest to my husband, Bob, should he survive me, by using, for valuation purposes, the lesser of the assets' adjusted basis for federal income tax purposes or their value of the asset at the distribution date(s).

    a. True worth.

    b. Fairly representative.

    c. Minimum worth.

    d. Fractional share.

40. Walter's will bequeaths $150,000 to Hugh. In lieu of that dollar amount, the executor offers to distribute a piece of real property to Hugh that has equivalent value. Hugh accepts the distribution. How would gain or loss be treated at the fiduciary level?

    a. Only gain would be recognized.

    b. Only loss would be recognized.

    c. Only capital gain or loss would be recognized.

    d. All gain or loss will be recognized.

41. The Breakwater Trust holds shares of MegaCo stock that are a loss asset in 2010. What disposition method would allow the trust to take advantage of the most loss recognition?

    a. Retaining the shares.

    b. Distributing the shares to a beneficiary.

    c. Selling the shares to a third party.

    d. A trust can never recognize loss due to the related-party rules.

42. The Davis Family Trust sells a piece of real estate for $200,000 on the installment basis in 2009. The land had a basis in the trust of $120,000. The trust received a down payment of $56,000 and took a note for the remaining $144,000. The note allowed 36 payments of $4,000 plus interest at a fair market rate. In 2010, after receiving 12 payments, the trustee distributes the note to Ray, a trust beneficiary. Calculate the gain on the distribution assuming that the note has a FMV of $80,000 when it is distributed to Ray.

    a. $22,400.

    b. $38,400.

    c. $48,000.

    d. $57,600.

43. The Estate of Michael Bower distributes a partnership interest to Michael's son, Frank. Which of the following determines whether this distribution will affect the partnership's existence?

    a. Frank.

    b. The estate.

    c. The partnership.

    d. The IRS.

44. Assume the same details as in the question above. If the Bower Estate has large debts to settle before bequests can be made, how will that affect the specific bequest of the partnership interest to Frank?

    a. Distributions from the partnership must be the first asset used to pay off debts.

    b. Partnership distributions can only be used to pay debts if the estate has a lack of liquidity.

    c. If other assets are available, partnership distributions cannot be used to pay estate debts.

    d. Partnership distributions can only be used to pay debts in a pecuniary bequest.

45. If a decedent owned S corporation stock, how can the estate dispose of that stock without it being considered a sale?

i. In satisfaction of a specific bequest

ii. In satisfaction of a pecuniary bequest

iii. In satisfaction of a general residuary bequest

iv. In satisfaction of a residuary bequest under a Section 643(e)(3) bequest

a. iv.

b. i. and iii.

c. ii. and iv.

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

GLOSSARY

Beneficiary: The party for whose benefit a will, trust, insurance policy, or contract is created. The beneficiary may be an individual or an organization (e.g., charity, school, club, or business). The party may receive title to property by will or by equitable interest in a trust.

Capital gain/loss: Capital gain or loss is derived from the sale or exchange of capital assets. The transaction may result in short-term or long-term gain or loss. Short-term gain or loss results when an asset is held for one year or less. Long-term gain or loss results when an asset is held for more than one year.

Complex trust: All trusts that do not qualify as simple trusts during the year. They compute their distribution deduction under a tier system.

Decedent: The deceased individual whose estate is being administered.

Deduction: An amount that may be subtracted to arrive at taxable income.

Distributable net income (DNI): The maximum amount of taxable income a fiduciary can claim as an income distribution deduction and the maximum amount required to be included in gross income of the beneficiaries.

Estate: A taxable entity that comes into being upon the death of a taxpayer. It consists of all the decedent's property and personal effects. The estate exists until the final distribution of its assets to the heirs and other beneficiaries. During the period of administration, the executor must usually file a return.

Executor: A person named in the will and empowered by the court to administer the decedent's estate, to act for the estate, and to carry out the terms of the will. An executor is empowered to marshal the assets and pay the debts of the estate and distribute the remaining assets as specified in the will. An executor is empowered to sell assets to pay debts. It is a fiduciary relationship. An executor has certain powers, duties, and liabilities, which are identical to those of administrators.

Fiduciary: One who holds a position of trust with respect to another party or its property. It is the fiduciary's duty to act selflessly for the benefit of another, with undivided loyalty, obedience, and diligence—with due care and in good faith. This is the primary duty of an agent to the principal, of a trustee to the trust, and of an executor to the estate.

Fiduciary accounting income: The income that comes from assets in an estate or trust. Expenditures closely associated with producing income are charged against the particular type of income. Expenditures closely associated with the assets in the body (or principal) of the trust, are generally charged to the particular asset (principal) and not against income.

Generation-skipping transfer (GST) tax: This tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor and on transfers involving trusts having beneficiaries in more than one generation below that of the transferor. It applies to direct skips, taxable distributions, and taxable terminations.

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

Partnership: A form of business in which two or more persons join their money and skills in conducting the business as co-owners. Partnerships are treated as a conduit and are not subject to taxation. Various items of partnership income, expenses, gains, and losses flow through to the individual partners and are reported on their personal income tax returns.

Pecuniary bequest: Gifts of a specific dollar value, which can be based on either a fixed dollar amount or a formula.

Residuary bequest: The bequest of a particular fraction or percentage of the estate after the payment of the specific and pecuniary bequests, any debts, and expenses.

S corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in Subchapter S of the Internal Revenue Code (IRC).

Separate share rule: If a single complex trust or an estate has two or more beneficiaries who have substantially separate and independent shares, their shares are treated as separate trusts or estates for the sole purpose of determining the amount of DNI allocable to each beneficiary.

Simple trust: Trusts that require all income to be distributed currently, make no distributions of principal in excess of the required income in a given year, and are not allowed a charitable contribution deduction for the year. A simple trust is allowed to deduct the amount of income required to be distributed currently, up to the amount of taxable DNI.

Specific bequest: Bequests that are specifically identified in the governing instrument and payable to a beneficiary in three or fewer installments.

Tax-exempt income: This includes tax-exempt interest, compensation for illness or injury, debt forgiveness income (Chapter 11 bankruptcy), and death benefits.

Tier 1 distributions: These include any amount required to be distributed that may be paid out of income or principal (such as an annuity), to the extent it is actually paid out of income for the tax year. The sum of Tier 1 and Tier 2 distributions, after adjusting for tax-exempt income and related expenses, is an allowed deduction for estates and complex trusts.

Tier 2 distributions: These include "proper" payments of income not required to be distributed currently and distributions of principal, whether required or discretionary. The sum of Tier 1 and Tier 2 distributions, after adjusting for tax-exempt income and related expenses, is an allowed deduction for estates and complex trusts.

Trust: A tax entity created by a trust agreement. This entity distributes all or part of its income to beneficiaries as instructed by the trust agreement. This entity is required to pay taxes on undistributed income.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 1—Reporting Various Income Items for Estates and Trusts (T41TG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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

   Thomson Reuters
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   T41TG101 Self-study CPE
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   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 1—Reporting Various Income Items for Estates and Trusts (T41TG101)

CTEC Course No. 3039-CE-0261
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Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1041 Deskbook—Course 1—Reporting Various Income Items for Estates and Trusts

Course Acronym: T41TG101

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC'S 1041 Deskbook—Course 2—Distributions (T41T102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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

   Thomson Reuters
   Tax & Accounting—R&G
   T41TG102 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 2—Distributions (T41TG102)

CTEC Course No. 3039-CE-0262
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1041 Deskbook—Course 2—Distributions Course Acronym: T41TG102

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____