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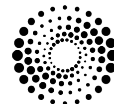

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Interactive Self-study CPE

Companion to PPC's 1041 Deskbook

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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/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2018**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 1

DISTRIBUTABLE NET INCOME, THE DISTRIBUTION DEDUCTION, AND PROPERTY DISTRIBUTIONS (T41TG171)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses issues related to types of distributions from estates and trusts. Lesson 1 takes a look at distributable net income and the distribution deduction. Lesson 2 examines property distributions.
PUBLICATION/REVISION DATE:	November 2017
RECOMMENDED FOR:	Users of *PPC's 1041 Deskbook*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of estate and trust taxation
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP):** This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.
CTEC CREDIT:	8 CTEC Federal Tax Law Hours
IRS EA CREDIT:	8 Federal Tax Law/Tax Related Matters Hours
IRS NCRP CREDIT:	8 Federal Tax Law Hours
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **November 30, 2018**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Distributable Net Income and the Distribution Deduction

Completion of this lesson will enable you to:

- Identify the proper deduction for distributions of taxable income, assess the importance of distributable net income (DNI), and determine how to compute DNI.

- Recognize when capital gains are excluded from and included in DNI, as well as how to compute the distribution deduction for simple trusts, estates, and complex trusts.
- Determine the best methods for dealing with distributions of amounts other than current income, the separate share rule, the 65-day distribution deduction, distributions of tax-exempt income, and "phantom" taxable income.

Lesson 2—Property Distributions

Completion of this lesson will enable you to:

- Recognize the tax effects of property distributions and how to deal with distributions of specific property or a sum of money and property distributions that are not specific bequests.
- Identify the best methods to use for distributions in lieu of a specific property or specific dollar amount, distributions of property in lieu of income, distributions of depreciated property, distributions of installment obligations, distributions of partnership interests and S corporation stock, distributions of encumbered property, reporting the holding period for distributed property, and dealing with reporting issues related to the generation-skipping transfer tax.

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Lesson 1: Distributable Net Income and the Distribution Deduction

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. Except for specific bequests, distributions of principal that are included in DNI, as well as income, will carry out DNI to the beneficiaries and entitle the estate or trust to the distribution deduction. 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. For the treatment of in-kind distributions, see Lesson 2.

Distributions made in error are not taxed to a beneficiary if they are returned to the trust.

Trust and estate beneficiaries are required to file their personal returns consistent with the information on their Schedule K-1 unless a notice of inconsistent treatment is filed with the return. If a beneficiary reports an item differently from that reported on the fiduciary tax return, the beneficiary must adequately disclose this inconsistent treatment.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the proper deduction for distributions of taxable income, assess the importance of distributable net income (DNI), and determine how to compute DNI.
- Recognize when capital gains are excluded from and included in DNI, as well as how to compute the distribution deduction for simple trusts, estates, and complex trusts.
- Determine the best methods for dealing with distributions of amounts other than current income, the separate share rule, the 65-day distribution deduction, distributions of tax-exempt income, and "phantom" taxable income.

Making the Deduction for Distributions of Taxable Income

Overview of Distribution Deduction and DNI Rules

If income is accumulated and not considered distributed by the fiduciary, it is taxed to the estate or trust. If cash or other property (whether from income or principal) is distributed from an estate or trust to a beneficiary, it is generally treated as a distribution of current taxable income to the extent of distributable net income (DNI). The fiduciary can claim a deduction for the taxable income distributed, and a corresponding amount is included in the beneficiary's gross income. 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 rely on local (i.e., state) law for guidance. All states, except Rhode Island, have adopted a version of the Revised 1962 or 1997 Uniform Principal and Income Act, which, without 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. The statutory definition of DNI is provided later in this lesson.

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 the current year, the trustee's only distributions were $15,000 for Billy's tuition, books, room, and board. 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 the current year 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.

Variation: 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 the current year, 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.

On November 2 of the current year, 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.

Computing DNI and the importance of DNI to the tax return preparation process are discussed later in this lesson.

Exception for Specific Bequests

A distribution of cash or other property (whether from income or principal) is generally treated as coming from current income to the extent of DNI. However, DNI is not carried out to the beneficiaries for 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. Therefore, no DNI is allocated to specific gifts or bequests. The fiduciary cannot claim a distribution deduction, 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 (2016). The estate has taxable DNI in 2017 of $100,000. The executor makes the $25,000 distribution to the niece in 2017; there were no other distributions.

Even though the estate had taxable undistributed income for 2017, there is no distribution deduction for the $25,000 distributed to the niece since it qualifies as a specific bequest. In addition, the niece is not subject to income tax on the $25,000 she received.

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 impact of tax-exempt income on the distribution deduction is discussed later in this lesson.

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 the current year, 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.
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. Guidance on calculating the distribution deduction for simple trusts is provided later in this lesson.

The character of a trust from "simple" to "complex" can change from year to year. An otherwise simple trust will be classified as a complex trust for any year that principal is distributed. Trusts are characterized as complex trusts in the year of termination since principal distributions are required.

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. Expanded coverage of the distribution deduction for estates and complex trusts is provided later in this lesson.

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. 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. An in-depth discussion of selecting an estate's year end is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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). A discussion of IRD is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

The Importance of Distributable Net Income (DNI)

Maximum Distribution Deduction to Fiduciary and Income Inclusion to Beneficiary

Distributable net income (DNI) governs the following three important issues. (Calculating DNI is discussed later in this lesson.)

1. It 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.

2. DNI is also the maximum amount the beneficiaries will have to include in their gross income.

3. It determines the character of income to the beneficiary.

Example 1B-1 DNI provides upper limit for distribution deduction.

The Robert Johnson Testamentary Trust requires all income to be distributed currently. In the current year, the trust has $3,000 of dividend income, $8,000 of taxable interest income, and the trustee's fee is $1,000. DNI is 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 impact of tax-exempt income on DNI and the distribution deduction, including the requirement to allocate expenses to tax-exempt income, are discussed later in this lesson.

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 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.

A complex 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, which equals 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 (or required to be 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, as discussed earlier in this lesson, do not carry out DNI to beneficiaries. More information on the effect of in-kind distributions is provided in Lesson 2.

The governing instrument or state law can require a special allocation of income among beneficiaries, although this is 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 certain modifications.

Starting with taxable income, the following items are added back:

1. The distribution deduction for distributions made to the beneficiaries.

2. The personal exemption.

3. Capital losses allocated to principal (except in the year of termination).

4. Net tax-exempt interest, which 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.

5. The income tax deduction for estate taxes paid on income in respect of a decedent (IRD).

6. Gains on the disposition of qualified small business stock that are excluded from taxable income under IRC Sec. 1202.

Subtract the following items from taxable income:

1. Capital gains allocated to principal (except in the year of termination). However, a discussion of the situations when capital gains are allocated to income is provided later in this lesson, in which case those capital gains would be included in DNI.

2. Extraordinary dividends or taxable stock dividends allocated to principal by a simple trust. However, for estates and complex trusts, this adjustment is unnecessary because such dividends are included in their DNI.

Additionally, short-term capital gain dividends from a regulated investment company (mutual fund) are generally included in DNI.

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.

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 illustrated in Example 1C-2.

Example 1C-2 DNI may exceed fiduciary accounting income.

A simple trust has the following receipts and other transactions in the current year:

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 federal income tax deduction. 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 the current year 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 modifications necessary to compute DNI for the tax year are determined 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 compute 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 allocable to income ($3,200), and interest expense ($1,500). A simple trust is required to distribute all of its fiduciary accounting income. Since fiduciary accounting income was zero, this simple trust will not be required to make any distributions to the beneficiaries and will pay income tax at the trust level on the $493,000 of taxable income. Additionally, the trust will be subject to the net investment income tax (NIIT) on its undistributed net investment income. An in-depth discussion of fiduciary accounting income and the NIIT is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

Variation: If the trust had been a complex trust, DNI would have been $419,300 ($13,000 higher than for the simple trust) because the extraordinary dividend would not have been excluded from DNI under IRC Sec. 643(a)(4).

Computing DNI for Simple Trusts

Distributions of income required to be distributed (or payable) each year are referred to as Tier 1 distributions, as explained earlier in this lesson. 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 its first tax year, the Harold Hollis Family Trust had the following receipts and other transactions:

Description of Receipt or Disbursement	Effect on Fiduciary Accounting Income: Income	Effect on Fiduciary Accounting 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 trustee fees to be charged against trust income.

Taxable income before the distribution deduction and 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 compute 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 that year.

Although DNI equals fiduciary accounting income in Example 1C-3, DNI and fiduciary accounting income can be different, even for a simple trust.

Example 1C-4 DNI may not be the same amount as fiduciary accounting income.

Assume in Example 1C-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.

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 the current year. 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.

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. More in-depth coverage of this calculation is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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.

SELF-STUDY QUIZ

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

1. Distributable net income (DNI) will be carried out to which of the following distributions?

   a. A distribution of cash from a trust's principal.

   b. A bequest of a specific sum of money.

   c. A distribution paid in two installments.

   d. A distribution that cannot be paid out of income.

2. Assuming all other characteristics exist, which of the following trusts would be considered a *simple trust*?

   a. The Gold Trust is required to distribute a minimum of half of its income every year.

   b. The Silver Trust makes distributions of principal each year.

   c. The Bronze Trust makes both Tier 1 and Tier 2 distributions in the current year.

   d. The Copper Trust does not claim a deduction for charitable contributions.

3. DNI does which of the following?

   a. Serves as the minimum amount beneficiaries will include in gross income.

   b. Serves as the maximum threshold of the distribution deduction.

   c. Allows the beneficiary to select the most advantageous character for income received.

   d. Indicates the appropriate tax year for a decedent's estate.

4. When computing DNI, which of the following items should be subtracted from taxable income?

   a. Extraordinary dividends paid to simple trusts.

   b. The amount of the distribution deduction.

   c. The amount of the personal exemption.

   d. Net tax-exempt interest.

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. Distributable net income (DNI) will be carried out to which of the following distributions? **(Page 3)**

   a. A distribution of cash from a trust's principal. [This answer is correct. A distribution of cash or other property (whether from income or principal) is generally treated as coming from current income to the extent of DNI, unless it meets the characteristics of a specific bequest, as described in the Internal Revenue Code. Therefore, DNI can be carried out to a distribution of cash from a trust's principal, as this does not fall into the specific bequests exception.]

   b. A bequest of a specific sum of money. [This answer is incorrect. According to the Internal Revenue Code, being payable under the terms of the governing instrument as either a gift or bequest of a specific sum of money or of specific property is one characteristic of a specific bequest. DNI is not carried out to beneficiaries for amounts that fall under the specific bequests exception.]

   c. A distribution paid in two installments. [This answer is incorrect. Based on the guidance in the Internal Revenue Code, DNI will not be carried out to the beneficiaries if the distribution falls under the exception for specific bequests. One characteristic of a specific bequest is that it is paid or credited all at once or in not more than three installments. Therefore, if this distribution was paid out in four or more installments, DNI would be more likely to apply.]

   d. A distribution that cannot be paid out of income. [This answer is incorrect. A distribution that, under the governing instrument, is not payable out of income meets one of the characteristics of a specific bequest. Therefore, DNI would typically not be carried out to this distribution.]

2. Assuming all other characteristics exist, which of the following trusts would be considered a *simple trust*? **(Page 3)**

   a. The Gold Trust is required to distribute a minimum of half of its income every year. [This answer is incorrect. One characteristic of a simple trust is that they are required to distribute *all* of their income currently. Therefore, the Gold Trust is not required to distribute enough income each year to meet the definition of a simple trust, so it will be considered a complex trust.]

   b. The Silver Trust makes distributions of principal each year. [This answer is incorrect. To be considered a simple trust, a trust must make *no* distributions of principal in a given year. Therefore, because the Silver Trust does distribute principle, it would be considered a complex trust.]

   c. The Bronze Trust makes both Tier 1 and Tier 2 distributions in the current year. [This answer is incorrect. Complex trusts (all trusts except for simple trusts) and estates compute their distribution deduction under a tier system. Therefore, because the Bronze Trust uses this system, it is accounting for its distributions as a complex trust, not a simple trust.]

   d. The Copper Trust does not claim a deduction for charitable contributions. [This answer is correct. Simple trusts have three characteristics, one of which is that they cannot claim a charitable contribution deduction under IRC Sec. 642(c) for the year. Because the Copper Trust has not made such a claim, if it meets the other two characteristics, it will be considered a simple trust for the current tax year.]

3. DNI does which of the following? **(Page 7)**

   a. Serves as the minimum amount beneficiaries will include in gross income. [This answer is incorrect. According to the Internal Revenue Code, DNI is the maximum amount (not the minimum amount) that the beneficiaries will have to include in their gross income.]

   b. Serves as the maximum threshold of the distribution deduction. [This answer is correct. DNI governs three important issues. One of those issues is that, according to the Internal Revenue Code, DNI serves as an upper limitation on the amount of the distribution deduction that is claimed by simple trusts, complex trusts, and estates in computing the taxable income of the fiduciary entity.]

   c. Allows the beneficiary to select the most advantageous character for income received. [This answer is incorrect. One of the functions of DNI is that it determines the character of income to the beneficiary. The beneficiary is not allowed to select the most advantageous character.]

   d. Indicates the appropriate tax year for a decedent's estate. [This answer is incorrect. The executor or administrator of a decedent's estate can choose any tax year permitted under the general rules for selecting allowable year ends. Determining this date is not a function of DNI.]

4. When computing DNI, which of the following items should be subtracted from taxable income? **(Page 8)**

   a. Extraordinary dividends paid to simple trusts. [This answer is correct. When calculating DNI, certain items must be subtracted. One of those items, according to the Internal Revenue Code, is extraordinary dividends or taxable stock dividends allocated to principal by a simple trust. However, for estates and complex trusts, this adjustment is unnecessary because such dividends are included in their DNI.]

   b. The amount of the distribution deduction. [This answer is incorrect. When calculating DNI, one of the items that must be added back to taxable income (not subtracted) is the distribution deduction for distributions made to the beneficiaries.]

   c. The amount of the personal exemption. [This answer is incorrect. According to the Internal Revenue Code, the personal exemption should be added back to taxable income when calculating DNI.]

   d. Net tax-exempt interest. [This answer is incorrect. Based on the guidance provided in the Internal Revenue Code, net tax-exempt interest—which 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—is one item that should be added back to taxable income (not subtracted) when computing DNI.]

Excluding Capital Gains from DNI

General Rules

Capital gains are generally excluded from DNI and "are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." They are typically allocated to principal and taxed to the estate or trust 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, as discussed later in this lesson.

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. 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 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 and not 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 taxed on DNI of $17,000.

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 (as defined earlier in this lesson), 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 three years 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).

Short-term Capital Gains and DNI

Short-term capital gains are taxed at ordinary income tax rates but remain capital gains and are normally excluded from DNI unless one of the four exceptions described below is met. 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 includable in DNI under the provisions of IRC Sec. 643(a)(3).

Example 1D-3 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 (i.e., mutual funds).

The trust's 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 includable 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.

Including Capital Gains in DNI

Although capital gains are normally excluded from DNI, there are certain exceptions to this rule. 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. allocated 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*,
        (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*, or
        (3) *Principal but Actually Distributed to the Beneficiary or Used to Determine Distributable Amount*;
3. paid, permanently set aside, or used for charitable purposes [thus producing a charitable deduction under IRC Sec. 642(c)]; or
4. made in partial or complete termination.

In addition to the exceptions included in the regulations, capital gains passed through from a partnership or S corporation's K-1 may be included in DNI if the executor or trustee has the power, according to the governing instrument, to allocate the gains to income. In the *Crisp* case, the trust instrument had discretion to make periodic payments of net profits or net earnings to the beneficiary during her lifetime but was specifically precluded from distributing any principal to the beneficiary. The Court of Federal Claims held that capital gains passed through to the trust from a partnership were correctly allocated to income and therefore, were includible in the trust's DNI.

For capital gains to be taxed to a beneficiary, the capital gain must be included in DNI. If the 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.

Income as 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 1E-1 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 included in DNI and thus taxed to Joan. The gain is included on Line 3 of Schedule B and allocated to the beneficiary in Part III of Schedule D.

Discretionary Power Allocated to Income, Based on Unitrust Amount. 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.

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. Because of the consistency requirement, this allocation method must be used beginning with the first year of the estate or trust. 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).

Example 1E-2 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.

Discretionary Distributions of Principal Consistently Allocated to Income

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 consistently as income on the fiduciary's books, records, and tax returns as part of a distribution to the beneficiary. 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.

Although the term, *consistently*, is not clearly defined in the regulations, a consistent practice is based on how the capital gains are classified in the first year the estate or trust reports them. Once this method of allocation to income is used, future principal distributions are included in DNI. According to Rev. Rul. 68-392, 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). It appears that the revenue ruling extends beyond the scope of the Code and existing regulations.

Example 1E-3 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 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. Dottie would like to treat discretionary distributions of principal as being paid first from any net capital gains realized by the trust. Thus, she 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). Dottie treats the discretionary distributions as paid from realized capital gains during the year. Therefore, the $10,000 realized capital gains are included in DNI and are taxed entirely to Sam.

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 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.

Discretionary Power Consistently Allocated to Income Based on Unitrust Amount. 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 1E-4 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 1E-3, 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 also taxed on $5,000 ordinary income. In future years, the trustee must follow this same treatment on all realized capital gains.

Principal, but Actually Distributed to Beneficiary or Used to Determine Distributable Amount

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. Note, however, 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.

Example 1E-5 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 1E-3, 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 1E-6 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.

Principal, but Distributed in 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 1E-7 Capital gains are included in DNI if made in partial or complete termination of the beneficiary's interest in the trust.

Assume the same facts as in Example 1E-6, 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.

The 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, as discussed later in this lesson.

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 1F-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 January of the current year, 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 the year was never distributed, the trust is entitled to an income distribution deduction on its Form 1041 for the current year. In addition, Jed must report the income required to be distributed from the trust on his current-year Form 1040. Under an identical fact pattern, the Tax Court ruled in *Seligson* 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 1F-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. However, the *separate share rule* is discussed later in this lesson.

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. (See Example 1F-4.) 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 causes an otherwise simple trust to become a complex trust only if exercised, but the power to accumulate income causes a trust to be complex even if that power is not exercised.

Example 1F-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. After Ted reaches age 40, the trust will be a complex trust in any year it distributes principal to him, but the trust will still be eligible for the $300 personal exemption.

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 (other than grantor 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. A detailed discussion of fiduciary accounting income is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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. See Lesson 2 for an example of a disallowed loss and basis to the beneficiary. 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 1F-4 Property distributions by simple trusts.

Hillary Hartman is the 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 the current year, 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. See Lesson 2 for expanded coverage of in-kind distributions.

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 income distribution deduction must be determined. 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, after adjusting for nontaxable income and related expenses.
4. Determine the character of the income distributed to the beneficiaries (e.g., interest, dividends).

Example 1F-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 the current year, 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 when calculating fiduciary accounting income. Depreciation expense is not allowed as a deduction in calculating 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 $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 income tax and potentially subject to the net investment income tax (NIIT). 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 1F-6 Simple trust's distribution deduction: Step 2—DNI.

Assuming the same facts as in Example 1F-5, DNI is calculated 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 1F-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). (A discussion of distributions of tax-exempt income appears later in this lesson.)

Since all of the trust income 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 (if there are no provisions in the governing instrument requiring depreciation reserves to be maintained).

After fiduciary accounting income and DNI 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 1F-7 Simple trust's distribution deduction: Step 3—"taxable" DNI.

Using the facts in Examples 1F-5 and 1F-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 1F-6)		$ 91,100
Less:		
Tax-exempt interest income (TEI)	25,000	
Expenses allocated to TEI (Example 1F-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).

The amount recorded on Schedule B, line 12 ($24,025) is identical to the amount on Schedule B, line 2. That is the result if tax-exempt interest is the only tax-exempt income distributed (included in the total distributions on line 11) and DNI (line 7) is less than or equal to the total amount distributed (i.e., all DNI was distributed). A detailed discussion appears later in this lesson.

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.

The Distribution Deduction for Estates and Complex Trusts

Overview of Allowable Distribution Deduction Rules

Estates and complex trusts are allowed to deduct distributions made 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. See the discussion later in this lesson for planning considerations when a trustee can make discretionary distributions.

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). A discussion of how to compute DNI appeared earlier in this lesson.

Example 1G-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, the trustee can accumulate the entire $35,000 in the current year. Alternatively, the trustee 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).

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. (A discussion of income required to be distributed appeared in the previous section.)

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 (through 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 sometimes 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. A detailed discussion of the interaction between charitable contributions and distribution deductions is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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

To determine the income distribution deduction for a complex trust or estate, the following distinct steps are necessary:

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, 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 or dividends).

Example 1G-2 Complex trust's distribution deduction: Step 1—fiduciary accounting income and Step 2—other amounts paid or credited.

In the current year, 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 the current year, 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 the current year, 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 1G-3 Complex trust's distribution deduction: Step 3—DNI.

Using the same facts as in Example 1G-2, the trust's DNI is calculated as follows:

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 is the total trust income (dividends, taxable interest, tax-exempt interest, and business income) before expenses. Additional coverage of the effects of tax-exempt income and related expenses on the distribution deduction is provided later in this lesson.

The next step is to determine the portion of DNI allowed as an income distribution deduction.

Example 1G-4 Complex trust's distribution deduction: Step 4—apportion taxable DNI between fiduciary and beneficiaries.

DNI is $30,000 as calculated in Example 1G-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 1G-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. An in-depth discussion of these rules is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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 1G-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 trust instrument also permits the trustee to pay the children's medical expenses to the extent not covered by insurance. In George's state of residence, paying medical expenses for a minor child is a parent or guardian's legal obligation of support, but paying for a college education is not. In the current year, 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 is support, and

therefore, the trust is considered a grantor trust 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 [reported on Schedule B (Form 1041)] 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 ruled that the estate could not claim a charitable deduction on Schedule A (Form 1041) 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.

Planning Considerations for Discretionary Distributions

Maximum Income Tax Rate of 39.6%. Trusts and estates are subject to a maximum income tax rate of 39.6%. The tax applies at a very low threshold (taxable income exceeding only $12,500 for 2017). Although individuals also have a maximum income tax rate of 39.6%, their threshold is much higher (taxable income exceeding $470,700 for married taxpayers filing jointly or $418,400 for single taxpayers in 2017). Fiduciaries should consider the impact of the higher income tax rate when planning distributions, and if the governing instrument allows discretionary distributions, fiduciaries should consider making distributions to individual beneficiaries to potentially avoid the maximum income tax rate and the NIIT.

Example 1G-6 Distributions made to reduce overall tax burden.

The ABC Trust has current year activity consisting of $50,000 interest income, $20,000 dividend income, and $5,000 trustee fees. The trustee can either accumulate income or distribute to its sole beneficiary, Emily, who is in the 25% income tax bracket. Because the trust is in the 39.6% income tax bracket, the trustee should consider making discretionary distributions to her.

Net Investment Income Tax (NIIT). Trusts and estates are subject to the 3.8% NIIT if (a) they have undistributed net income, and (b) their AGI exceeds $12,500 (in 2017). Individuals are not subject to this tax unless their modified AGI exceeds $250,000 for married taxpayers filing jointly or $200,000 for single taxpayers. Additionally, the tax does not apply to individual taxpayers until the net investment income is received, whereas trusts and estates are taxed on their net investment income when it is not fully distributed. Making discretionary distributions to beneficiaries may save overall taxes. In-depth discussions of the NIIT and distributing income to minimize the NIIT are beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

SELF-STUDY QUIZ

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

5. Assuming all other qualifications are met, under what circumstances would gains from selling or exchanging capital assets be excluded from the DNI of an estate or trust?

   a. They are used for charitable purposes.

   b. They are allocated to principal by the governing instrument.

   c. They are paid to beneficiary during the tax year.

   d. They are permanently set aside.

6. Which of the following trusts has correctly addressed an issue related to capital gains and DNI?

   a. The Twilight Trust includes capital gains in DNI that are distributed to a beneficiary as a specific bequest.

   b. The Midnight Trust excludes capital gains from DNI when they are allocated to principal and then distributed to a beneficiary.

   c. Despite local law to the contrary, the fiduciary of the Dawn Trust consistently treats capital gains as income.

   d. The Sunny Trust includes capital gains that are part of fiduciary income in its DNI.

7. What is the last step a simple trust should take when computing its distribution deduction?

   a. Calculate its DNI.

   b. Determine its fiduciary accounting income.

   c. Determine the character of income distributed to beneficiaries.

   d. Compute its actual distribution deduction after making applicable adjustments.

8. Which of the following statements best describes an aspect of the allowable distribution deduction rules for complex trusts?

   a. Once a trust is classified as a complex trust, that status remains for the rest of the trust's life.

   b. A complex trust instrument cannot require more income to be distributed to a beneficiary than earned in the current year.

   c. Trust instruments can give the trustees of complex trusts flexible distribution powers.

   d. A complex trust should include amounts paid to a charitable organization on its Schedule B.

9. Anna receives a Tier 1 distribution from a complex trust of $10,000. She then receives another $5,000, which is classified as a Tier 2 distribution. None of Anna's distributions would be considered specific bequests. The trust has DNI of $13,000 and made no charitable distributions. How much is Anna required to report in her gross income?

   a. $5,000.

   b. $10,000.

   c. $13,000.

   d. $15,000.

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. Assuming all other qualifications are met, under what circumstances would gains from selling or exchanging capital assets be excluded from the DNI of an estate or trust? **(Page 16)**

   a. They are used for charitable purposes. [This answer is incorrect. One of the qualifications set forth in the regulations for this exclusion is that capital gains not be used for charitable purposes.]

   b. They are allocated to principal by the governing instrument. [This answer is correct. According to the general rule, gains from the sale or exchange of capital assets are *excluded* from DNI to the extent such gains are 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 one other qualification is met.]

   c. They are paid to beneficiary during the tax year. [This answer is incorrect. According to the regulations, capital gains may be excluded from DNI if they are *not* paid, credited, or required to be distributed to any beneficiary during the tax year.]

   d. They are permanently set aside. [This answer is incorrect. Gains that are not paid or permanently set aside may qualify under the regulations for exclusion from DNI, assuming other qualifications are met.]

6. Which of the following trusts has correctly addressed an issue related to capital gains and DNI? **(Page 17)**

   a. The Twilight Trust includes capital gains in DNI that are distributed to a beneficiary as a specific bequest. [This answer is incorrect. If the fiduciary is required to distribute a specific bequest, any capital gains included in the distribution to satisfy the bequest are not included in DNI, even if made in partial termination of the beneficiary's interest.]

   b. The Midnight Trust excludes capital gains from DNI when they are allocated to principal and then distributed to a beneficiary. [This answer is incorrect. 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. Therefore, in this scenario, the Midnight Trust should include its capital gains in DNI.]

   c. Despite local law to the contrary, the fiduciary of the Dawn Trust consistently treats capital gains as income. [This answer is incorrect. Capital gains can be allocated to DNI if a fiduciary, according to the 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 consistently as income on the fiduciary's books, records, and tax returns as part of a distribution to the beneficiary. However, because of local law to the contrary, in this scenario the Dawn Trust should not include capital gains in its DNI.]

   d. The Sunny Trust includes capital gains that are part of fiduciary income in its DNI. [This answer is correct. Capital gains can be included in DNI if directed by the terms of the governing instrument and applicable local law. Therefore, according to IRS regulations, any capital gains that are included in fiduciary income, as defined in IRC Sec. 643(b), are included in DNI, as done by the Sunny Trust in this scenario.]

7. What is the last step a simple trust should take when computing its distribution deduction? **(Page 20)**

   a. Calculate its DNI. [This answer is incorrect. Calculating DNI (the upper limit on the amount of the distribution deduction) is the second step in this process.]

   b. Determine its fiduciary accounting income. [This answer is incorrect. Determining the simple trust's fiduciary accounting income (the amount it is required to distribute currently) is the first step in computing the distribution deduction.]

c. **Determine the character of income distributed to beneficiaries. [This answer is correct. Once a trust has been classified as a simple trust, the income distribution must be determined. This determination can be broken down into four distinct steps. The final step is to determine the character of the income distributed to the beneficiaries (e.g., interest, dividends).]**

d. Compute its actual distribution deduction after making applicable adjustments. [This answer is incorrect. The third step of four is to compute the simple trust's actual distribution deduction after adjusting for nontaxable income and related expenses.]

8. Which of the following statements best describes an aspect of the allowable distribution deduction rules for complex trusts? **(Page 25)**

a. Once a trust is classified as a complex trust, that status remains for the rest of the trust's life. [This answer is incorrect. In years that a trust distributes principal in excess of required income, it is a complex trust, even if it is a simple trust in other years. Therefore, the status of the trust is changeable, not static.]

b. A complex trust instrument cannot require more income to be distributed to a beneficiary than earned in the current year. [This answer is incorrect. 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.]

c. **Trust instruments can give the trustees of complex trusts flexible distribution powers. [This answer is correct. The trust instrument can 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 grated to a trustee are very flexible. Note, however, that different powers have different income or transfer tax consequences associated with them.]**

d. A complex trust should include amounts paid to a charitable organization on its Schedule B. [This answer is incorrect. According to IRS regulations, 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.]

9. Anna receives a Tier 1 distribution from a complex trust of $10,000. She then receives another $5,000, which is classified as a Tier 2 distribution. None of Anna's distributions would be considered specific bequests. The trust has DNI of $13,000 and made no charitable distributions. How much is Anna required to report in her gross income? **(Page 25)**

a. $5,000. [This answer is incorrect. According to the guidance in the Internal Revenue Code, Anna must include more than just the Tier 2 distribution in her gross income.]

b. $10,000. [This answer is incorrect. Per the Internal Revenue Code, Anna will start by including her Tier 1 contribution in gross income; however, further calculation is needed to figure out Anna's correct total.]

c. **$13,000. [This answer is correct. The beneficiary of a complex trust or estate must include distributed amounts in gross income. According to the Internal Revenue Code, 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. Therefore, though both Anna's Tier 1 and Tier 2 distributions qualify to be included in gross income, she will not need to include more than the maximum DNI amount.]**

d. $15,000. [This answer is incorrect. This is the total amount of Anna's distributions from the complex trust in the current year. However, DNI has not appropriately been factored into this calculation.]

Dealing with Distributions of 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 as discussed previously 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 considered "properly paid or credited" 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 1H-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 the current year. 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. See Lesson 2 for coverage of this election and the tax effects of distributions of property by an estate or trust.

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 1H-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 *DuPont*, a trust was required to maintain the property as the surviving spouse's personal residence. 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 through 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.

The Separate Share Rule

If a 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 (e.g., a trust instrument that directs the accumulation of income for the benefit of one beneficiary and the discretionary distribution of income for the benefit of another beneficiary). 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 1I-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 1I-2 Separate shares do not exist if income may be distributed to or accumulated for any beneficiary.

Assume the same facts as in Example 1I-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 1I-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, unless comparable distributions are made to Bob, 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 1I-4 Consequences of distributions with the separate share rule.

Assume the same facts as in Example 1I-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 × 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 1I-5 Application of the separate share rule.

According to the trust document of the Ben Wheeler Family Trust, the trust was created and funded at the beginning of the current year 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 attaining age 35, each beneficiary is entitled to receive his share of the remaining trust assets.

During the year, 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.

If the separate share rule applies, the DNI applicable to each beneficiary should be shown in a statement attached to and made a part of the single Form 1041. The fiduciary entity is subject to income tax for the undistributed portion of DNI allocable to each separate share.

Example 1I-6 Reporting DNI allocable to each separate share.

Assume the same facts as in Example 1I-5 and the application of the separate share rule. A statement, such as the following, should be attached to the trust's Form 1041:

Ben Wheeler Family Trust	91-1515155
Form 1041	2017
DNI Allocable to Separate Shares	
Robert Wheeler (534-90-1279)	$ 50,000
William Wheeler (527-39-6426)	-0-
Income distribution deduction (Schedule 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 because 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 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 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. Alternatively, two separate accounts, which are then combined for tax reporting purposes, can be used.

Example 1I-7 Disproportionate distribution may require interim allocation.

Kim died on January 1 of the current year 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, 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 for the year. If the distribution had occurred on December 31, 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 %	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 during the year, 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.

3. A qualified revocable trust.

In addition to the general rule, 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 (e.g., a bypass trust amount determined by the largest amount that would result in no Federal estate tax). 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 1I-8 Allocating DNI between a pecuniary bequest and the estate residue.

John Booth died in 2017. 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 2017, the estate transfers $5.49 million to the bypass trust but does not make a distribution to the marital trust. Funding the bypass trust generates $60,000 long-term capital gain. The estate's taxable income is $199,400 ($200,000 DNI − $600 personal exemption), which includes the $60,000 long-term capital gain recognized upon funding the pecuniary bequest.

The estate has two separate shares, one for the bypass trust and another for the marital trust. Since the bypass trust 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 $5.49 million distributed to the bypass share, since it is a pecuniary bequest. Although the estate has DNI of $200,000, 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 $199,400 of taxable income.

Variation: If the estate's taxable income included pass-through income from an S corporation or partnership, the result would be 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 1I-10).

Fractional Formula Bequest. A fractional formula bequest that divides the residuary estate is subject to the separate share rules.

Example 1I-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 includable 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 prorata 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 1I-10 Pecuniary formula bequest not required to, but could be funded with IRD.

Donald died in 2017, 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 $6.49 million. The estate was the designated beneficiary of Donald's IRA, and in 2018, the estate received a distribution of $750,000 from the IRA, which is included in the estate's gross income as IRD, under IRC Sec. 691(a). The entire $750,000 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 $5.49 million and a residuary bequest to Rita, valued at $1 million. 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 $750,000 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 $634,438 to the trust for Mandie's benefit [$750,000 × ($5.49 million ÷ $6.49 million)] and $115,562 to Rita [$750,000 × ($1 million ÷ $6.49 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 (the trust and/or Rita) must include this amount in income for 2017.

Example 1I-11 Fractional share funding with requirement to be funded first with IRD.

Assume the same facts as in Example 1I-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 $750,000 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 the year.

Impact on 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 1I-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 $30,000 to 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). A discussion of allocating indirect expenses to TEI appears later in this lesson.]. Although the estate distributed $30,000 to the trust, the income distribution deduction is limited to its DNI of $20,000. The estate's income distribution deduction of $20,000 to the trust reduces its taxable income to zero.

In the same taxable year, the trust has $25,000 of taxable interest income and $5,000 of deductions before receiving the distribution from the estate. The trust has one beneficiary, Nancy, who received $50,000 from the trust. After the estate's distribution, the trust has taxable interest income of $40,000 [the taxable income 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.

Impact on 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.

The 65-day Distribution Deduction

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 *Igoe*, 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 (a) fiduciary accounting income for the tax year for which the election is made or (b) DNI for that year. Both (a) and (b) are 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. In addition to making the 65-day election to push income back to a year in which the beneficiary is in a lower tax bracket, the election may also minimize the 3.8% net investment income tax on the share of any net investment income carried out by the distribution.

Example 1J-1 The 65-day election.

On February 9, 2018, the preparer completes the 2017 Form 1041 for a calendar-year complex trust that had $100,000 of fiduciary accounting income and $95,000 of DNI. The trustee paid $50,000 to the beneficiary, Al, on January 31, 2017, and $60,000 on July 31, 2017. A copy of the 2016 Form 1041 indicates a valid Section 663(b) election treating the $50,000 distribution as paid on December 31, 2016. The 2017 trust records indicate a distribution of $45,000 on January 31, 2018.

The maximum amount available for the Section 663(b) election on the 2017 Form 1041 is $40,000 ($100,000 fiduciary accounting income less the $60,000 distribution on July 31, 2017). The $50,000 distribution on January 31, 2017 does not reduce the maximum amount to which the 2017 election may apply because that amount was properly treated on the 2016 Form 1041 as distributed on December 31, 2016.

Since $5,000 in excess of the $40,000 maximum potential 2017 Section 663(b) election has already been distributed within the first 65 days of 2018, 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 2017. This decision may be made as late as the due date (including extensions) of the Form 1041 for 2017.

Dealing with Distributions of 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 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 1K-1 Effect of tax-exempt DNI on distribution deduction.

The preparer of a Form 1041 for the current year 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 during the year.

The distribution deduction for the year 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 the limit on the distribution deduction. An in-depth discussion of allocating the income to the beneficiary is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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 1K-2 Allocating indirect expenses to tax-exempt income.

In the current year, 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.

Variation: Assume the same facts, except that 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. 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 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. Further discussion of this issue, as well as reporting implications when the entity has tax-exempt income and a charitable contribution in the same year, is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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 1K-3 Interest expense allocable to tax-exempt interest income.

The preparer of a 2017 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 trust received only two types of income in 2017: $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 2017, producing a large capital gain for the trust when the bonds are sold (as the trustee projects) around the end of 2017.

The trust's only expense for 2017 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 2019.

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, 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.

The proration ensures that when total distributions are less than DNI, line 12 includes only the tax-exempt income included on line 11 (in total distributions). The tax-exempt income included in line 11 must also be adjusted if line 11 includes tax-exempt income other than tax-exempt interest income. From the tax-exempt income included on line 11, any expenses allocable to such tax-exempt income are subtracted and the remaining amount is included on line 12.

"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, as discussed earlier in this lesson. 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 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 1L-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 the current year, 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 (passive activity)	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*.

Income May Be Taxable but Not Included in Fiduciary Accounting 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.

SELF-STUDY QUIZ

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

10. Which of the following trusts or estates has distributed an other amount paid or credited or required to be distributed (OAPC)?

    a. Trust 1 distributes $10,000 of income to a beneficiary as required by the trust instrument.

    b. Estate 2 distributes real estate with a title that vests immediately in the distributee upon the decedent's death.

    c. Estate 3 makes a specific bequest to a beneficiary per the terms of the trust instrument.

    d. Trust 4 makes a bookkeeping entry for an extra distribution amount to the beneficiary's account.

11. Assuming all other conditions are met, under which of the following circumstances would separate shares exist?

    a. The economic interests of two beneficiaries are intertwined.

    b. The separation is determined in fact but not designated by the trust or estate.

    c. Both principal and its associated interest are included with the share.

    d. The entity is an estate, not a trust.

12. Which of the following trusts and estates qualifies for separate share treatment?

    a. The trustee of the Spring Trust can distribute income among beneficiaries at his discretion.

    b. After paying specific bequests, the Summer Estate pays the residual estate, including applicable income and depreciation, to a single beneficiary.

    c. The Autumn Trust's charitable contributions are such that the charity has a separate economic interest in the trust.

    d. The Winter Estate makes a distribution to one beneficiary with no compensating adjustment, so another beneficiary's income is affected.

13. What is an advantage of using the 65-day rule for an estate or complex trust's distribution deduction?

    a. It can help to minimize the beneficiaries' income tax burden.

    b. The fiduciary can begin planning income for the next year early.

    c. The complex trust or estate will be subject to the net investment income tax.

    d. The election can cover all of the entity's fiduciary accounting income.

14. Which of the following statements best describes an aspect of distributions of tax-exempt income?

    a. Estates and trusts can deduct interest expenses for debt incurred to purchase municipal bonds.

    b. Expenses that are indirectly attributable to both taxable and tax-exempt income must be allocated between the two by the fiduciary.

    c. Charitable deductions are not tax deductible by estates or trusts because of the tax-exempt nature of the charity.

    d. Expenses related to tax-exempt income can be deducted from any taxable income left after expenses related to taxable income are deducted.

15. The "Holloway adjustment" helps to reduce the effects of which of the following?

    a. The 65-day election.

    b. Payments made on the beneficiary's behalf.

    c. Phantom income.

    d. Tax-exempt 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.)**

10. Which of the following trusts or estates has distributed an other amount paid or credited or required to be distributed (OAPC)? **(Page 34)**

    a. Trust 1 distributes $10,000 of income to a beneficiary as required by the trust instrument. [This answer is incorrect. According to IRS regulations, income required to be distributed currently is not considered OAPC.]

    b. Estate 2 distributes real estate with a title that vests immediately in the distributee upon the decedent's death. [This answer is incorrect. According to IRS regulations, an estate's distribution of real estate is not considered OAPC if the title to the real estate vests in the distributee immediately upon the death of the decedent.]

    c. Estate 3 makes a specific bequest to a beneficiary per the terms of the trust instrument. [This answer is incorrect. Specific gifts and bequests under IRC Sec. 663(a) are not considered OPAC.]

    d. Trust 4 makes a bookkeeping entry for an extra distribution amount to the beneficiary's account. [This answer is correct. When an estate or 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 OAPC under IRC Sec. 661(a)(2). Actual payments or credits to beneficiaries are considered "properly paid or credited" 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 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 that amount by the beneficiary. Therefore, Trust 4's payment would be considered OAPC.]

11. Assuming all other conditions are met, under which of the following circumstances would separate shares exist? **(Page 35)**

    a. The economic interests of two beneficiaries are intertwined. [This answer is incorrect. According to IRS regulations, 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.]

    b. The separation is determined in fact but not designated by the trust or estate. [This answer is incorrect. The language of the governing instrument determines whether the separate share rule applies.]

    c. Both principal and its associated interest are included with the share. [This answer is correct. According to IRS regulations, 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.]

    d. The entity is an estate, not a trust. [This answer is incorrect. 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.]

12. Which of the following trusts and estates qualifies for separate share treatment? **(Page 35)**

    a. The trustee of the Spring Trust can distribute income among beneficiaries at his discretion. [This answer is incorrect. Per the regulations, 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.]

    b. After paying specific bequests, the Summer Estate pays the residual estate, including applicable income and depreciation, to a single beneficiary. [This answer is correct. According to IRS regulations, 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.]

    c. The Autumn Trust's charitable contributions are such that the charity has a separate economic interest in the trust. [This answer is incorrect. 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 because charities are not allocated DNI.]

    d. The Winter Estate makes a distribution to one beneficiary with no compensating adjustment, so another beneficiary's income is affected. [This answer is incorrect. According to IRS regulations, separate share treatment does not 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.]

13. What is an advantage of using the 65-day rule for an estate or complex trust's distribution deduction? **(Page 42)**

    a. It can help to minimize the beneficiaries' income tax burden. [This answer is correct. This election may present an opportunity to minimize the combined income tax burden of the trust or estate and the beneficiaries. Income can be pushed back to a year in which the beneficiary was in a lower tax bracket.]

    b. The fiduciary can begin planning income for the next year early. [This answer is incorrect. An advantage of the 65-day rule is that the fiduciary can 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 the year.]

    c. The complex trust or estate will be subject to the net investment income tax. [This answer is incorrect. Being subject to the net investment income tax on the share of any net investment income carried out by the distribution is a disadvantage that the 65-day rule may help eliminate.]

    d. The election can cover all of the entity's fiduciary accounting income. [This answer is incorrect. The maximum amount covered by the election is limited to the greater of (1) fiduciary accounting income for the tax year for which the election is made or (2) DNI for that year. Therefore, if the fiduciary accounting income exceeds DNI, it would not all be covered even if the 65-day rule is elected.]

14. Which of the following statements best describes an aspect of distributions of tax-exempt income? **(Page 43)**

    a. Estates and trusts can deduct interest expenses for debt incurred to purchase municipal bonds. [This answer is incorrect. According to the Internal Revenue Code, 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.]

    b. Expenses that are indirectly attributable to both taxable and tax-exempt income must be allocated between the two by the fiduciary. [This answer is correct. When an expense is indirectly attributable to both taxable and tax-exempt income, the fiduciary is required by IRS regulations to make an allocation of the expense to ensure an appropriate portion is not deducted.]

c. Charitable deductions are not tax deductible by estates or trusts because of the tax-exempt nature of the charity. [This answer is incorrect. According to IRS regulations, when a fiduciary makes a charitable contribution, the portion of the contribution deemed paid from tax-exempt income is not deductible. Therefore, that means that the portion of the contribution deemed paid from taxable income will be deductible by the estate or trust.]

d. Expenses related to tax-exempt income can be deducted from any taxable income left after expenses related to taxable income are deducted. [This answer is incorrect. 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 related directly to taxable income, all the expenses are fully deductible. Conversely, if the only expenses related directly to tax-exempt income, none of the expenses are deductible.]

15. The "Holloway adjustment" helps to reduce the effects of which of the following? **(Page 45)**

a. The 65-day election. [This answer is incorrect. The "Holloway adjustment" is not part of the adjustments fiduciaries make when using the 65-day election for their distribution deduction.]

b. Payments made on the beneficiary's behalf. [This answer is incorrect. 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. However, the "Holloway adjustment" does not apply to this action.]

c. Phantom income. [This answer is correct. There are circumstances in which remainder beneficiaries may bear the tax burden for "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.]

d. Tax-exempt income. [This answer is incorrect. The "Holloway adjustment" will not allow tax-exempt income to qualify for a deduction that does not otherwise apply.]

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 provides coverage of the general rules 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 specific bequest, 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.

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 are explained in this lesson.

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 the following:

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.

In-depth discussions of property transactions other than distributions, distributions of interests in passive activities, distributions of income in respect of a decedent (IRD), and property distributions to beneficiaries of charitable remainder trusts are beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook.*

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the tax effects of property distributions and how to deal with distributions of specific property or a sum of money and property distributions that are not specific bequests.
- Identify the best methods to use for distributions in lieu of a specific property or specific dollar amount, distributions of property in lieu of income, distributions of depreciated property, distributions of installment

obligations, distributions of partnership interests and S corporation stock, distributions of encumbered property, reporting the holding period for distributed property, and dealing with reporting issues related to the generation-skipping transfer tax.

The Tax Effects of 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 of no gain or loss recognition 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 Sec. 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. 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 these 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.

When the estate or trust makes property distributions, the following questions should be considered:

1. Does the distribution require gain or, for estates satisfying pecuniary bequests, loss recognition?

2. If gain recognition is not required, can it be elected under IRC Sec. 643(e)(3)?

3. Does the distribution carry out DNI to the beneficiary? If so, how much?

4. What is the basis of the property for the beneficiary?

5. What is the holding period of the property for the beneficiary?

For property distributions from taxable estates (those exceeding the exclusion amount, which is $5.49 million for 2017), a basis consistency requirement for transfer tax and income tax purposes applies when (1) the estate is required to file an estate tax return (Form 706) after July 31, 2015, and (2) the property increases the estate tax liability. If this rule applies, the executor must, within 30 days of the earlier of the due date or filing of Form 706, provide a statement disclosing the property's value, as finally determined and reported on Form 706, to the IRS and beneficiaries who acquire (or *will* acquire) assets from the estate. Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent, is to be used for this purpose.

Making Distributions of Specific Property or a Sum of Money

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), as described later in this lesson (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 several years ago. Bill's last will and testament bequeathed his Rolls Royce to his great-niece, Bonnie. In the current year, 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 the year. 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 the current year. 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 the year, even though the estate had undistributed taxable DNI. 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. It seems this should be done by issuing a Form 1099-INT to the recipient. 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 (e.g., "my Rolex watch" or "my lake house at 7744 Lakeside Drive") 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. Furthermore, the capital gain must be included in the estate or trust's net investment income when determining whether the 3.8% net investment income tax applies.

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.

Example 2B-2 Distribution of unspecified property in satisfaction of a beneficiary's right to receive a specific dollar amount (pecuniary bequest) under the traditional rules.

The Karla Willow Estate, which was created in 2016, bequeaths $100,000 to Joyce Willow, payable in cash or property. The executor distributes shares of stock to Joyce in the current year 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. Her basis in the stock acquired from the estate is $100,000 ($80,000 stepped-up basis on date of death + $20,000 gain recognized by the estate).

The estate must include the $20,000 capital gain in its calculation of net investment income and may be subject to the 3.8% net investment income tax.

The fact that some or all of the bequest may not be satisfied if the estate has insufficient assets does not affect these results.

Estates Subject to Modified Carryover Basis Rules. A safe harbor applies to limit the amount of gain recognized by estates created in 2010 that elected out of federal estate tax. If the election was made, the modified carryover basis rules, rather than the traditional step-up in basis rules, apply to assets acquired from the decedent. 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, 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 (effective for estates of decedents who died in 2010).

This safe harbor limiting the estate's gain recognition to appreciation from the date of the decedent's death to the date of distribution also applies to trusts that would have otherwise been included in the decedent's gross estate for federal estate tax purposes under IRC Sec. 2036, 2037, or 2038 if the executor had not elected out of federal estate tax. Additionally, qualified revocable trusts are eligible for this treatment.

Bequests Payable in Three or Fewer Installments

To be treated as a specific bequest, the distribution must be *required* to be paid in three or fewer installments. 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 the current year. 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.

If the recipient of a 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. Lesson 1 included a detailed discussion of the separate share rule.

Bequests Payable in More than Three Installments

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.

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.

Each of the four installment distributions to Sam will be an "other amount paid or credited" and will carry out DNI to him (to the extent of taxable DNI).

Example 2B-5 Property bequeathed in more than three installments, but paid all at once.

Sarah Jones died on March 19 of the prior year. 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 of the current year.

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 "an other amount paid or credited" and is subject to the DNI carryout rules of IRC Secs. 661 and 662.

Making 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.

Property distributions in lieu of required income distributions are discussed later in this lesson.

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. If the property is distributed in satisfaction of a pecuniary bequest and gain is recognized by the estate or trust, the fiduciary's distribution deduction and the beneficiary's income inclusion amount are equal to the property's FMV (but capped at the amount of taxable DNI), as explained in Lesson 1.

The basis of the property in the hands of the beneficiary is the FMV of the property, and a new holding period begins at the date of distribution.

Similarly, 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 (with the distribution deduction and income inclusion amount limited by DNI).

Example 2C-1 Discretionary distribution of property.

In the current year, 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 section.) 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.

For distributions of property that are considered income in respect of a decedent (IRD), Lesson 1 discusses allocating IRD according to the separate share rule. Additional information is available in *PPC's 1041 Deskbook.*

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. (Contrast this example with Example 2B-1, where a decedent's depreciation recapture potential incurred prior to his death is not passed through to the beneficiary of the estate upon a distribution of specific property.)

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 and pecuniary 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.

Benefits of the Election. The election to recognize a gain on property distributions may be beneficial in the following situations:

1. When the basis of property is insufficient to carry out all of the estate's or trust's distributable net income (DNI).

2. To give the beneficiary a step-up in basis and thus, minimize the beneficiary's future income taxes.

3. When the estate or trust has current or carryforward capital losses or unused deductions to offset the capital gain.

4. When the income beneficiary has a net operating loss to offset any increase in ordinary income resulting from the election.

5. To provide tax and economic parity among the separate share beneficiaries.

6. When the executor or trustee does not want to burden the beneficiary with taxes on the sale of the property.

Potential Disadvantages of the Election. The election to recognize gain for property distributions should be avoided in the following circumstances:

1. The beneficiary has capital losses available to offset the gain on a later sale of the distributed property.

2. The beneficiary is in a lower tax bracket. Estates and trusts are subject to the 20% long-term capital gain tax rate at a much lower threshold than individuals. In 2017, estates and trusts are subject to the 20% capital gain rate when their taxable income exceeds $12,500, where individuals have a 15% long-term capital gain tax rate until their taxable income exceeds $418,400 (for singles) or $470,700 (for married couples filing jointly).

3. The estate or trust is subject to the 3.8% net investment income tax, where the beneficiary may not be subject to the tax.

4. The beneficiary has no current intention of selling the property or is seriously ill or elderly; thus, the gain could be deferred (or even eliminated) and the appreciated property could receive a new step-up in basis upon the beneficiary's death.

5. The distribution is a final distribution on termination of the estate or trust. In that case, the gain "flows through" to the beneficiary regardless of the election.

Impact of the Election. 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 (limited by DNI). The property basis in the hands of the beneficiary is the carryover basis plus the gain recognized by the fiduciary, and a new holding period begins.

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 the beneficiary's. Instead, the beneficiary's holding period begins on the date of acquisition (i.e., date of distribution). A discussion of reporting the holding period for distributed property appears later in this lesson.

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 of the current year, 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 the year. Bee is one of 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 the year is $10,000 ($20,000 x 50%). Bee was the only beneficiary to receive a distribution in that year, 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 taxes (both income tax and net investment income 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 for 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 the current year, 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*. However, such losses are deductible because they are not disallowed by the related party rules.

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 is 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. Specific bequests were discussed earlier in this lesson.

Formula Pecuniary Clauses

A *pecuniary bequest* is a fixed dollar amount (e.g., "I bequeath $100,000 to my daughter, Beth") which is often expressed in terms of a formula (e.g., "I bequeath to the Trustee the largest amount that can pass free of federal estate tax by reason of the applicable exclusion amount available to my estate"). 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. (Specific bequests were covered earlier in this lesson.)

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. Note that loss recognition is not available to trusts due to related party rules.

A discussion of transfers of the right to receive income-in-respect of a decedent (e.g., proceeds from a retirement plan in satisfaction of a pecuniary formula bequest) is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook.*

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. Lesson 1 includes a discussion of the separate share rule.

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 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 2016. The terms of Sam's 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 previous 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 second 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 $2.4 million and common stock of an international oil company valued at $4.05 million on the date of death. A gross estate of $6.45 million less a marital deduction of $1 million equals a taxable estate of $5.45 million. The resulting estate tax of $2,125,800, assuming no prior taxable gifts, is completely sheltered by the applicable credit amount, producing zero estate tax liability. Accordingly, the Form 706 showed no estate tax due.

The land had not appreciated in value between the Form 706 valuation date and the date of distribution, but the stock was worth $4.3 million on the date of distribution, over a year after Form 706 was timely filed. The stock paid $29,000 in ordinary dividends prior to its distribution in 2017. 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 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 $1 million 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 $1 million cash to Anne, who then used the cash to purchase the stock from the estate. The estate has a long-term capital gain of $58,140 for the stock distribution to Anne [($1 million ÷ $4.3 million) × $250,000 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 $87,140 ($29,000 from the ordinary cash dividends collected by the estate plus the $58,140 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 2017.] 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 $58,140 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. Additionally, the capital gain would have been included in the estate's net investment income when calculating the 3.8% net investment income tax.

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. For more on the separate share rules, see Lesson 1.

Fairly Representative Pecuniary Funding. The fairly representative pecuniary funding method values each asset at its income tax basis [the date of death value or, for estates created in 2010 that elected to apply the modified carryover basis rules, the lesser of the decedent's adjusted basis (plus any allowable basis increases) or the property's FMV at the date of death], 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 basis of each asset as finally determined for federal estate tax purposes. 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 executor funded the marital deduction bequest in late 2017 by distributing 15.5% [($6.45 million − $5.45 million applicable exclusion amount) ÷ $6.45 million] of the land and 15.5% of the stock to Anne. Using (for valuation purposes) the adjusted 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 $372,093 [$2.4 million × ($1 million ÷ $6.45 million)] and stock with a basis of $627,907 [$4.05 million × ($1 million ÷ $6.45 million)] and a FMV at the date of distribution of $666,667 ($4.3 million × 15.5%). The FMV of the stock distribution to Anne is $38,760 more than basis ($666,667 − $627,907) since the $4.05 million in stock on Form 706 was worth $4.3 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 2017.

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 the 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 $87,140 in Example 2C-6, which included $58,140 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.

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 $1 million is the same, and the estate has no assets that depreciated between the date of death valuation and the date of distribution, and no capital gain is triggered by the distribution.

Variation: Assume the stock had depreciated $250,000 (rather than appreciated $250,000) between the date of death valuation and the date of distribution. The stock valued at $1 million 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 prorata 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 *nonprorata 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. 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), as discussed previously in this lesson. 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 the previous year. The terms of Claude's 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 the current year, 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 the current year was $20,000 and no other distributions were made.

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 the current year. 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.

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. See Lesson 1.) 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 nonprorata 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 prorata 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. Donna's estate terminated in the prior year and issued its final Schedules K-1 to the beneficiaries. Josh's Schedule K-1 and Donna's will are included with the material Josh sent to his tax return preparer in February of the current year.

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 date of distribution at $2 million and having an income tax basis of $1.9 million ($100,000 of net appreciation since Donna's date of death). 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 land was valued as of Donna's date of death. Just prior to the distribution, 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 of the current year.)

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 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.

Because 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 the date of distribution, and vice versa. Since IRC Sec. 1031 (like-kind exchange treatment) does not apply, Josh has $50,000 of 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 net long-term capital gain to recognize from her transaction (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 both parties). Thus, the total basis is $3,150,000.

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 the current year, 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.

16. The general rule for dealing with the tax effects of in-kind distributions will affect which of the following trusts and estates?

    a. The Breakthru Trust distributes property to satisfy a beneficiary's right to receive a specific dollar amount.

    b. The Leavenworth Estate distributes property as a share of the residuary estate.

    c. The Mannorbound Trust distributes property to a beneficiary in lieu of income.

    d. The Westwood Estate elects to recognize gain under IRC Sec. 643(e)(3).

17. Which of the following rules applies to distributions of specific property?

    a. Gain or loss is required to be recognized on this type of distribution.

    b. If the bequest is paid in three or more installments, the general rules for this type of distribution apply.

    c. Interest is incurred on this type of property distribution.

    d. If one property is swapped for the bequeathed property, gain or loss is recognized.

18. Which of the following estates and trusts would benefit the most from electing to recognize gain on distributions of property?

    a. The Rollings Estate has current carryforward capital losses.

    b. The beneficiary of the Heatherton Trust who receives the property has capital losses.

    c. The Derringer Estate is subject to the 3.8% net investment income tax.

    d. The United Trust distributes property to a beneficiary who is terminally ill.

19. Which of the following methods values assets that are distributed in kind by an estate or trust as of the date of their distribution instead of the date of death or an alternate valuation date?

    a. Fairly representative pecuniary funding.

    b. Fractional share clauses.

    c. Minimum worth pecuniary funding.

    d. True worth pecuniary funding.

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. The general rule for dealing with the tax effects of in-kind distributions will affect which of the following trusts and estates? **(Page 54)**

    a. The Breakthru Trust distributes property to satisfy a beneficiary's right to receive a specific dollar amount. [This answer is incorrect. One of the exceptions to the general rule for in-kind distributions is 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 (such as the one made by Breakthru in this scenario) trigger gain, but not loss.]

    b. The Leavenworth Estate distributes property as a share of the residuary estate. [This answer is correct. Generally, no gain or loss is recognized when a fiduciary distributes property (an in-kind distribution) to beneficiaries. 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 (such as the one distributed by Leavenworth in this scenario).]

    c. The Mannorbound Trust distributes property to a beneficiary in lieu of income. [This answer is incorrect. One of the exceptions to the general rule governing in-kind distributions is distributions of property in lieu of income. These distributions (such as the one made by Mannorbound in this scenario) result in recognition of gain, but not loss.]

    d. The Westwood Estate elects to recognize gain under IRC Sec. 643(e)(3). [This answer is incorrect. Distributions of property when the fiduciary elects to recognize gain under IRC Sec. 643(e)(3) are one of the exceptions to the general rule for in-kind distributions. When the election is made (as Westwood did in this scenario), 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 fair market value (FMV).]

17. Which of the following rules applies to distributions of specific property? **(Page 55)**

    a. Gain or loss is required to be recognized on this type of distribution. [This answer is incorrect. According to the regulations, *no* gain or loss is recognized on the distribution of specific property unless certain conditions are met.]

    b. If the bequest is paid in three or more installments, the general rules for this type of distribution apply. [This answer is incorrect. 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), not using the general rules for distributions of specific property.]

    c. Interest is incurred on this type of property distribution. [This answer is incorrect. If a specific bequest of money is not distributed promptly, some state laws require the estate to pay interest. However, interest is incurred only if these specific circumstances are met and if the distribution is a sum of money, not specific property.]

    d. If one property is swapped for the bequeathed property, gain or loss is recognized. [This answer is correct. According to IRS regulations, if the property distributed is substituted for the specific property bequeathed, gain or loss is recognized.]

18. Which of the following estates and trusts would benefit the most from electing to recognize gain on distributions of property? **(Page 58)**

    a. The Rollings Estate has current carryforward capital losses. [This answer is correct. When the estate or trust has current or carryforward capital losses or unused deductions to offset the capital gain, it can be advantageous to elect to recognize a gain on property distributions. Therefore, under these circumstances, the election is likely to be beneficial for the Rollings Estate.]

    b. The beneficiary of the Heatherton Trust who receives the property has capital losses. [This answer is incorrect. If the beneficiary has capital losses available to offset the gain on a later sale of the distributed property, it would not be advantageous for the trust to make the election to recognize gain on property distributions. Therefore, the Heatherton Trust should not make this election.]

    c. The Derringer Estate is subject to the 3.8% net investment income tax. [This answer is incorrect. It would not be advantageous for the estate to make the election to recognize gain for property distributions if the estate is subject to the 3.8% net investment income tax, but the beneficiary who received the property distribution is not. Therefore, the Derringer Estate should investigate further before making the election.]

    d. The United Trust distributes property to a beneficiary who is terminally ill. [This answer is incorrect. If the beneficiary has no current intention of selling the property or is seriously ill or elderly, gain could be deferred (or even eliminated) and the appreciated property could receive a new step-up in basis upon the beneficiary's death. Therefore, since this is likely to occur, it would not be advantageous for the United Trust to make the election to recognize gain for property distributions under these circumstances.]

19. Which of the following methods values assets that are distributed in kind by an estate or trust as of the date of their distribution instead of the date of death or an alternate valuation date? **(Page 58)**

    a. Fairly representative pecuniary funding. [This answer is incorrect. The *fairly representative pecuniary funding method* values each asset at its income tax basis {the date of death value or, for estates created in 2010 that elected to apply the modified carryover basis rules, the lesser of the decedent's adjusted basis (plus any allowable basis increase) or the property's FMV at the date of death}, with the additional requirement that the assets distributed fairly represent the appreciation and the depreciation in the value of all assets available for distribution that has occurred between the valuation date and the date the assets are distributed.]

    b. Fractional share clauses. [This answer is incorrect. A less commonly used alternative to the formula pecuniary clauses is *the fractional share clause*. It describes a fraction, rather than an amount in money or value, that must be calculated to determine the portion of the residuary estate a particular beneficiary will receive.]

    c. Minimum worth pecuniary funding. [This answer is incorrect. 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.]

    d. True worth pecuniary funding. [This answer is correct. *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 alternative valuation date) values. According IRS regulations, this method can easily trigger gain or loss since the in-kind asset distribution in satisfaction of a pecuniary bequest is a taxable event.]

Making Distributions in Lieu of Specific Property or a Specific Dollar Amount

Gain Recognition Rules

If a property distribution is in satisfaction of specific property or a specific dollar amount other than what is actually distributed, gain but not loss is recognized at the fiduciary level. 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. (Property distributions in satisfaction of a pecuniary bequest are discussed later in this lesson.)

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 is 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 and potentially subject to the 3.8% net investment income tax. 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. An in-depth discussion of IRD distributions is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook.*

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), as discussed later in this lesson. 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. Specific bequests were discussed earlier in this lesson.

Example 2D-1 In-kind distribution satisfying beneficiary's right to other property.

In the current year, 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 that year.

The DNI for the current year 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 gain is also included in the estate's net investment income and may be subject to the 3.8% net investment income tax.

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 holding period 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 discussion of reporting the holding period for distributed property appears later in this lesson.

A Schedule B (Form 1041) should be filled out in this scenario. 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.

See Example 2E-1 for an example of an in-kind distribution that satisfies a beneficiary's right to a specific dollar amount of income.

Making 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 (e.g., a Tier 1 distribution of a complex trust or required distribution of a simple trust), which is not the same as a pecuniary bequest, 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 deemed sale results in a capital gain, the fiduciary must include the gain in net investment income and potentially be subject to the 3.8% net investment income tax.

Example 2E-1 Property distributed in satisfaction of 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). Income in excess of $50,000 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, as discussed in Lesson 1.) 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). As in Example 2D-1, 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. (A discussion of the distribution deduction for estates and complex trusts appears in Lesson 1.)

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).

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. (See Example 2F-1.)

Example 2E-2 Property distributed in satisfaction of beneficiary's right to receive income when the property's FMV does not exceed DNI.

The preparer of the current year 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 for the year. 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 the year. No other distributions were made that year.

The trust will have a $20,000 capital gain 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 the current year (i.e., a Tier 1 distribution; see Lesson 1 for an explanation of the tier system), 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-3 Cash and property distributed to satisfy required income distribution.

Assume the same facts as in Example 2E-2, 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 computations. 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-4 Gains included in trust accounting income results in larger required income distribution.

Assume the same facts as in Example 2E-2, 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.

Depreciated Property Distributions

As discussed earlier in this lesson, the related-party loss limitation rules of IRC Sec. 267 disallow loss recognition on transactions between fiduciaries and their beneficiaries [(except for sales or exchanges between an estate and its beneficiaries in satisfaction of pecuniary bequests (fixed amounts)].

If a trust beneficiary receives 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 current year 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.

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. Any capital gain recognized by the estate or trust must be included in net investment income and may be subject to the 3.8% net investment income tax.

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 2016. 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 2017, 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 (potentially subject to the net investment income tax) 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 income in respect of a decedent (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 step-up in basis to the FMV at death or the basis increase that may have been allocated under the modified carryover basis rules. 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. The income and gain recognition by the fiduciary may be subject to the 3.8% net investment income tax by the estate or trust. 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. Thus, 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 (potentially subject to the net investment income tax) 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.

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.
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. For a detailed discussion of the continuation of the partnership after the partner's death, see *PPC's 1065 Deskbook*.

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 rules. 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. As discussed earlier in this lesson, 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 the Example in Reg. 1.706-1(c)(2)(ii) and Rev. Rul. 72-352. Although the entity in the Example in Reg. 1.706-1(c)(2)(ii) 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. The two approaches for allocating partnership interest are discussed as follows. In either case, the partnership does not terminate, since no sale occurs. The two approaches are as follows:

1. *Approach One [based on the Example in Reg. 1.706-1(c)(2)(ii)].* 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, 2017. 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 2017, will send Rosie a Schedule K-1 (Form 1065) allocating the partnership's income and loss from October 1 through December 31, 2017, 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 2017, so the partnership income from October 1 to December 31, 2017, is reported on the estate's Form 1041. On April 30, 2018, 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 (potentially subject to the net investment income tax), 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, 2018, to the estate and its income from May 1 through December 31, 2018, 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, 2018, 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 2017, the partnership income from October 1 to December 31, 2017, is reported on the estate's Form 1041. In 2018, the estate notifies the partnership of its distribution of partnership interests to Rosie and Fred. The allocation of 2018 partnership income between the estate, Rosie, and Fred depends upon the approach used, as follows:

    a. *Approach One [based on the Example in Reg. 1.706-1(c)(2)(ii)].* None of the partnership income for 2018 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 2018. Although the estate's 2018 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 2018 income on their individual tax returns.

    b. *Approach Two (based on Rev. Rul. 72-352).* As of October 31, 2018 (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, 2018, on a Schedule K-1 (1065) issued to the estate. On its 2018 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, 2018. The estate will include the partnership income earned through October 31, 2018, in its DNI for 2018. Since Rosie and Fred each received 50% of the total estate distributions, each would receive their separate 50% share of the estate's DNI.

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, 2018, 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 2018 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, 2018, 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, 2018, through October 31, 2018. Because both beneficiaries share in this increase in the estate residue on an equal basis, using Approach Two may provide a more equitable allocation of income to both beneficiaries. (Nonprorata distributions were discussed earlier in this lesson.)

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. (The gain may be subject to the net investment income tax at the estate or trust level.) Thus, the share of partnership liabilities assumed by the beneficiary increases his or her tax basis in the distributed partnership interest. For more information, see *PPC's 1065 Deskbook*.

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 (potentially subject to the net investment income tax) equal to the negative capital account.

Distribution of S Corporation Stock from an Estate or Trust

Estates and certain trusts, such as qualified Subchapter S trusts (QSSTs) and electing small business trusts (ESBTs), 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 a 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 prorata 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. As discussed earlier in this lesson, the distribution of noncash property to satisfy a pecuniary bequest is a sale requiring the estate to report any gain or loss (potentially subject to the net investment income tax). 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 (potentially subject to the net investment income tax). 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, 2017. 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 2017, will send Rosie a Schedule K-1 (Form 1120S) allocating the S corporation's income and loss from October 1 through December 31, 2017, 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 2017, so the S corporation's income from October 1 to December 31, 2017, is reported on the estate's Form 1041. On April 30, 2018, 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 (potentially subject to the net investment income tax). The estate notifies ABC Inc. of the distribution. The S corporation will allocate the S corporation's income from January 1 through April 30, 2018, to the estate and its income from May 1 through December 31, 2018, 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, 2018, 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 2017, the corporation income from October 1 to December 31, 2017, is reported on the estate's Form 1041. In 2018, the estate notifies ABC, Inc. of the distribution of corporate stock to Rosie and Fred. The estate reports its distributive share of S corporation income earned through October 31, 2018, 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, 2018.

Unless the fiduciary has the authority (according to state law and the governing instrument) to make *nonpro-rata distributions*, a deemed sale (potentially subject to the net investment income tax) 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, 2018, 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, 2018, since Fred is never considered an owner of the ABC Inc. stock.

Distributions 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 the five exceptions discussed at the beginning of this lesson. 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 (1) there is a debtor/creditor relationship, and (2) 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 the five exceptions discussed at the beginning of this lesson 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 Due to the Beneficiary

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

Inherited Property. Except for estates created in 2010 that elected to apply the modified carryover basis rules instead of federal estate tax, the holding period attributed to assets distributed from an estate or testamentary trust 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.

If the estate was created in 2010 and the executor elected to apply the modified carryover basis rules, the automatic long-term holding period that would otherwise be available to assets inherited from the decedent will not apply. A tacked on holding period is available, however, which gives the estate a holding period that includes the period held by the decedent and the estate.

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.

Specific Bequests from Estates and Testamentary Trusts. The holding period of specific bequests is the same as for inherited property, as described previously. A discussion of reporting specific bequests appeared earlier in this lesson.

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 previously (i.e., trust or estate's holding period is tacked onto the beneficiary's. See Example 2C-1. 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 the transferor's holding period onto the beneficiary's. See Example 2C-3.

Distributions Substituted for Specific Property or Dollar Amount. f 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. See Examples 2D-1 and 2E-1.

Pecuniary Bequests. The determination of whether the estate or trust's holding period tacks onto 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 2J-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 2006, had a value of $9,000 on the date of her death in the current year. 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.

Reporting Issues Related to the Generation-skipping Transfer Tax

The trustee of any trust that makes a taxable distribution for generation-skipping transfer (GST) purposes is normally 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. The GST 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. *PPC's 706/709 Deskbook* provides additional coverage of generation-skipping transfers.

The GST tax rate is equal to the highest estate tax rate (40%) in effect for the year of transfer. An exemption of $5.49 million is available for 2017. The tax applies to the following types of transfers: direct skips, taxable distributions, and taxable terminations. This discussion covers taxable distributions from a trust. Direct skips are beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

Taxable Distribution

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. 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 2017, each transferor is allowed a $5.49 million lifetime exemption.) 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.

Example 2K-1 Determining the inclusion ratio.

In 2017, Harold White transferred property worth $8 million to a newly created irrevocable trust for the benefit of his grandson, Hal. Harold allocated the full $5.49 million GST tax exemption to the trust. The applicable fraction is $5.49 million/$8 million, or .686 (.6863 rounded to the nearest one-thousandth). The inclusion ratio is .314 (1 −.686). Thus, 31.4% of any taxable distribution from the trust is subject to the GST tax.

Notification of a Distribution from a Generation-skipping Transfer Trust

A trustee that makes a GST taxable distribution is required to file Form 706-GS(D-1) to report the distribution to the recipient and the IRS. Form 706-GS(D-1) is an information return that provides the recipient with the amount of the taxable distribution and the inclusion ratio of the trust. The recipient, who is liable for the tax, uses the information to compute the GST tax due on the distribution. The recipient of a taxable distribution from a trust must file Form 706-GS(D) to report the distribution and compute the GST tax payable. The return must be filed on or before April 15 following the calendar year when the distributions were made (or later, by filing for an extension of time on Form 7004). However, distributions with an inclusion ratio of zero do not have to be reported on Form 706-GS(D).

Example 2K-2 Reporting taxable distributions to the distributee.

Several years ago, Ted Dancer transferred $3 million to an irrevocable trust for the benefit of his son, Bob. Pursuant to the trust agreement, the trustee is required to pay all of the trust's income annually to Bob for life.

The trustee also has the power to invade principal for the benefit of Bob's son, Ken (Ted's grandson) for his health, education, maintenance, or support. At Bob's death, the balance in the trust will be distributed to Ken.

At the time of the transfer to the trust, Ted allocated $2 million of his remaining GST tax exemption to the trust. [He had previously allocated the balance of his GST exemption to other generation-skipping transfers (i.e., not to this trust). Furthermore, increases in his GST tax exemption since the initial transfer have been fully allocated to other generation-skipping transfers (not in this trust).] The trust's inclusion ratio is .333 [1 − ($2 million ÷ $3 million)]. On May 8, 2017, the trustee distributed $20,500 to Ken to cover living expenses. The trustee distributed an additional $3,150 on December 15 to cover the GST tax on both the May 8 transfer and the December 15 transfer.

Filing Requirement. The trustee is required to file Form 706-GS(D-1) for each skip person that received a taxable distribution during the year. This form must be filed even if the inclusion ratio applicable to the distribution is zero.

Due Date. The trustee must file Form 706-GS(D-1), Copy A, with the IRS and send Copy B to the distributee on or before April 15 of the year following the calendar year in which the distribution was made. There is no provision for obtaining an extension of time to file Form 706-GS(D-1).

Filing Location. Copy A of Form 706-GS(D-1) should be filed with the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH, 45999.

Partial Terminations of a Trust

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*.

SELF-STUDY QUIZ

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

20. Which of the following statements best describes an issue related to property distributions?

    a. Specific requests are the only ones for which an estate or trust can recognize loss.

    b. Cash is considered to satisfy a beneficiary's right to income before property.

    c. Beneficiaries recognize loss on depreciated property based on the original acquisition value.

    d. When a partnership interest is distributed, debt will be assumed by the fiduciary.

21. If property is sold on the installment method before the decedent's death, how will any gain unrecognized at death be treated?

    a. It will be taxed upon collection.

    b. The estate will be eligible for a step-up in basis.

    c. The estate will recognize income as payments are due.

    d. Transferring the obligation to a beneficiary will trigger acceleration of gain recognition.

22. Which of the following will occur when an estate or trust distributes partnership interests or S corporation stock?

    a. The partnership will automatically terminate if it only had two members.

    b. A technical termination will occur if 50% or more of the partnership is sold within 12 months.

    c. Once the interest is transferred, the partnership's tax year will continue uninterrupted as that of the beneficiary.

    d. When a partnership interest is distributed as part of a residuary estate, it will be considered a sale.

23. William's mother dies in the current tax year. He inherits a vacation home from her estate. No extenuating circumstances apply to this property distribution; however, William sells the property six months later. How will this affect William's holding period?

    a. He will need to make a Section 643 election.

    b. He will be subject to a tacked on holding period.

    c. He will be excluded from the general rule for the holding period.

    d. His holding period will be considered long-term.

24. What is the inclusion ratio for the generation-skipping transfer (GST) tax?

    a. The amount of the GST exemption over the lifetime exemption.

    b. The value of the property minus federal estate tax.

    c. One minus the applicable fraction.

    d. 40% of the lifetime exemption for the current year.

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.)**

20. Which of the following statements best describes an issue related to property distributions? **(Page 73)**

    a. Specific requests are the only ones for which an estate or trust can recognize loss. [This answer is incorrect. The related party rules in IRC Sec. 267 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.]

    b. Cash is considered to satisfy a beneficiary's right to income before property. [This answer is correct. 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.]

    c. Beneficiaries recognize loss on depreciated property based on the original acquisition value. [This answer is incorrect. If the property is depreciated or declines in value while held by the beneficiary, any subsequent loss is based on the FMV of the property at the time of the original distribution from the trust to the beneficiary.]

    d. When a partnership interest is distributed, debt will be assumed by the fiduciary. [This answer is incorrect. 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, per the Internal Revenue Code, 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.]

21. If property is sold on the installment method before the decedent's death, how will any gain unrecognized at death be treated? **(Page 75)**

    a. It will be taxed upon collection. [This answer is correct. According to the Internal Revenue Code, such income will be considered income in respect of a decedent (IRD) and taxable upon collection.]

    b. The estate will be eligible for a step-up in basis. [This answer is incorrect. The estate's basis is the same as the decedent's because IRD assets are not eligible for either the step-up in basis to the FMV at death or the basis increase that may have been allocated under the modified carryover basis rules.]

    c. The estate will recognize income as payments are due. [This answer is incorrect. According to IRS regulations, 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 payments.]

    d. Transferring the obligation to a beneficiary will trigger acceleration of gain recognition. [This answer is incorrect. According to the Internal Revenue Code, transferring the decedent's installment obligation to a beneficiary does not automatically trigger an acceleration of gain recognition.]

22. Which of the following will occur when an estate or trust distributes partnership interests or S corporation stock? **(Page 76)**

    a. The partnership will automatically terminate if it only had two members. [This answer is incorrect. According to the Internal Revenue Code, 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.]

b. A technical termination will occur if 50% or more of the partnership is sold within 12 months. [This answer is correct. 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, according to the Internal Revenue Code. This is often referred to as a technical termination.]

c. Once the interest is transferred, the partnership's tax year will continue uninterrupted as that of the beneficiary. [This answer is incorrect. The tax year of a partnership closes with respect to a partner who dies during the year. The deceased partnerships 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 that the remaining income (or loss) on the estate's tax return, per the Internal Revenue Code.]

d. When a partnership interest is distributed as part of a residuary estate, it will be considered a sale. [This answer is incorrect. 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. Therefore, such treatment only applies if the election is made.]

23. William's mother dies in the current tax year. He inherits a vacation home from her estate. No extenuating circumstances apply to this property distribution; however, William sells the property six months later. How will this affect William's holding period? **(Page 82)**

a. He will need to make a Section 643 election. [This answer is incorrect. The estate would be the one that makes a Section 643 election, and that election is made in reference to residuary or fractional bequests, not inherited property such as in this scenario.]

b. He will be subject to a tacked on holding period. [This answer is incorrect. If the estate was created in 2010 and the executor elected to apply the modified carryover basis rules, the general rule for the holding period will not apply. A tacked on holding period would be available, which would give the estate a holding period that includes the period held by the decedent and the estate. However, because William's mother's estate arise in the current tax year (i.e., not 2010), this rule does not apply.]

c. He will be excluded from the general rule for the holding period. [This answer is incorrect. The general rule would not apply if there has been a taxable event upon the distribution (i.e., a deemed sale of the property); however, since that did not happen, William will be subject to the general rule.]

d. His holding period will be considered long-term. [This answer is correct. According to the Internal Revenue Code, except for estates created in 2010 that elected to apply the modified carryover basis rules instead of federal estate tax, the holding period attributable to assets distributed from an estate or testamentary trust is generally considered long-term, regardless of how long it was held by the decedent. Therefore, despite the fact that William sold the property so quickly, his holding period should be considered long-term.]

24. What is the inclusion ratio for the generation-skipping transfer (GST) tax? **(Page 83)**

a. The amount of the GST exemption over the lifetime exemption. [This answer is incorrect. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust. For 2017, each transferor is allowed a $5.49 million lifetime exemption. This numerator is part, but not all, of the formula for the inclusion ratio.]

b. The value of the property minus federal estate tax. [This answer is incorrect. Part of the calculation of the denominator of the applicable fraction is subtracting any federal estate tax or state death tax recovered from the trust attributable to the transfer from the value of the property transferred. The gift or estate tax charitable deduction, if any, allowed for the property must also be subtracted. However, this is not the entirety of the inclusion ratio.]

c. **One minus the applicable fraction. [This answer is correct. According to the Internal Revenue Code, the *inclusion ratio* is defined as one minus the *applicable fraction*. When computing the inclusion ratio, the applicable fraction must be rounded to the nearest one-thousandth (.001) before subtracting it from one.]**

d. 40% of the lifetime exemption for the current year. [This answer is incorrect. The GST tax rate is equal to the highest estate tax rate (40%) in effect for the year of transfer. An exemption of $5.49 million is available for 2017. However, these amounts are not specific to the inclusion ratio.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 1—Distributable Net Income, the Distribution Deduction, and Property Distributions (T41TG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This 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 the course, 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.

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   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with 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.

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EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 1—Distributable Net Income, the Distribution Deduction, and Property Distributions (T41TG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. The Anderson trust distributes $10,000 of income to each of its two beneficiaries in the current year. How will these amounts be taxed?

   a. The trust is responsible for paying taxes on this income.

   b. The trust must pay taxes on income to the trust, and then the beneficiaries have to pay taxes on income they receive.

   c. Because the income has been distributed to the beneficiaries, the trust can deduct this taxable income to the extent of distributable net income (DNI).

   d. The issue of whether the trust, the beneficiaries, or both will pay taxes on this income will be resolved by local law in the state in which the trust was created.

2. The distribution deduction for an estate or trust will typically be which of the following amounts?

   a. The lesser of total distributions or total DNI.

   b. Total distributions plus total DNI.

   c. The lesser of income required to be distributed currently or other amounts paid, credited, or required to be distributed.

   d. Income required to be distributed currently plus other amounts paid, credited, or required to be distributed.

3. A Tier 1 distribution is made up of which of the following?

   a. Discretionary distributions of income.

   b. Income required to be distributed currently.

   c. Discretionary distributions of principal in excess of required income.

   d. Required distributions of principal in excess of required income.

4. Which of the following beneficiaries has correctly addressed an issue related to DNI and the character of distributions from an estate or trust?

   a. Allison only reports income distributed from an estate if it is included in fiduciary accounting income.

   b. Bryant includes the amount of a specific bequest from an estate when calculating DNI.

   c. Caroline classifies distributed gross income using the same character it had in the trust.

   d. Douglas allocates direct expenses which exceed the related income to their related class of income and no other class of income.

5. Which of the following occurs when calculating DNI?

    a. Gains on the disposition of qualified small business stock excluded from taxable income under IRC Sec. 1202 are subtracted from taxable income.

    b. Short-term capital gain dividends from regulated investment companies are subtracted from DNI.

    c. An adjustment is made to take into account expenses that were directly charged to principal, such as state income tax paid on capital gains taxed to the trust.

    d. DNI is not adjusted for income items allocated to principal, which may result in DNI that exceeds an estate or trust's fiduciary accounting income.

6. When computing DNI for a complex trust or an estate, the deduction for Tier 2 distributions will be limited to which of the following?

    a. Taxable DNI prior to deductions for charitable contributions.

    b. Taxable DNI after deductible charitable contributions.

    c. Taxable DNI after Tier 1 distributions and prior to deductible charitable contributions.

    d. Taxable DNI after Tier 1 distributions and deductible charitable contributions.

7. How are depreciation and depletion allocated between beneficiaries and the applicable estate or trust?

    a. The estate or trust can only deduct depreciation or depletion that is not allocable to the income beneficiaries.

    b. Income beneficiaries can only deduct depreciation or depletion that is not allocable to the estate or trust.

    c. For estates, if the controlling instrument permits an entity level reserve, deductions for depreciation and depletion will be allocated based on fiduciary accounting income.

    d. For income beneficiaries, depreciation and depletion deductions should flow through to page 1 of Form 1041.

8. How are capital gains treated in relation to DNI?

    a. Capital gains must be excluded from DNI.

    b. Capital gains must be included in DNI.

    c. Typically, capital gains are excluded from DNI, but there are exceptions.

    d. Typically, capital gains are included in DNI, but there are exceptions.

9. What type of capital gains are both taxed at ordinary income tax rates and usually excluded from DNI?

    a. Long-term capital gains.

    b. Short-term capital gains.

    c. Capital gains used for specific bequests.

    d. Capital gains used to determine the amount distributed to a certain beneficiary.

10. Under which of the following circumstances would capital gains be included in DNI?

    a. The governing instrument specifically allocates them to principal.

    b. They will be used for charitable purposes and produce a related charitable deduction.

    c. They were made before a complete termination became necessary for the trust.

    d. They were exercised in response to a request from the beneficiary.

11. Hal is trustee of the Blankenship Trust. Fiduciary income is based on a fixed rate of 3%, and the trust's governing instrument allows the trustee to determine appropriate ordering. In the first year, Hal decides to include capital gains in DNI. Which of the following will Hal need to do?

    a. Consistently make the same inclusion in subsequent years.

    b. Allocate an annual amount that equals the unitrust amount over DNI plus capital gain.

    c. Distribute such capital gains to beneficiaries as part of a complete liquidation.

    d. Use his discretionary power to change the amount of the distribution.

12. Which of the following will cause a simple trust to become a complex trust?

    a. The fiduciary is allowed to distribute amounts in excess of income.

    b. The trustee sprinkled income among a class of beneficiaries.

    c. The trust distributes the year's income after the close of the tax year.

    d. The fiduciary has the power to accumulate income.

13. Funding a depreciation reserve will do which of the following?

    a. Prevent the trust from being classified as a simple trust.

    b. Decrease the amount of cash flow received by income beneficiaries of a simple trust.

    c. Allow the trust to distribute property in excess of fiduciary accounting income.

    d. Create phantom income to the trust.

14. What is the maximum amount the beneficiary of a simple trust can be taxed?

    a. The fiduciary accounting income required to be distributed.

    b. The fiduciary accounting income actually distributed by year end.

    c. The trust's taxable DNI.

    d. The trust's phantom income.

15. The Weatherford-Stone Trust has fiduciary income of $5,000 on which Tier 1 distributions are based. Its Tier 2 distributions are based on other amounts paid, credited, or required to be distributed, which total $2,000. The trust's DNI is $8,000. What is the trust's distribution deduction?

    a. $2,000.

    b. $5,000.

    c. $7,000.

    d. $8,000.

16. For 2017, a trust or estate with AGI that exceeds what amount is subject to the 3.8% net investment income tax (NIIT)?

    a. $12,300.

    b. $12,500.

    c. $200,000.

    d. $250,000.

17. Which of the following distributions would be exempted from being included in other amounts properly paid or credited or required to be distributed (OAPC)?

    a. Distributions of the residuary estate.

    b. Tier 2 distributions made to more than one beneficiary.

    c. Specific bequests of principal paid in one installment.

    d. A decedent's bequest of property chosen by the executor.

18. The Stellar Trust distributes property to Mary as an OAPC distribution. The property has a fair market value of $10,000. Stellar's basis in the property was $9,000. Mary will pay taxes of what amount on this property OAPC distribution?

    a. $1,000.

    b. $9,000.

    c. $10,000.

    d. $19,000.

19. John resides in a house owned by his family's trust. The trust maintains the residence on John's behalf. How will payments of the residential expenses be treated?

    a. They are allocated as income to John.

    b. The trust can deduct them as a required income distribution.

    c. The trust can deduct them specifically because they are related to the residence.

    d. The trust pays taxes on taxable income used to pay the expenses.

20. When the separate share rule comes into effect, which of the following will occur?
    a. DNI is spread equally over all the shares.
    b. Income attributable to that share is not allocated to other shares.
    c. Each share must be limited to a single beneficiary.
    d. The trustee will have the power to make discretionary allocations between shares.
21. Which of the following is required, related to the separate share rule?
    a. Physical segregation of assets.
    b. Independent bookkeeping and accounting records.
    c. Mandatory implementation if separate shares exist.
    d. DNI calculated for the whole trust and then divided between shares.
22. Separate shares exist under which of the following circumstances?
    a. Trust W is classified as a qualified revocable trust.
    b. Estate X makes a specific bequest in one installment.
    c. Trust Y makes a distribution to two spouses, neither of whom elect separate shares.
    d. Estate Z makes a pecuniary bequest that can be determined as of the date of death.
23. The last day of the Butterfield Trust's tax year is September 30. What is the last date that the trust can distribute income to beneficiaries and have it credited to this tax year?
    a. September 30.
    b. October 30.
    c. December 4.
    d. January 28.
24. If an estate or trust has expenses that are indirectly attributable to both taxable and nontaxable income, how should it allocate them?
    a. Using the required proration based on total income method.
    b. Using any method that is reasonable under the facts and circumstances.
    c. Allocating them first to taxable income, up to maximum DNI, then the remainder to tax-exempt income.
    d. Allocating them first to tax-exempt income until all of that is accounted for, and then the remainder to taxable income.
25. Which of the following items could cause "phantom" taxable income?
    a. Interest expense that can be deducted at the fiduciary level.
    b. Expenses that reduce DNI but not fiduciary accounting income.
    c. Disproportionate distributions to separate share beneficiaries.
    d. Expenses subject to the 2% of AGI floor at the fiduciary level.

26. The value of property distributed by an estate or a complex trust will be the smaller of which of the following?

    a. Fair market value (FMV) or the fiduciary's adjusted basis in the property before the distribution plus any Section 643(e)(3) gain elected to be recognized by the fiduciary.

    b. The fiduciary's adjusted basis in the property before the distribution plus any Section 643(e)(3) gain elected to be recognized by the fiduciary or the original cost of the property.

    c. FMV or the carryover basis and holding period the beneficiaries receive from the property.

    d. The original cost of the property or the carryover basis and holding period the beneficiaries receive from the property.

27. To qualify as a bequest or a gift of specific property, the identity of the property to be distributed by an estate must be ascertainable as of what date?

    a. The date the decedent writes his or her will.

    b. The decedent's date of death.

    c. The date of the distribution.

    d. The date the beneficiary decides to sell the property.

28. When James dies, his will makes following bequests. Which one would be considered a specific bequest?

    a. Monica is awarded proceeds from the sale of James's personal residence.

    b. Connor is awarded an annuity that will be paid out over several years.

    c. Joanne is awarded the trust principal.

    d. Daniel is awarded the Monet painting that hung above the fireplace.

29. Which of the following would be disregarded when determining whether a specific bequest meets the three-or-fewer-installments rule?

    a. The bequest of an automobile.

    b. A bequest of money.

    c. Bequests paid at the same time.

    d. Bequests for which no specific time is specified.

30. An estate or a complex trust typically will not recognize gain or loss on a distribution unless it is which of the following?

    a. A specific bequest.

    b. A pecuniary bequest.

    c. A residuary bequest.

    d. A distribution of property to satisfy claims.

31. The Anderson Family Trust elects to recognize gain on property distributions. Which of the following will occur?

    a. The trust can choose which distributions of property are covered by the election.

    b. The distribution deduction will be equal to the amount of DNI.

    c. The beneficiary will receive a step-up in basis on property distributions.

    d. The trust will also be able to recognize losses taken on property distributions.

32. A bequest for which neither the amount nor the identity of the property to be distributed are ascertainable under the governing instrument is called which of the following?

    a. A formula pecuniary clause.

    b. A fractional share.

    c. A residuary bequest.

    d. A specific bequest.

33. Which of the following occurs when a distribution is made in lieu of specific property or a specific dollar amount?

    a. The transfer will be treated as an in-kind distribution.

    b. Distributions of capital assets will be exempt from the 3.8 net investment income tax.

    c. The estate or trust should recognize gain, but not loss.

    d. DNI will be carried out to the beneficiary in the amount of the distribution.

34. Carole is entitled to receive a specific sum of money from her aunt's estate. Instead, the fiduciary distributes a piece of property to Carole that is valued at the same amount. Which of the following will occur?

    a. Carole will be treated as having sold the property.

    b. The estate will be deemed to have distributed cash.

    c. Carole will be responsible for recognizing any gain if the property has appreciated.

    d. The estate will be allowed to recognize any loss associated with the property.

35. The related-party rules of IRC Sec. 267 disallow which of the following?

    a. Loss recognition on transactions between a fiduciary and a beneficiary.

    b. Gain recognition on transactions between a fiduciary and a beneficiary.

    c. Gain recognition on sale of depreciated property by a beneficiary.

    d. Distributions of depreciated property that will incur a loss.

36. If a trustee or an executor sells property on behalf of the trust or estate on an installment basis, which of the following will occur?

    a. Gain must be reported using the installment method of accounting.

    b. The fiduciary can elect out of using the installment method of accounting.

    c. The installment note cannot be distributed to a beneficiary until all installments are paid in full.

    d. If the installment note is distributed to a beneficiary, the beneficiary will recognize gain to the extent that FMV exceeds the obligation's basis.

37. Who is responsible for addressing issues that arise when an estate or trust distributes a partnership interest to a beneficiary?

    a. The partnership.

    b. The beneficiary.

    c. The trust or estate.

    d. A third party.

38. The Marshall Trust distributes in-kind property to Jeanine that includes a debt for which Jeanine will be liable. Which of the following will occur?

    a. The Marshall Trust will recognize a loss on the amount of the debt.

    b. Jeanine will not recognize gain or loss until selling or disposing of the property.

    c. If the amount of the debt exceeds the basis, Jeanine will receive debt relief.

    d. A cancellation of indebtedness must be recognized by the Marshall Trust.

39. The trustee of the Tom Bleakman Testamentary Trust transfers stock with a FMV of $20,000 to Kelly, the decedent's niece, in satisfaction of a specific bequest of $20,000. The stock, acquired by Tom in 2006, had a value of $18,000 on the date of her death in the current year. The transfer was made within one year of Tom's death. Which of the following will occur?

    a. The basis of the stock to Kelly is $18,000.

    b. The trust will recognize $18,000 of capital gain.

    c. Kelly's holding period begins when she receives the stock.

    d. Kelly will recognize long-term loss, even if she sells within 12 months.

40. When dealing with the generation-skipping transfer (GST) tax, a skip person would be a minimum of how many generations below the transferor?

    a. One.

    b. Two.

    c. Three.

    d. Four.

GLOSSARY

65-day distribution deduction: If an election is made by the fiduciary in accordance with the regulations, 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 and will be treated so for all purposes.

Complex trusts: Any trust that does not meet the qualifications of a simple trust for the tax year (including all terminating trusts). They compute their distribution deduction using a tier system.

Distributable net income (DNI): This is the maximum amount of taxable income for which the fiduciary can claim an income distribution deduction and the maximum amount required to be included in gross income of the beneficiaries.

Distribution deduction: An income tax deduction that estates and trusts are allowed to take when they make, or are required to make, distributions. It ensures that the estates and trusts are not taxed on the amounts of their distributions.

Fairly representative pecuniary funding: This 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.

Fiduciary accounting income: Income of an estate or trust determined according to the terms of the governing instrument and local (usually state) law. It is also called trust accounting income.

Formula pecuniary bequest: 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.

Fractional share clause: A fraction, rather than an amount in money or value, that must be calculated to determine the portion of the residuary estate a particular beneficiary will receive.

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 the transferor.

Holloway adjustment: A discretionary judgment trustees can make under New York law that reduces fiduciary accounting income and reimburses principal (on behalf of the remainder beneficiaries) for income taxes paid on phantom income.

Income required to be distributed currently: Income that is payable to the beneficiary each year, regardless of whether the income is actually distributed. Thus, such income is part of the distribution deduction for an estate or trust.

In-kind distributions: Property distributions (i.e., noncash distributions). This type of distribution is governed by different rules than those used for cash distributions.

Minimum worth pecuniary funding: This 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 fre3edom to select particular assets to fund this type of bequest, in contrast to the restrictions placed on the fiduciary under the fairly representative funding method.

Net tax-exempt interest: When calculating DNI, this 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.

Nonprorata distribution: An in-kind distribution of 100% of selected estate assets, rather than a prorate portion of all assets.

Other amounts paid, credited, or required to be distributed (OAPC): All distributions other than income required to be distributed currently, whether from income or principal. Thus, these amounts are part of the distribution deduction for an estate or trust.

Pecuniary bequests: Bequests of a specific dollar value, which can be based on either a fixed dollar amount or a formula.

Phantom income: Income remainder beneficiaries must pay taxes on that they never received from an estate or trust. This can occur when fiduciary accounting income is 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. This can also occur when a trust or estate owns an interest in a partnership or S corporation and taxable income reported on Schedule K-1 exceeds the actual distributions from the pass-through entity.

Residuary bequests: A distribution of the remaining estate after the payment of specific and pecuniary bequests, any debts, and expenses.

Separate share rule: If a complex trust or estate has two or more beneficiaries who have substantially 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. DNI is computed separately for each share, so all income, deductions, gains, or losses attributable to that share will not be allocated to any other share. This rule does not apply to charities, because they are not allocated DNI.

Separate shares: These 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 interest neither affect nor are affected by the economic interests of another beneficiary or class of beneficiaries.

Simple trusts: A trust that (1) is required to distribute all income currently, (2) makes no distributions of principal in a given year, and (3) cannot claim a charitable contribution deduction under IRC Sec. 642(c) for the year. Trusts meeting these terms for the tax year are allowed to deduct the amount of income required to be distributed currently, up to the amount of taxable DNI.

Skip person: Typically, individuals who are two or more generations below the transferor.

Specific bequest: An amount that, under the terms of the governing instrument, is payable as a gift or a bequest of a specific sum of money or of specific property. It must be paid in three or fewer installments. No DNI is allocated to such gifts or bequests.

Taxable distribution: For the GST tax, this is any distribution of income or principal (other than a taxable termination or a direct skip) from a trust to a skip person.

Technical termination: A partnership termination that occurs when a decedent owned 50% or more of the shares and the executor sells the interest within a 12-month period. This can be sale to a third party, distribution of the interest to satisfy a pecuniary bequest, or making an election under IRC Sec. 643(e)(3) to recognize gain in the year interest is distributed.

Tier 1 distribution: Distributions a complex trust makes from income required to be distributed currently. They include any amount required to be distributed that may be paid out of income or principal, to the extent that it is actually paid out of income for the tax year. The deductible amount is limited to the taxable portion of DNI, computed without any deduction for charitable contributions.

Tier 2 distribution: Distributions made by a complex trust consisting of other amounts paid, credited, or required to be distributed during the tax year (whether from income or principal). They generally include "proper" payments of income not required to be distributed currently and distributions of principal, whether required or discretionary. The deduction is limited to the amount of taxable DNI left after Tier 1 distributions and deductible charitable contributions.

True worth pecuniary funding: This method values assets distributed in-kind at their date-of-distribution values, rather than their date-of-death (or alternate valuation date) values. The fiduciary has the freedom to select particular assets to fund a true worth pecuniary bequest.

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COMPANION TO PPC'S 1041 DESKBOOK

COURSE 2

CAPITAL ASSET TRANSACTIONS, RENTS, ROYALTIES, AND PASS-THROUGH INCOME (T41TG172)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses two topics related to the types of income that are recorded on Form 1041. Lesson 1 examines capital asset transactions. Lesson 2 takes a look at rents, royalties, and pass-through income.
PUBLICATION/REVISION DATE:	November 2017
RECOMMENDED FOR:	Users of *PPC's 1041 Deskbook*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of estate and trust taxation
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP):** This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.
CTEC CREDIT:	8 CTEC Federal Tax Law Hours
IRS EA CREDIT:	8 Federal Tax Law/Tax Related Matters Hours
IRS NCRP CREDIT:	8 Federal Tax Law Hours
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **November 30, 2018**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Capital Asset Transactions

Completion of this lesson will enable you to:
- Identify capital gains rates, how to report capital gains, when capital gains and losses are reportable by the fiduciary or beneficiaries, when capital gains are distributed to absorb a decedent's capital loss carryover, and how to address capital losses incurred by a fiduciary.

- Recognize considerations for determining basis of trust and estate property and the appropriate holding period for estate property.
- Determine the best treatment for mutual fund gains and losses, sales and exchanges of property between related parties, personal residence transactions, the redemption of stock to pay estate taxes, IRD rules for property sales, property sales used in a trade or business, the sale of qualified small business stock, and installment sales.

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

Completion of this lesson will enable you to:
- Recognize how to interpret a partnership's Schedule K-1, how to report partnership income or loss for deceased partners, and what happens when estates and trusts are considered S corporation shareholders.
- Identify the reporting methods for pass-through income or loss from S corporations, how to deal with pass-through income from other fiduciaries, and the rules associated with rental and royalty income.

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Lesson 1: Capital Asset Transactions

Introduction

A capital asset is any property held by an estate or trust, except depreciable or real property used in the taxpayer's trade or business (IRC Sec. 1231 allows capital gain treatment on such items if certain conditions are met), inventory, specified literary or artistic property, business accounts or notes receivable, or certain U.S. publications.

Capital gain is classified as long-term when the property sold was held for more than one year. Normally, capital gain is also considered long-term if the property was acquired from a decedent, and the property was included in the decedent's gross estate (regardless of the holding period and even if the estate was not taxable). This will include nearly all capital gains for estates and testamentary trusts. However, for estates created in 2010 that elected to apply the modified carryover basis rules instead of being subject to estate tax, the automatic long-term holding period that would otherwise be available to assets received from the decedent does not apply. A tacked holding period (i.e., a carryover of the decedent's actual holding period) is available.

Normally capital gains are allocated to the fiduciary rather than carried out to the income beneficiaries on their Schedule K-1s from the estate or trust. However, if the governing instrument or state law authorizes allocating capital gains to the income beneficiaries (or one of the other exceptions to the general rule of allocating capital gains to the fiduciary is met), it may be beneficial to allocate the capital gains to the income beneficiaries. This may be the case even though the net capital gain rates are the same for individuals and for estates and trusts (except the 10% income tax bracket, which is not available to trusts and estates). For instance, when the income beneficiaries have significant net capital losses to offset the net capital gains distributed to them, the overall tax burden may be reduced.

There might also be a tax advantage in distributing the capital gains to minimize the trust's or estate's taxable income due to the highly compressed fiduciary income tax rates. [For taxable years beginning in 2017, the 28% marginal income tax rate for trusts and estates applies to taxable income as low as $6,001, contrasted to individuals who do not reach the 28% bracket until their taxable income reaches $91,901 (filing single) and $153,101 (married filing jointly)]. Distributing the capital gains to beneficiaries may also be beneficial to avoid or minimize the estate or trust's 3.8% net investment income tax (NIIT). Because the applicable NIIT threshold for estates and trusts is only $12,500 (for 2017), in contrast with $200,000 for unmarried individuals and $250,000 for a married-filing jointly couple, the overall tax burden may be reduced by distributing the net investment income to the beneficiaries. However, this strategy will generally not be appropriate when the income and residuary beneficiaries are different. Furthermore, the testator's (or settlor's) intent for distribution, as provided in the governing instrument, must be given primary consideration.

Capital losses exceeding capital gains are deductible against ordinary income up to $3,000 annually, with the balance carried forward. Capital losses do not pass through to the beneficiaries until the termination year.

This lesson covers the tax rules covering sales of capital assets. A discussion of the tax rules covering distributions of capital assets to beneficiaries is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify capital gains rates, how to report capital gains, when capital gains and losses are reportable by the fiduciary or beneficiaries, when capital gains are distributed to absorb a decedent's capital loss carryover, and how to address capital losses incurred by a fiduciary.
- Recognize considerations for determining basis of trust and estate property and the appropriate holding period for estate property.
- Determine the best treatment for mutual fund gains and losses, sales and exchanges of property between related parties, personal residence transactions, the redemption of stock to pay estate taxes, IRD rules for property sales, property sales used in a trade or business, the sale of qualified small business stock, and installment sales.

The Capital Gain Rates

The maximum tax rate on an estate or trust's net long-term capital gain is 15% (20% for fiduciaries in the 39.6% ordinary income tax bracket). Thus, estates and trusts with taxable income exceeding $12,500 (for 2017) are subject to a maximum long-term capital gain tax rate of 20%, rather than 15%. Also, many trusts and estates are subject to the 3.8% net investment income tax, which applies to undistributed capital gains on dispositions of assets held for investment if the fiduciary's AGI exceeds the applicable threshold amount ($12,500 for 2017). This could effectively make the federal long-term capital gain rate as high as 23.8%.

The long-term capital gain rate for estates or trusts that are in the 15% ordinary income tax bracket is 0%, but only to the extent the gain would otherwise be in that ordinary income tax bracket. The reduced rates also apply for alternative minimum tax purposes.

The capital gain rates apply to "adjusted net capital gain," which is defined as net capital gain (i.e., excess of net long-term gains over net short-term losses) plus qualified dividend income. Adjusted net capital gain is determined by—

1. reducing net capital gain (but not below zero) by the following two items:
    a. capital gain attributable to unrecaptured depreciation on Section 1250 property (see the following "unrecaptured Section 1250 rule"), and
    b. 28% rate capital gains, then
2. adding qualified dividend income.

Qualified dividend income (i.e., dividends received from certain domestic and qualified foreign corporations) is taxed at the same rates as adjusted net long-term capital gain. However, dividends are not included when determining net capital gain. Therefore, qualified dividends 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.

Gain on the sale or exchange of collectibles (such as coins) is taxed at a maximum rate of 28% if held for more than 12 months. Furthermore, the "unrecaptured Section 1250 rule" sets a maximum 25% rate on gain from the sale or exchange of real property held for more than one year to the extent depreciation adjustments on the property exceed those subject to ordinary income recapture. Depreciation recapture is discussed later in this lesson.)

How to Report Capital Gains

General Rules

Schedule D (Form 1041) and/or Form 8949 are required to report gains and losses from the sale or exchange of capital assets by an estate or trust unless the capital gain results from the sale of business property (in that case, Form 4797 should be used).

Form 8949 (Sales and Other Dispositions of Capital Assets), Part 1 summarizes three categories (A, B, and C) of short-term capital gains and losses, and Part II summarizes three categories (D, E, and F) of long-term capital gains and losses. A separate Form 8949 should be completed for each category type. The capital gains and losses will be included in category A or D if the investment's cost or other basis is shown in box 3 of Form 1099-B; category B or E if no investment basis is shown in box 3 of Form 1099-B; and category C or F if none of the other boxes are checked. When completed, the summarized Form 8949 information is transferred to Form 1041 Schedule D (Capital Gains and Losses). An estate or trust's share of capital gains (losses) from a partnership, S corporation, or another estate or trust is reported only on Schedule D (1041) (i.e., not on Form 8949).

When Amount Distributed is Less than DNI

Form 1041, Schedule B, line 3, says to list the amount of capital gains allocated to beneficiaries (from Form 1041, Schedule D, line 19, column 1). However, the two lines will not always match. For example, if some or all of the

current year's net capital gains are allocated under the governing instrument to income but less than this amount is distributed to the beneficiaries, only the amount distributed to the beneficiaries should be listed on Schedule D, line 19, column 1. Nonetheless, in this situation, 100% of the amount of net capital gains allocated to income should be reported on Form 1041, Schedule B, line 3.

Determining Whether the Fiduciary or Beneficiaries Can Report Capital Gains (Losses)

General Rules

To determine whether capital gains or losses are reportable by the fiduciary or beneficiaries, it is first necessary to know whether such gains or losses are included in distributable net income (DNI). If the capital gains (losses) are included in DNI, the fiduciary is eligible for a distribution deduction (to the extent of DNI) for any distributions made to the beneficiaries, and to that extent, the capital gains are "carried out" to and reportable by the beneficiaries.

Normally, capital gains are reported by the fiduciary and are not included in DNI. Capital losses are also excluded, except to the extent such losses are taken into account in determining net capital gains included in DNI. Thus, except in the termination year, net capital losses cannot be distributed to the beneficiaries even if the conditions for including net capital gain in DNI are otherwise satisfied.

Exceptions to the General Rule.

In certain situations, capital gains are included in DNI, and thus, potentially reportable to the beneficiary. For example, the terms of the trust instrument or provisions of state law may define capital gains as income, rather than principal.

When capital gains are included in DNI, but only a portion is distributed to the beneficiaries in the current year, an allocation must be made to determine the amount reportable to the beneficiaries.

Example 1C-1 Capital gains included in DNI but not distributed.

According to the terms of the Bowers Testamentary Trust, capital gains are included in trust accounting income. The trustee has the discretion to distribute or accumulate income; thus, the trust is a complex trust. In the current year, the trust recognized a gain of $25,000 from the sale of stock. It also had qualified dividends of $5,000 and interest of $10,000. There were no trust expenses. Distributions were $25,000. The distribution represents:

	Total	Beneficiary
Qualified dividends	$ 5,000	$ 3,125
Interest	10,000	6,250
Capital gains	25,000	15,625
Total	$ 40,000	$ 25,000

Additionally, the trust would be subject to the 3.8% net investment income tax on its undistributed net investment income. More information about DNI is beyond the scope of this course, but a more detailed discussion can be found in *PPC's 1041 Deskbook*.

The Distribution of Capital Gains in Order to Absorb the Decedent's Capital Loss Carryover

If a decedent is survived by his or her spouse, and a joint return can be filed for the year of death, distributions of capital gains from the decedent's estate to the surviving spouse may be used to offset pre-death capital losses (including capital loss carryovers) on the joint return, provided one of the exceptions in Reg. 1.643(a)-3(b) applies to the general rule that capital gains are excluded from DNI.

The ability to make a distribution of capital gains from the estate can be particularly valuable since a capital loss carryover is personal to the decedent and may only be deducted on the decedent's final income tax return. However, if the assets producing the loss carryover were community assets, only the decedent's half of the capital loss carryover from the final joint return would not carry forward. The other half remains the community property of the surviving spouse and would carry forward. The capital gain potentially available for distribution to the surviving spouse must be recognized and distributed in the year of the final joint Form 1040 (i.e., the calendar year in which the decedent died).

The tax basis of property acquired from a decedent is generally the fair market value at the date of death or alternate valuation date, if elected. However, estates created in 2010 could have elected to apply the modified carryover basis rules. In that case, the property acquired from the decedent is the decedent's carryover basis plus the aggregate basis increase or spousal property basis increase amounts allocated by the executor, as discussed later in this lesson. However, income in respect of a decedent (IRD) is not eligible for either the step-up in basis under IRC Sec. 1014 or the basis increase under the modified carryover basis rules of former IRC Sec. 1022.

Example 1D-1 Distribution of capital gain to surviving spouse in year of death.

Joan Getwell died on December 1, 2017, survived by her husband John. The couple's 2016 joint Form 1040 shows a net capital loss carryforward of $33,000 entirely attributable to a 2016 sale of part of Joan's separate property. The only capital gain recognized in 2017 prior to her death is $15,000 of long-term capital gain, which were profits from a sale of her separate property.

Initially, it appears that no other capital gain can be recognized on the joint 2017 Form 1040 and that $15,000 ($33,000−$15,000−$3,000 annual net capital loss limitation) of Joan's capital loss carryforward will expire unused due to her death. However, Joan's will requires that all of her estate's income be distributed currently to John. The provisions of Joan's will also specifically allocate all capital gain to fiduciary accounting income and require the executor (John) to use capital gain in determining the income amount to be distributed.

Joan's estate collected a 2017 payment from her prior installment sale on December 28, 2017 and has $15,000 gain to report. Because the $15,000 of long-term capital gain is IRD to the estate, which is not eligible for the step-up in basis, the estate must recognize $15,000 of long-term capital gain on the annual installment payment in 2017. John, as executor, elects a calendar year-end for the estate and distributes the $15,000 of gain (a component of fiduciary accounting income in this case) to himself as income beneficiary, producing a distribution deduction on the estate's Form 1041 of the same amount. (Thus, the estate will not have undistributed net investment income that would cause the net investment income tax to apply.) The $15,000 of long-term capital gain retains its character in John's hands, thereby allowing Joan's capital loss (the $15,000 capital loss carryforward that would have otherwise expired unused) to offset the $15,000 of long-term capital gain distributed to him as the income beneficiary of Joan's estate.

Capital Losses That Are Incurred by a Fiduciary

Net capital losses of a trust or an estate are allocated to principal. Therefore, as a general rule, they are deductible only at the trust or estate level (subject to the $3,000 annual net capital loss limitation). A capital loss carryover is available for the excess, as in the case of individuals. The carryover is calculated on a worksheet included in the Schedule D form instructions. When DNI is fully distributed (e.g., a simple trust with DNI less than or equal to its fiduciary accounting income), the $3,000 capital loss deduction is not lost or wasted, but restored as part of the carryover calculated on the Schedule D worksheet.

On Form 1041 Schedule B, DNI is compared to the total distributions for the year (actual distributions and those required but not yet distributed) rather than to the adjusted total income on line 17 of Form 1041. As such, it is possible to have a larger DNI (and thus a larger distribution deduction) than adjusted total income. For example, this could occur when capital losses were subtracted from adjusted total income but were added back to DNI or when tax-exempt interest income was included in DNI but excluded from adjusted total income. Similarly, it is possible to have a smaller DNI, and thus, a smaller distribution deduction than adjusted total income (e.g., when capital gains are included in adjusted total income but not in DNI).

Unless the estate or trust terminates with an unused capital loss carryover, the beneficiaries are not entitled to a pass-through of the capital loss.

Example 1E-1 Capital loss deductions are limited at fiduciary level.

The trustee of the LHTW Family Trust purchased 1,000 shares of the common stock of ABC Banc Corporation on September 8, 2002, for $45,000. The value of the shares of this bank holding company declined as a result of a large number of nonperforming loans. In March 2017, the holding company's primary asset, its 100% owned bank subsidiary, was seized and liquidated by the FDIC.

As a result, the shares of the holding company were delisted from the New York Stock Exchange and began trading "over the counter" at a bid price of $0.05 per share and an asking price of $0.10 per share. Knowing the trust could not recognize a capital loss for worthlessness (because the stock was still being actively traded), the trustee sold the 1,000 shares on March 15, 2017, at an average price of $0.06 a share, netting $50 after various sales expenses.

The trust's only other capital gain or loss item in 2017 was $2,500 of capital gain distributions from mutual funds. A $44,950 long-term capital loss is reported on the 1,000 shares on Schedule D (via Form 8949). Therefore, the 2017 net capital loss is $42,450. Of this amount, $3,000 is deducted currently against trust ordinary income and $39,450 is carried forward to 2018.

Character of Capital Losses in Carryover Year

Capital losses retain their character (e.g., 28%, 25%, 20%, or 15%) when carried over to the following year. To the extent the capital loss subject to limitation is deducted from ordinary income in the following year, the net short-term capital loss is deducted first. Within each capital gain group, gains and losses are first netted to arrive at a net gain or loss for each category.

Short-term Loss Ordering Rules. A net short-term capital loss, including any short-term carryover, is first applied to reduce any net long-term gain from the 28% category. Any remaining net short-term loss is then applied to reduce any net gain from the 25% category, and finally applied (if not already netted against other categories of gain) to reduce any net gain from the 15% or 20% category.

Long-term Loss Ordering Rules. A net loss from the 28% category, including any carryover in that category, is first applied to reduce any gain in the 25% category. Any remaining net 28% loss is then applied to reduce any net gain from the 15% or 20% category. A net loss from the 15% or 20% category, including any carryover in that category, is first applied to reduce any gain from the 28% category and then (if any loss from the 15% or 20% category is still available) applied to reduce any gain in the 25% category.

Distribution of Unused Capital Losses to Beneficiaries in the Estate or Trust's Final Year

Losses of an estate or trust generally may not be passed through to the beneficiaries succeeding to the fiduciary property except in the year of termination. This rule applies to both net operating losses and capital losses.

Losses on Distributions of Property to a Beneficiary

Trusts and estates may distribute property with a basis greater than fair market value (FMV) to beneficiaries, but the fiduciary may not recognize a loss on Form 1041 on the distribution unless the distribution is treated as a sale and the loss is not barred by the related party rules of IRC Sec. 267(b)(6) and (13). An in-kind distribution is treated as a sale if it is in satisfaction of a right to receive a specific dollar amount (often called a pecuniary bequest) or to receive property other than that distributed. Such in-kind distributions are (in effect) indirect sales—deemed distributions of cash in an amount equal to the FMV of the property, followed by the purchase of the property by the beneficiary for the cash. An in-kind distribution is also treated as a deemed sale if the estate or trust so elects under IRC Sec. 643(e)(3).

Trusts. Even if the distribution is treated as a sale, IRC Sec. 267(a)(1) denies loss recognition treatment for direct or indirect sales or exchanges between certain related persons, and IRC Sec. 267(b)(6) includes the trust fiduciary

and the trust beneficiaries in the definition of related persons. However, since the trust is denied a loss on the distribution, the beneficiary does not include in gross income any gain on a later taxable disposition of the property to the extent of the loss disallowed to the trust.

Example 1E-2 Discretionary distribution of depreciated property to beneficiary.

In the current year, the trustee of a complex trust made a discretionary distribution to its beneficiary of 10,000 common shares of ABC Corporation stock. The trust's basis in the stock at the time of the distribution was $100,000 and the FMV was $75,000.

The trust cannot recognize the $25,000 loss since the stock distribution was not in satisfaction of the beneficiary's *right* to a specific dollar amount or in lieu of a right to other specific property. Therefore, the distribution will not be treated as an indirect sale. Furthermore, the trustee cannot elect, under IRC Sec. 643(e), to recognize the disallowed loss due to the Section 267 related party rules.

The beneficiary's basis in the shares is $100,000 because the trust recognized no gain or loss on the distribution. The distribution deduction is limited to $75,000 (the lesser of the beneficiary's basis or the FMV at the time of distribution).

Estates. An estate and its beneficiaries are also considered related parties under IRC Sec. 267(b)(13), except for a sale or exchange in satisfaction of a pecuniary bequest. In that case, gain or loss is recognized. This is the only exception to the related party rules for trusts and estates. All other losses on property distributions by a trust or an estate to a beneficiary are not recognized due to the related party rules of IRC Secs. 267(b)(6) and (13).

SELF-STUDY QUIZ

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

1. The Blankenship Estate has taxable income of $15,275 in the current year. The estate also has undistributed capital gains from disposing of assets the decedent had held for investment. What is the estate's long-term capital gains tax rate?

    a. 0%.

    b. 15%.

    c. 20%.

    d. 23.8%.

2. Net short-term capital loss reduces what category of net long-term capital gain first?

    a. 15%.

    b. 20%.

    c. 25%.

    d. 28%.

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. The Blankenship Estate has taxable income of $15,275 in the current year. The estate also has undistributed capital gains from disposing of assets the decedent had held for investment. What is the estate's long-term capital gains tax rate? **(Page 110)**

   a. 0%. [This answer is incorrect. The long-term capital gain rate for estates and trusts that are in the 15% ordinary income tax bracket is 0%, but only to the extent the gain would otherwise be in that ordinary income tax bracket. However, since this scenario is talking about the capital gains rate, the 0% rate does not apply.]

   b. 15%. [This answer is incorrect. The maximum tax rate on an estate or trust's net long-term capital gain is 15% if they are not in the 39.6% ordinary income tax bracket. As that is not the case for the Blankenship Estate, a different tax rate will apply.]

   c. 20%. [This answer is incorrect. Estates and trusts with taxable income exceeding $12,500 (for 2017) are subject to a maximum long-term capital gain tax rate of 20%. However, this percentage does not take into account the net investment income tax (NIIT).]

   d. 23.8%. [This answer is correct. Due to the Blankenship Estate's taxable income, which exceeds $12,500, it is subject to the 20% long-term capital gain tax rate. It is also subject to the 3.8% NIIT, which applies to undistributed capital gains on dispositions of assets held for investment if the fiduciary's AGI exceeds the applicable threshold amount ($12,500 for 2017). This makes the estate's federal long-term capital gain rate as high as 23.8%.]

2. Net short-term capital loss reduces what category of net long-term capital gain first? **(Page 114)**

   a. 15%. [This answer is incorrect. This is one of the last categories of net long-term gain the net short-term loss will be applied to when the short-term loss ordering rules are used.]

   b. 20%. [This answer is incorrect. Under the short-term loss ordering rules, this is one of the final categories of net long-term gain the net short-term loss can be applied to (assuming it is not already netted against other categories of gain).]

   c. 25%. [This answer is incorrect. Under the short-term loss ordering rules, any remaining net short-term loss is applied to reduce net gain from the 25% category second. However, under the long-term loss ordering rules, net loss from the 28% category is first applied to reduce any gain in the 25% category.]

   d. 28%. [This answer is correct. Capital losses retain their character (e.g., 28%, 25%, 20%, or 15%) when carried over to the following year. To the extent the capital loss subject to limitation is deducted from ordinary income in the following year, the net short-term capital loss is deducted first. Specific short-term loss ordering rules are used. A net short-term loss, including any short-term carryover, is first applied to reduce any net long-term gain from the 28% category. Then any remaining net short-term loss can be applied to other categories.]

Basis Considerations that Affect Trust Property

General Rules

For property acquired by gift (whether by a transfer in trust or otherwise), the property's basis for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. An adjustment is required if gift tax is incurred, as explained later in this lesson. The same rule applies in determining loss unless the basis is greater than the property's fair market value (FMV) at the time of the gift. In that case, the basis for determining loss is the FMV at the time of the gift.

Example 1F-1 Transfer of appreciated property to a trust.

In the current year, John Smith contributed 100 shares of ABC stock to a trust for the benefit of his daughter, Susan. John purchased the stock several years ago for $10,000, and at the time of the transfer, the stock was valued at $11,000. The trust's basis in the stock, for determining gain or loss, is $10,000, the stock's basis to John at the time of the transfer.

Example 1F-2 Transfer of depreciated property to a trust.

Assume the same facts as in Example 1F-1, except that the stock was worth only $9,000 at the time of transfer. During the current year, the stock's value continued to decline. The trustee decided to sell the stock when the FMV was $8,000. For determining the loss, the trust will use a basis of $9,000 (the FMV at the time of the transfer to the trust), resulting in a loss of $1,000.

If the stock appreciated in value after the transfer to trust, gain would be recognized only if the stock sold for more than $10,000, John's original basis. However, if the stock sold for more than $9,000 but less than $10,000, no gain or loss would be recognized.

If the property was acquired by a transfer in trust (other than a transfer in trust by a gift, bequest, or devise), the basis is the same as it would be in the hands of the grantor, increased by the amount of the gain or decreased by the amount of the loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made.

For assets transferred to an intentionally defective grantor trust (IDGT), there has been some question as to whether the property is entitled to a step-up in basis under IRC Sec. 1014 upon the grantor's death. The IRS has concluded that property transferred prior to death, even to a grantor trust, is not entitled to a Section 1014 step-up in basis unless the property is includible in the grantor's gross estate for federal estate tax purposes.

If property is transferred to a trust and the transferor retains a life estate in the property (e.g., the right to receive income to the property or the right to live in the property), and the property is includable in the transferor's gross estate (because of the retained life estate), the property should be eligible for a stepped-up (or down) basis upon the transferor's death.

Effect of Gift and/or Generation-skipping Transfer (GST) Tax Paid

The donee's basis in donated property is increased by any gift tax attributable to appreciation in the property's value while held by the donor. The increase in basis for the gift tax paid is an amount (not in excess of the tax paid) bearing the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift. Net appreciation in value of any gift is the amount by which the FMV of the gift exceeds the donor's adjusted basis immediately before the gift.

The donee's basis is also increased (but not above the property's FMV) by the portion of the GST tax attributable to the excess of the property's FMV over its basis (before the transfer). If gift tax also applies, the gift tax basis adjustment is applied before the GST tax basis adjustment.

Example 1F-3 Increase in basis for gift tax.

The preparer of a 2017 Form 709 (U.S. Gift Tax Return) receives the following information from the donor, who wishes to know the donee's tax basis in the gift:

- Date of gift: June 30, 2017
- Gift: 45,000 shares of ABC Corporation common stock
- Fair market value on date of gift: $125 a share
- Donor's tax basis in the 45,000 shares: $10 a share
- Donee: Trust with one beneficiary (donor's granddaughter)
- Donor is single and has made no prior taxable gifts
- Donor wishes to use the generation-skipping transfer (GST) tax exemption ($5.49 million in 2017)

The taxable gift is $5,611,000 (FMV of $5,625,000 less the $14,000 annual exclusion), resulting in a gift tax liability of $48,400 ($2,190,200 tax on $5,611,000 transfer, less the gift tax applicable credit amount of $2,141,800). The GST tax liability is also $48,400 after using the $14,000 GST tax annual exclusion and the $5.49 million GST tax exemption.

The gift tax applicable exclusion amount is $5.49 million for gifts in 2017 (equivalent to an applicable credit amount of $2,141,800). The annual exclusion amount is indexed for inflation, but adjustments are rounded down to the nearest $1,000. For 2017 gifts, the annual gift exclusion amount is $14,000.

The increase in basis for the gift tax is calculated as follows:

$$\frac{\$5{,}175{,}000 \text{ pre-gift appeciation}}{\$5{,}611{,}000 \text{ taxable gift}} \times \$48{,}400 \text{ gift tax} = \$44{,}639 \text{ increase in donee's basis}$$

The increase in basis for the GST tax is calculated in the same manner as the gift tax, resulting in an additional basis increase of $44,639. (Since the gift tax and GST tax basis adjustments, when added to the donor's basis, do not exceed the FMV of the stock upon transfer to the trust, this amount is not limited.)

The trust's (donee's) basis is calculated as follows:	
Donor's basis in the stock immediately prior to the gift:	$ 450,000
Increase by gift tax attributable to the appreciation while held by the donor:	44,639
Increase by GST tax attributable to the appreciation while held by the donor:	44,639
Trust's adjusted basis	$ 539,278

More detailed information on gift and GST taxes and whether the annual exclusion applies can be found in *PPC's 706/709 Deskbook*.

Property Distributed in Kind from a Trust

Generally, property received in kind from a trust has the same basis in the hands of the distributee as it had in the trust. In addition, the property's basis will be increased for any gain or decreased for any loss recognized by the fiduciary on the distribution. Gain is recognized if the fiduciary elects under the provisions of IRC Sec. 643(e)(3), as discussed later in this lesson (see the topic "Fiduciary Can Elect to Give Beneficiary an FMV Basis"). Gain may also be recognized if an in-kind distribution is made in satisfaction of a beneficiary's right to receive a specific dollar amount (e.g., a pecuniary obligation, a simple trust required income distribution, or a Tier 1 complex trust required income distribution) or to receive property other than that distributed. However, a loss will not be recognized by the trust in either case because a trust and its beneficiaries are considered related parties under IRC Sec. 267(b)(6). If a loss is disallowed to the trust, the beneficiary will not recognize gain on a subsequent sale to an unrelated party until the loss has been recovered.

If a fiduciary distributes in-kind property subject to a debt that is assumed by the beneficiary, the general rule of carryover of income tax basis from the fiduciary to the beneficiary applies. If the debt is assumed by the beneficiary,

debt relief income is not recognized by the fiduciary unless (a) there is a debtor/creditor relationship, and (b) the debt has been cancelled.

For in-kind distributions, the amount of DNI considered distributed for calculating 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 (which is usually the carryover basis from the trust, as discussed in the prior paragraph) or fair market value of the property at the time it was distributed. However, if a Section 643(e)(3) election is made, the distribution deduction and income inclusion amounts equal the property's fair market value. For simple trusts (generally, trusts required to distribute all income currently), the distribution deduction and income inclusion amounts are equal to the income required to be distributed currently, and the trust recognizes a capital gain on the distribution to the extent of the excess of the property's fair market value over its adjusted basis.

Example 1F-4 Basis of property distributed from trust.

A trust terminates and distributes all its residual assets, consisting of stocks and bonds, to the remainder beneficiaries. The trust had no DNI in its termination year. The remainder beneficiaries' basis in each stock and bond is the trust's basis, measured immediately prior to the distribution, unless the trust makes an election under IRC Sec. 643(e)(3) to treat the distribution as a sale, thereby recognizing gain and producing a fair market value basis for each asset. (See Example 1F-5.) A trust cannot recognize loss on a distribution. Recognized gain or disallowed loss is to be determined as to each separate asset that is distributed under the Section 643(e)(3) election.

Fiduciary Can Elect to Give Beneficiary an FMV Basis

A fiduciary can give the beneficiary a fair market value (FMV) basis in noncash property distributions by electing under IRC Sec. 643(e)(3) to treat the property distributed as if it were sold to the beneficiary for its fair market value. The election to recognize gain applies to all distributions made during a tax year and is made by checking a box on page 2 of the return for that year. However, a residuary bequest (from an estate) does not cause capital gain recognition for a distribution of appreciated property. Losses are disallowed according to the related party rules of IRC Sec. 267(b)(6) and (13). Therefore, a trustee cannot use a Section 643(e)(3) election to recognize a loss on a distribution to a beneficiary. 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.

Example 1F-5 Election to step up basis of property distributed.

The XYZ Trust is a complex trust with a $25,000 long-term capital loss carryforward from 2016. The trust owns 1,000 shares of ABC Corporation stock with a fair market value of $60,000 and a basis of $45,000. The trust has held the stock for several years. The grantor requested that the stock be retained for eventual distribution to the trust beneficiary, if feasible. The trust has little cash on hand despite its significant holdings and $100,000 of taxable income (before capital gains and the distribution deduction) from zero-coupon bonds. The beneficiary has adequate liquidity, but little taxable income and a $75,000 individual net operating loss (NOL) carryforward to 2017. Under its discretionary powers, the trustee distributed the ABC corporation stock to the beneficiary in 2017, but made no other distributions.

The Section 643(e)(3) election is made on the return by checking the appropriate box "Yes" in the "Other Information" section of page 2 (Form 1041) and attaching a completed Schedule D.

As a result of the election, the trust recognizes long-term capital gain of $15,000 (which will be offset by its capital loss carryforward). The $7,000 remaining long-term capital loss ($25,000 − $15,000 − $3,000 deducted in 2017) will carry forward to 2018. The trust also obtains a $60,000 distribution deduction, thereby offsetting much of its total income. The trust would also be subject to the net investment income tax (NIIT) on its undistributed net investment income. The $3,000 excess capital loss deduction can offset the undistributed net investment income (interest income) for NIIT purposes. Additional information on the distribution deduction and how to compute and report the net investment income tax is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

The beneficiary receives the ABC Corporation shares at a $60,000 basis (the fair market value on the date of distribution). In addition, the beneficiary will recognize $60,000 of ordinary income from receipt of the stock (which will be sheltered by his NOL carryforward).

Variation: If no election is made, the trust would report a $45,000 distribution deduction (the trust's stock basis) and no capital gain. The beneficiary would have a $45,000 basis in the ABC Corporation shares and a taxable distribution of $45,000. The trust would still have an unused capital loss carryover of $25,000, and the beneficiary would only be able to offset the NOL deduction carryover by $45,000, rather than $60,000.

If no Section 643(e) election is made, it seems logical that the estate or trust's in-kind distribution of a partnership interest would trigger gain recognition if the fiduciary partner's share of liabilities exceeds its tax basis. However, it is most likely that no gain recognition would apply if the beneficiary remains liable for the partnership debt.

Special Basis Adjustment When an Interest in a Passive Activity Is Distributed

If any interest in a passive activity is distributed by an estate or trust, the basis of the interest is increased by the amount of any unused passive activity losses allocable to the interest. Such losses are not allowable as a deduction for any tax year.

However, the basis adjustment for the suspended passive losses will be available to increase loss or reduce gain when the asset is sold.

The Basis of Estate Property

General Rules

The estate's basis in property acquired from a decedent is generally the fair market value of the property on the decedent's date of death (or alternate valuation date, if elected). (However, different rules apply for estates created in 2010 that elected to use the modified carryover basis rules, as discussed later in this lesson.) The beneficiary's basis will be the FMV of the property on the date of decedent's death (or alternate valuation date) (i.e., the same as the estate's basis) even if the beneficiary does not actually receive the property distribution until a significant time has passed. If the property was community property, both halves of the community (decedent's and surviving spouse's) obtain a basis equal to fair market value (provided at least half of the community property is included in the gross estate).

Basis Consistency Rule and Form 8971 Reporting

For property distributions from taxable estates (those exceeding the applicable exclusion amount), there is a basis consistency requirement for transfer and income tax purposes. The basis consistency rule applies when (1) the estate is required to file an estate tax return (Form 706) after July 31, 2015, and (2) the property increases the estate tax liability. When this rule applies, the executor must, within 30 days of the earlier of (1) the due date or (2) filing of Form 706, provide a statement disclosing the property's value, as finally determined and reported on Form 706, to the IRS and beneficiaries who acquire assets from the estate. Form 8971, (Information Regarding Beneficiaries Acquiring Property from a Decedent), is used to disclose this information. More information on completing Form 8971 is available in *PPC's 706/709 Deskbook*.

According to the basis consistency rule, the basis of property for income tax purposes cannot exceed the value—

1. as finally determined and reported on Form 706 or
2. identified on a statement furnished under IRC Sec. 6035(a) (for property not included on Form 706).

The beneficiaries must use the value reported on Form 706, which is generally the fair market value (other than for property considered IRD) upon the decedent's death, as their income tax basis. The basis consistency rule is intended to prevent beneficiaries from overstating the basis on their income tax returns, which can result in a 20% penalty for the underpayment due to inconsistent reporting.

For any property distributions made from the estate (even if made by estates not required to use the basis consistency rules), the beneficiary should be provided with basis and holding period information. (The holding period rules are discussed later in this lesson.)

While the property is held by the estate or trust, deductions for depreciation, depletion, and amortization will adjust basis in the usual way (based on the date of death or alternate valuation date value).

A detailed discussion of basis issues for an estate's interest in a partnership or shares in an S corporation acquired upon the decedent's death is provided in Lesson 2.

Basis of Property Received from an Estate—Traditional Rules

If property is paid, credited, or required to be distributed in kind, no gain or loss is generally realized by the trust or estate unless (a) the fiduciary elects to recognize gain or loss under IRC Sec. 643(e)(3) or (b) the distribution is in satisfaction of a right to receive a distribution of a fixed-dollar amount or specific property (i.e., a pecuniary bequest) or specific property other than that distributed. An in-depth discussion of the tax effects of property distributions from an estate and the exceptions to the general rule of no gain recognition for in-kind distributions from the estate to the beneficiary is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

Distributions That Are Not Pecuniary Bequests or Subject to Section 643(e)(3) Election. The basis of in-kind property received from an estate (not in satisfaction of a pecuniary bequest, discussed later in this lesson) is the adjusted basis in the hands of the estate immediately before the distribution, adjusted for any gain or loss recognized by the estate on the distribution. Thus, if the distribution is not in satisfaction of a pecuniary bequest (or other fixed dollar obligation), or the estate does not elect to recognize gain on the distribution under the provisions of IRC Sec. 643(e)(3), the distributee will receive a carryover basis.

Example 1G-1 Basis of property received from an estate.

Immediately prior to Bill's death in the current year, his basis in 1,000 shares of DEF Corp. stock was $10,000. The FMV of the shares at his date of death was $100,000. Thus, the estate's basis in the shares is $100,000 under IRC Sec. 1014.

The 1,000 shares were distributed by the estate to one of the estate beneficiaries (not in satisfaction of a pecuniary bequest) when the shares had a FMV of $120,000. If no election is made to recognize gain under IRC Sec. 643(e)(3), the beneficiary will receive the shares at the estate's tax basis immediately prior to the distribution, $100,000.

Variation: If Bill had died in 2010 and the executor opted out of federal estate tax, the modified carryover basis rules of former IRC Sec. 1022, as discussed later in this lesson, would apply. In that case, the estate's basis in the shares is Bill's carryover basis of $10,000, rather than the stepped-up basis of IRC Sec. 1014. However, if the executor had allocated $90,000 of the $1.3 million aggregate basis increase (see the discussion of basis increase later in this lesson) to the shares of DEF Corp. Stock, the estate's basis in the shares is $100,000 ($10,000 carryover basis + $90,000 basis increase).

Pecuniary Bequests. If appreciated property is distributed to satisfy a beneficiary's right to receive a pecuniary bequest of a fixed amount or specific property, the estate must recognize gain for the difference between FMV on the date of the distribution and the FMV on the date of the decedent's death. Because the funding results in a taxable event (i.e., a deemed sale), the beneficiary's basis will be the estate's basis plus any gain recognized by the estate upon transfer.

The requirement to recognize gain when appreciated property is distributed in satisfaction of pecuniary bequests also applies to estates created in 2010 that elected to use the modified carryover basis rules. However, a safe harbor limits the gain to the appreciation between the date of death and the time of distribution. In other words, even with the modified carryover basis rules, the gain on funding pecuniary bequests is limited to the post-death appreciation. Note that although the safe harbor limits the amount of gain recognition to the estate or testamentary trusts, the beneficiary's basis in the assets acquired is not stepped-up to FMV as of the date of death. Instead, the beneficiary's basis will be the carryover basis immediately before the distribution plus the amount of gain recognized by the estate or trust on transfer.

Example 1G-2 Basis of property received in satisfaction of a pecuniary (fixed-dollar) bequest.

Joe Jones died in the current year. Included in Joe's estate are 1,000 shares of ABC Corp. stock with a basis to Joe of $6,000 as of his date of death and an FMV of $8,000. In his will, Joe left $10,000 to his nephew, Sam Jones. With Sam's consent, the executor distributes ABC Corp. common stock, which has appreciated in value to $10,000, to satisfy the bequest. The amount of capital gain the estate must recognize is $2,000 ($10,000 FMV on date of distribution − $8,000 FMV on the date of Joe's death). Sam's basis in the stock will be $10,000 ($8,000 estate's basis immediately prior to the distribution + $2,000 gain recognized by the estate).

Property Owned Jointly with a Right of Survivorship (JTWROS) or as Tenants by the Entirety. When determining the basis of property that passes to a surviving joint tenant, the date of the creation of the joint interest as well as the amount each tenant contributed toward the purchase of the joint property will impact the basis to the survivor. Determining the basis of property received as a joint tenant depends on whether the joint tenants were legally married.

General Rules. If the joint tenants are not legally married, the general rule of IRC Sec. 2040(a) is that the portion of the joint tenancy property included in the decedent's estate will depend on his or her contribution to the acquisition of the property. That portion of the property will also obtain a new income tax basis under IRC Sec. 1014. If the joint tenants are legally married, half of the fair market value of spousal joint interest property that meets the requirements of a qualified joint interest is included in the gross estate of the first spouse to die regardless of how much each spouse contributed towards the purchase price of the property. This rule is sometimes referred to as the "50% inclusion rule."

A qualified joint interest is any interest in property owned by the decedent and his or her spouse as tenants by the entirety or as joint tenants with right of survivorship if the decedent and his or her spouse are the only joint tenants. The 50% rule applies regardless of which spouse furnished the original consideration.

The surviving spouse's basis in qualified joint interest property is determined by adding one-half of the original cost basis of the property to the one-half of the fair market value included in the gross estate and subtracting from this sum any deductions for wear and tear, such as depreciation or depletion, previously allowed to the surviving spouse in computing taxable income.

Example 1G-3 Basis of property received as a joint tenant under the traditional rules.

Cecilia acquired depreciable property several years ago for $150,000 and deeded it to herself and her husband, Dan, as tenants by the entirety (upon one spouse's death, title passes by law to the surviving tenant, instead of via the decedent's will). They do not live in a community property state. Prior to Cecilia's death, depreciation deductions of $5,000 had been taken. The FMV of the property at Cecilia's death is $175,000. Dan's basis in the property is calculated as follows:

Cecilia's interest ($175,000 × 50%)	$ 87,500
Dan's interest ($150,000 × 50%)	75,000
Less 1/2 depreciation taken before Cecilia's death ($5,000 × 50%)	(2,500)
Dan's basis (under the traditional rules)	$ 160,000

See Example 1H-1 for a discussion of the holding period under the traditional rules.

If Modified Carryover Basis Rules Apply. For decedents who died in 2010 for which the executor elected to use the modified carryover basis rules instead of the traditional estate tax rules, a different basis calculation applies. When determining eligibility for the basis increase, the decedent is treated as owning, at the time of death, a portion of the value of property owned jointly by the decedent and another person as joint tenants with a right of survivorship or as tenants by the entirety. The portion of the joint property that is deemed owned by the decedent is based on the rules that are similar to those currently in IRC Sec. 2040, which apply for estate tax purposes. The other joint owner's basis will be his or her adjusted basis plus the modified carryover basis for the property acquired from the decedent (i.e., the basis plus any basis increase allocated by the executor, up to the property's FMV on the decedent's date of death).

If the property is owned jointly with a surviving spouse, and the decedent died in 2010, he or she is deemed to have owned 50% of any asset that is owned jointly with the decedent's surviving spouse, either as joint tenants with a right of survivorship or as tenants by the entirety. The amount contributed by the surviving spouse for the property is irrelevant.

Example 1G-4 Basis of property received as a joint tenant under the modified carryover basis rules.

Assume the same facts as in example 1G-3 except that Dan was Cecilia's brother, rather than her husband, the estate was created in 2010, and the executor of Cecilia's estate elected to use the modified carryover basis rules, rather than the traditional estate tax rules.

The executor elected to allocate $15,000 of the aggregate basis increase to Cecilia's interest, which is the maximum amount eligible for the basis increase [50% ($175,000 FMV − $145,000 tax basis, net of depreciation)]. (See the discussion of basis increase later in this lesson.) Thus, the modified carryover basis of Cecilia's interest is $87,500 [($145,000 tax basis × 50%) + $15,000]. Dan's basis in the property is calculated as follows:

Cecilia's interest (modified carryover basis)	$ 87,500
Dan's interest ($150,000 × 50%)	75,000
Less Dan's share of depreciation taken before Cecilia's death ($5,000 × 50%)	(2,500)
Dan's basis	$ 160,000

A discussion of the holding period when the modified carryover basis rules are elected appears later in this lesson.

Community Property Distributions. Under the traditional estate tax rules, if property is community property, the entire basis of the property is stepped up (or down) to fair market value on the death of the first spouse to die, even though only half of the property's value is included in the deceased spouse's gross estate.

Example 1G-5 Basis of property received as community property under the traditional step-up in basis rules.

During their marriage, Jay and Pam acquired depreciable property for $200,000. Since they lived in Texas for all of their married life and had no legal agreements to the contrary, the property is classified as community property. When Jay died, the property was worth $350,000. Although depreciation of $12,000 had accumulated while Jay was living, both halves of the property will receive a stepped-up basis of $175,000 and all prior depreciation is entirely ignored. Both Jay's probate estate (or person who inherits the property) and Pam will be allowed to use $175,000 as their depreciable basis, and both would make a new depreciation election after Jay's death. See Example 1H-1 for a discussion of the holding period.

If Modified Carryover Basis Rules Apply. If community property is acquired from a decedent who died in 2010 and the executor elected to use the modified carryover basis rules, the determination of the surviving spouse's basis is similar to the traditional rules of IRC Sec. 1014. When determining the eligibility for the basis increase, community property is deemed owned 100% by the decedent if the decedent owned at least a one-half interest in the property at the time of his or her death. In other words, the executor could have allocated the $1.3 million aggregate basis increase or $3 million spousal property basis increase to 100% of the community property. However, if the value of the property is less than the basis as of the decedent's death, the basis of both interests will become the total FMV as of the decedent's date of death.

Example 1G-6 Basis of property received as community property under the modified carryover basis rules.

Assume the same facts as in Example 1G-5 except that Jay died in 2010 and the executor of his estate elected to use the modified carryover basis rules. He allocated $162,000 of the basis increase to the property so that the estate's modified carryover basis will be $350,000, which is the FMV of the property on Jay's death. Both

Jay's probate estate and Pam will be allowed to use $175,000 as their depreciable basis. The depreciation method, recovery period, and convention used by Jay should continue to be used for the property acquired by Pam and the estate, based on the original basis of $200,000 ($100,000 to each) and considering prior depreciation already taken. The $162,000 basis increase is treated, for depreciation purposes, as a separate asset that Pam and the estate placed in service on the day after Jay's death ($81,000 each). Jay's holding period will tack onto Pam's holding period.

Furthermore, to the extent there were Section 165 built-in losses attributable to the surviving spouse's community property, this amount may have been added to the basis increases allocated to other property owned and acquired by the decedent. However, only the decedent's net operating loss (NOL) and capital loss carryovers could be added to any basis increase. If the community property was sold prior to the decedent's death, only the decedent's half of any carryover loss was eligible for the basis increase.

Rev. Proc. 2011-41 clarifies that the surviving spouse's basis in the community property may be stepped down if the FMV upon the decedent's death was less than its basis.

Modified Carryover Basis Rules for Electing Estates Created in 2010

The fair market value basis rules of IRC Sec. 1014 for decedents who died in 2010. In their place, modified carryover basis rules under former IRC Sec. 1022 were to apply to property owned by and acquired from a decedent dying in 2010. However, the 2010 Tax Relief Act reinstated the estate and GST taxes retroactively to January 1, 2010, along with the traditional step-up (or step-down) rules of IRC Sec. 1014. A special election was made available, allowing an executor of an estate created in 2010 to opt out of federal estate taxes. If the election was made on or before January 17, 2012, the basis of assets acquired from the decedent is determined under the modified carryover basis rules of former IRC Sec. 1022. Effectively, if the election was made, the property acquired from a decedent in 2010 is treated, for income tax purposes, as if received by a gift, and the basis to the estate (or other person) acquiring the property is the *lesser* of—

1. the decedent's adjusted basis (with certain modifications, as discussed in the following paragraphs) or

2. the FMV of the property at the date of the decedent's death.

Beneficiary's Basis in a Passive Activity Interest Received from an Estate

If an interest in a passive activity is distributed by an estate, the basis of that interest shall be increased by the amount of any unused passive activity losses allocable to the interest. Those losses are not allowable as a deduction for any tax year.

However, if an estate distributes a passive activity interest in satisfaction of a pecuniary bequest in a fully taxable transaction under IRC Sec. 469(g)(1), the unused passive activity losses are deductible by the estate.

Basis of Property Received by Decedent Shortly before Death

Traditional Rules. Under the traditional rules, the basis of appreciated property acquired by a decedent by gift within one year prior to death that is in turn reacquired from the decedent by (or passes from the decedent to) the original donor of such property (or the spouse of such donor) is equal to the basis in the hands of the decedent immediately before death. The beneficiary will not receive a step-up (or down) basis to the FMV at death. Instead, he or she will retain the decedent's basis existing at death (i.e., carryover basis).

Example 1G-7 Inheritance of previously gifted property under the traditional rules.

Tom gave publicly traded common stock with a basis of $10,000 and a FMV of $200,000 to his mother, Jane, outright in 2016. Tom paid no gift tax on the transfer because his full applicable exclusion amount was available. Jane died in 2017 within a year of receiving the stock. At the time of her death, the stock had a FMV of $500,000. Under Jane's will, Tom inherited the shares.

Jane's estate owed no taxes because her estate was less than her applicable exclusion amount ($5.49 million in 2017). Tom's tax basis in the shares received is equal to the basis in Jane's hands immediately before her

death: $10,000. Even though Tom used a portion of his own applicable exclusion amount by making a taxable gift of $186,000 ($200,000 less the $14,000 annual exclusion for 2016), Jane's death within one year of the gift will cause his basis to be $10,000—the same basis he would have had if he had kept the shares.

If Jane had lived more than a year after receiving the gift, Tom would have obtained shares worth $500,000 with a tax basis of $500,000, permitting him to sell the shares at that value without incurring income tax.

Modified Carryover Basis Rules. If the estate was created in 2010 and the executor elected the modified carryover basis rules, property acquired from the decedent was not eligible for the $1.3 million aggregate basis increase or $3 million spousal property increase if the decedent had received the property by gift (i.e., a lifetime transfer for less than adequate and full consideration) within the three-year period ending on the date of death. This rule did not apply to property acquired from a surviving spouse unless the surviving spouse also acquired the property by gift during the three-year period prior to the decedent's death.

Example 1G-8 Inheritance of previously gifted property under the modified carryover basis rules.

Assume the same facts as in example 1G-7 except that Jane died in 2010 and the executor of her estate elected to use the modified carryover basis rules. The estate's basis of the shares is $10,000 and was not eligible for the basis increase under the modified carryover basis rules. When the estate distributes the shares to Tom, the basis, in Tom's hands, will equal the basis to the estate ($10,000) because Jane died within three years of the gift.

Variation: If Jane were Tom's wife, rather than his mother, the executor could have elected to apply the spousal property basis increase of up to $490,000 ($500,000 FMV on Jane's date of death − $10,000 basis). Thus, upon distribution to Tom, Tom's basis in the shares would have been $500,000 rather than $10,000.

Effect of Alternate Valuation Election on Tax Basis of Assets

Under certain circumstances, the executor of an estate may elect to value all the estate's assets at their fair market value six months after the decedent's date of death (the alternate valuation date) rather than their fair market value on the date of death. If this election is made, rules contained in IRC Sec. 2032 determine the tax basis of the estate's assets.

If the alternate valuation date was elected and an asset is distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death, it is valued as of the date on which it is distributed, sold, exchanged, or otherwise disposed of.

Example 1G-9 Interim asset sales when estate elects alternate valuation date.

Dr. Clint H. Williams, M.D., a widower, died on December 20, 2016, with an estate valued at $6 million. For simplicity, assume that the executor elected a calendar year for the estate. Roughly 75% of his gross estate consisted of 45,000 shares of Modern Medical Enterprises, Inc. (MME) stock, worth $100 a share on his date of death. The executor believed MME stock was peaking in value around the time Dr. Williams died. To protect the estate from a decline in the value of MME, diversify the estate's assets, and raise cash to pay the estate taxes, the executor began to sell MME shares shortly after his appointment was approved by the probate court.

The following schedule of MME stock sales was prepared by the executor and provided to the tax preparer:

Sale Date	Number of Shares	Net Proceeds per Share	Tax Basis per Share	Gain (Loss) on Share Sale
01/03/17	5,000	$ 105	$ 100	$ 25,000
01/13/17	5,000	100	100	—
02/10/17	5,000	95	100	(25,000)
03/08/17	5,000	90	100	(50,000)
04/13/17	5,000	80	100	(100,000)
Total net capital loss				$ (150,000)

A note from the executor along with the estate income tax return data confirms the estate still holds the remaining 20,000 MME shares and asks if there is a way to get a 2016 income tax benefit from the net capital loss even though the estate had no other capital asset transactions for that year.

The value of the MME stock had declined to $50 per share by June 20, 2017. The preparer contacts the executor to determine whether he plans to elect the alternate valuation date for the estate's assets on the Form 706 due September 20, 2017. If so, the 25,000 MME shares sold prior to that date will be included on Form 706 at their $2.35 million total sale price instead of their $2.5 million date-of-death value. The remaining 20,000 shares will be included at their June 20, 2017, $1 million alternate valuation instead of their $2 million date-of-death value.

The election will save estate tax unless the estate's other assets appreciated more than the net depreciation of MME stock ($1.15 million) between the date of death and June 20, 2017. However, if the election is made, there will be no capital loss on the 25,000 MME shares sold in 2017 and the estate (and the decedent's heirs) will have a $50 basis in each unsold MME share instead of $100.

Variation: If the alternate valuation election had not been made, the $150,000 long-term capital loss would have been includable on the 2017 Form 1041, of which $3,000 would have reduced the estate's ordinary income and $147,000 would have carried forward to the 2018 Form 1041. To the extent the carryforward was not used by the estate prior to its termination, it would have passed to estate beneficiaries at that time, retaining its character.

Allocating Basis between Life Estate and Remainder Interest Holders

The basis of the decedent's property is allocated between the life estate holder and the remainder interest holder according to the relative value of the life estate and the remainder interest determined in accordance with IRS Table S (Valuation Factors for a Single Life). The allocation depends upon the expected number of years in the life estate (i.e., how many years the life estate holder is expected to live) and the Section 7520 rate used to determine the present value of the life estate. Receiving the property at the end of the life estate (i.e., the remainder interest) has a value today equal to the value of the asset today minus the present value of the life estate.

The Section 7520 rate is equal to 120% of the applicable federal midterm rate (rounded to the nearest 0.2%) in effect for the month of the valuation. The IRS releases a revenue ruling each month that lists the Section 7520 rate. Once the rate is determined for the valuation month it does not change.

Example 1G-10 Taxable disposition of a remainder interest.

Claude Laird died in the current year, survived by his wife, Maude. Included in the estate's assets that Maude inherited was a tract of raw land with a FMV of $100,000. A month after Claude died, Maude sold a remainder interest in the land to an unrelated person for $60,000 but she retained a right to use the land while she was alive (i.e., a life estate). Maude was 60 years old when she sold the remainder interest.

Maude must recognize a capital gain on the sale of the remainder interest. Her basis in the land must be apportioned between the retained life estate interest and the remainder interest. The apportionment is computed using IRS actuarial tables.

Assume that the monthly Section 7520 rate was 3.6% when the remainder interest was sold. Using Table S (for a 3.6% rate), for age 60, the factor for the remainder is 0.49617, and the factor for the life estate is 0.50383 (1.00000 − 0.49617).

Since the property's value is $100,000, Maude's basis in the remainder interest in the property is $49,617. Because she sold the remainder interest for $60,000, Maude must report a capital gain of $10,383 ($60,000 − $49,617) on her Form 1040 for the current year. The gain will be a long-term capital gain, as discussed later in this lesson.

Table S is located on the IRS's website at **www.irs.gov/Retirement-Plans/Actuarial-Tables**.

Holding Periods for Estate Property

Traditional Rules

Under the traditional rules, when property is acquired from a decedent, the taxpayer acquiring the property is deemed to have held the property for more than one year. This rule allows most capital gains of estates and testamentary trusts to receive the favorable long-term capital gain rate regardless of the length of time the underlying property is actually held by the fiduciary.

Example 1H-1 Holding period of property acquired from decedent under the traditional rules.

Joe Blue died in January of the current year. In November of that year, the executor sold 500 shares of ABC Corp. stock for $37,500. The stock's value as of Joe's date of death was $30,000 (according to the step-up rules of IRC Sec. 1014).

Even though the estate held the stock for less than one year, the $7,500 gain is considered a long-term capital gain, and is reported on Part II, Line 1 of Form 8949 (Sales and Other Dispositions of Capital Assets), which is then entered on line 8b of Schedule D (Form 1041).

An in-depth discussion of the holding period for distributions of capital assets to beneficiaries (i.e., specific bequests, discretionary distributions, pecuniary bequests in satisfaction of the beneficiary's right to receive a fixed-dollar amount or specific property, or residuary or fractional bequests), is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

If Modified Carryover Basis Rules Apply

If the executor of an estate created in 2010 elected to use the modified carryover basis rules, as discussed earlier in this lesson, the automatic long-term holding period that would otherwise be available to inherited property does not apply. If elected, the modified carryover basis rules effectively treat property acquired from a decedent who died in 2010, for income tax purposes, as if received by a gift. This allows for the tacking on of the decedent's holding period for property passing to the estate or other recipient. In other words, the decedent's holding period tacks onto the recipient's, regardless of whether the assets had appreciated or depreciated in value at the time of the decedent's death or any basis increase had been allocated to the property.

Joint Ownership of Property

General Rules. In addition to property passing from the decedent, the same holding period rules apply to the entire interest of property held jointly by the decedent and another person. Thus, the surviving joint owner's holding period is considered to have been held for more than 12 months even if it is sold or otherwise disposed of within 12 months after the decedent's death, regardless of when the property was actually acquired by the decedent or other person.

Property Subject to the Modified Carryover Basis Rules. If property was held jointly by the decedent and another person, and the property passed from the decedent to the estate, which was created in 2010 and subject to the modified carryover basis rules, the decedent's holding period applies only to the interest held by the decedent, and not to the other person. However, the decedent's holding period tacks on to the estate's (or other beneficiary's), as discussed above. An exception applies to the decedent's interest in community property if he or she owned at least a one-half interest in the property at the time of his or her death. In that situation, the decedent is also treated as owning the surviving spouse's interest in the property. (See Example 1G-6.) Thus, the surviving spouse's holding period in his or her one-half interest of the community property will include the decedent's holding period.

Life Estates Created by Will

The holding period of real property received by a remainder beneficiary after the death of a life tenant begins when the life tenancy and the remainder interest are created, rather than when the remainder interest ripens into possession. However, if the property is acquired from a decedent who died in 2010 and the decedent's executor elected to use the modified carryover basis rules, the holding period presumably does not begin until the remainder interest ripens into possession. This is because, under former IRC Sec. 1022, a decedent is not treated as owning, at the time of death, property that he or she transferred with a retained beneficial enjoyment.

SELF-STUDY QUIZ

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

3. How is a donee's basis in donated property affected by gift tax?

   a. It will be increased by gift tax due to appreciation.

   b. It can increase more than the gift tax paid.

   c. Any generation-skipping transfer (GST) tax is applied first.

   d. The fair market value (FMV) of the gift cannot exceed the donor's adjusted basis.

4. Under the basis consistency rule, for income tax purposes, the basis of a property cannot exceed the value reported on which of the following?

   a. Form 706.

   b. Form 1041.

   c. Form 1099-DIV.

   d. Form 8949.

5. Which of the following occurs when appreciated property is distributed to satisfy a pecuniary bequest?

   a. The distributee will receive a carryover of basis if the estate did not elect to recognize gain.

   b. The estate recognizes the difference between FMV on the distribution date and FMV on the decedent's date of death.

   c. Basis is determined by adding one-half of the property's original cost basis to one-half of the FMV included in the gross estate.

   d. The entire basis of the property will be stepped up or down to FMV on the date of the decedent's death.

6. Hal inherits property upon his father's death, which is July 31, 2018. He receives the property on August 31, 2018. His tax year ends on December 31, 2018. He files his taxes on March 31, 2019. Hal's holding period on the property will be considered to be more than how long on his 2018 tax return?

   a. Four months.

   b. Five months.

   c. Seven months.

   d. Twelve months.

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.)**

3. How is a donee's basis in donated property affected by gift tax? **(Page 117)**

   a. It will be increased by gift tax due to appreciation. [This answer is correct. The donee's basis in donated property is increased by any gift tax attributable to appreciation in the property's value while held by the donor.]

   b. It can increase more than the gift tax paid. [This answer is incorrect. Any increase related to gift tax cannot be in excess of the tax paid.]

   c. Any generation-skipping transfer (GST) tax is applied first. [This answer is incorrect. According to IRC Sec. 2654(a)(1), if gift tax also applies, the gift tax basis adjustment is applied before the GST tax basis adjustment.]

   d. The fair market value (FMV) of the gift cannot exceed the donor's adjusted basis. [This answer is incorrect. According to IRC Sec. 1015(d)(6), net appreciation in value is the amount by which the FMV of the gift exceeds the donor's adjusted basis immediately before the gift.]

4. Under the basis consistency rule, for income tax purposes, the basis of a property cannot exceed the value reported on which of the following? **(Page 120)**

   a. Form 706. [This answer is correct. According to IRC Sec. 1014(f)(1), under the basis consistency rule, the basis of property for income tax purposes cannot exceed the value (1) as finally determined and reported on Form 706 or (2) identified on a statement furnished under IRC Sec. 6035(a) (for property not included on Form 706).]

   b. Form 1041. [This answer is incorrect. Losses on distributions of property to a beneficiary are reported on Form 1041, among other things; however, this form does not help determine property that must follow the basis consistency rule.]

   c. Form 1099-DIV. [This answer is incorrect. Dividend income and capital gains realized by a mutual fund are reported to shareholders as income on Form 1099-DIV. This form is not used under the basis consistency rule.]

   d. Form 8949. [This answer is incorrect. Form 8949 is used when reporting capital gains and losses, but it is not factored into the basis consistency rule.]

5. Which of the following occurs when appreciated property is distributed to satisfy a pecuniary bequest? **(Page 123)**

   a. The distributee will receive a carryover of basis if the estate did not elect to recognize gain. [This answer is incorrect. If a distribution is *not* in satisfaction of a pecuniary bequest (or other fixed dollar obligation), or the estate does not elect to recognize gain on the distribution under the provisions of IRC Sec. 643(e)(3), the distributee will receive a carryover basis.]

   b. The estate recognizes the difference between FMV on the distribution date and FMV on the decedent's date of death. [This answer is correct. If appreciated property is distributed to satisfy a beneficiary's right to receive a pecuniary bequest of a fixed amount or a specific property, according to Reg. 1.661(a)-2(f), the estate must recognize gain for the difference between FMV on the date of the distribution and the FMV on the date of the decedent's death.]

c. Basis is determined by adding one-half of the property's original cost basis to one-half of the FMV included in the gross estate. [This answer is incorrect. A surviving spouse's basis in *qualified joint interest property* (different from a pecuniary bequest) is determined by adding one-half of the original cost basis of the property to the one-half of the FMV included in the gross estate and subtracting from this sum any deductions for wear and tear previously allowed to the surviving spouse in computing taxable income.]

d. The entire basis of the property will be stepped up or down to FMV on the date of the decedent's death. [This answer is incorrect. Under traditional estate tax rules, if property is community property, the entire basis of the property is stepped up (or down) to FMV on the date of the first spouse to die. However, community property is a different consideration from a pecuniary bequest.]

6. Hal inherits property upon his father's death, which is July 31, 2018. He receives the property on August 31, 2018. His tax year ends on December 31, 2018. He files his taxes on March 31, 2019. Hal's holding period on the property will be considered to be more than how long on his 2018 tax return? **(Page 127)**

a. Four months. [This answer is incorrect. Though he will have actually held the property for four months at the end of the tax year (September through December), the Code specifies a longer holding period for estate property.]

b. Five months. [This answer is incorrect. Though it is five months between Hal's father's death and the date he takes possession of the property, this is not representative of the holding period indicated in IRC Sec. 1223(9).]

c. Seven months. [This answer is incorrect. The date that Hal filed his tax return (seven months after he acquired the property) has no bearing on Hal's holding period.]

d. Twelve months. [This answer is correct. Under the traditional rules, outlined in IRC Sec. 1223(9), when property is acquired from a decedent, the taxpayer acquiring the property is deemed to have held the property for more than one year. This rule allows most capital gains of estates and testamentary trusts to receive the favorable long-term capital gain rate regardless of the length of time the underlying property is actually held by the fiduciary.]

The Determination of Gains and Losses from Mutual Fund Shares

Reporting Shareholder Income

It is common for decedents to own mutual fund shares at the date of death and for trusts and estates to use mutual funds as investment vehicles. This discussion is intended to provide guidance to account for mutual fund distributions, reinvestments, and dispositions. Because mutual fund investments may have undistributed dividend income and capital gains (due to reinvestment by shareholders or gains retained by the fund) reported as current income and gain to shareholders, special calculations are necessary [under IRC Sec. 852(b)] to determine the tax basis of mutual fund shares.

Distributed and Reinvested Income and Gains. Dividend income and capital gains realized by a mutual fund are reported to shareholders as income on Form 1099-DIV. This income is taxable to shareholders regardless of whether the income and gains are received as distributions or reinvested in additional fund shares (or retained by the fund itself). Dividends declared and payable to mutual fund shareholders of record on a date in the calendar year fourth quarter and actually paid by January 31 of the following year are taxable in the year *declared*. Thus, practitioners may encounter fiduciaries who think there is a discrepancy between the Form 1099-DIV and the actual amount of dividends taxable for a year.

Retained Long-term Gains. In some cases, the mutual fund will retain realized long-term capital gains and must pay a fund-level income tax. The fund will then send a Form 2439 (Notice to Shareholder of Undistributed Long-Term Capital Gains) to each shareholder. Form 2439 reports the shareholder's portion of both the retained gains and the fund-level income tax paid on those gains. Each shareholder must report his share of the retained gain on his tax return. However, the shareholder is also entitled to a credit on his return for his share of the income tax paid by the fund. On Form 1041, the credit is reported in the "Tax and Payments" section of page 1. The basis of fund shares is increased by the gain reported on Form 2439 and reduced by the share of fund-level income tax credited to the shareholder. Retained long-term capital gains do not result in the acquisition of additional shares. (See Example 1I-2 in this lesson.)

Tax-exempt Income. Mutual fund income from tax-exempt interest paid must be reported to shareholders in box 8 of Form 1099-INT. When an estate or trust earns tax-exempt income, the fiduciary must check a box and enter the amount on page 2 of Form 1041. Some or all of the tax-exempt interest may be an alternative minimum tax (AMT) preference item. The tax-exempt income may result in some of the taxpayer's expenses associated with carrying the mutual fund shares being disallowed.

Return of Capital (Nontaxable) Distributions. A distribution that is not made from earnings and profits is a return of the shareholder's investment, or capital, in the mutual fund and is shown in box 3 of Form 1099-DIV. These return of capital distributions are generally not taxed; however, they reduce the shareholder's basis in the shares. To the extent a distribution exceeds the shareholder's basis in the funds, the excess is a short- or long-term taxable capital gain reportable on Form 8949.

Determining Basis in Mutual Fund Shares

Investors in mutual funds may reinvest dividends and capital gains so they have current income without actually receiving any distributions or, in some cases, a fund may retain realized capital gains. In these situations, special calculations are necessary to determine the tax basis of the mutual fund shares.

When mutual funds are sold, exchanged, or redeemed, their basis must be determined. Except for shares owned at death that are subject to the step-up in basis rules of IRC Sec. 1014, the original cost of the shares is the starting point in determining basis. Original cost is then increased or decreased for the following items.

1. *Additions to Basis* (because of reinvestment of income and gains resulting in additional fund shares or because of retention of long-term gains by the fund):

   a. Reinvested dividends (included in income reported on Form 1099-DIV).

   b. Reinvested capital gains (included in income reported on Form 1099-DIV).

c. Reinvested tax-exempt dividends (reported on information statements issued by the fund).

d. Undistributed long-term capital gains (reported as income on Form 2439).

2. *Reductions of Basis:*

a. Distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV).

b. Fund-level income tax paid on retained long-term capital gains (reported on Form 2439).

For decedents owning mutual fund shares at the time of death, the starting point is generally the FMV at the date of death or alternate valuation date. For estates created in 2010 that elected to use the modified carryover basis rules, the starting point is the decedent's carryover basis plus any basis increases allocated by the executor. Thereafter, the same adjustments discussed previously should apply to determine basis for a subsequent disposition.

A special rule applies to mutual fund load charges if (1) the load charges are incurred in a transaction in which the taxpayer acquires fund shares and a reinvestment right, (2) such shares are disposed of within 90 days, and (3) the taxpayer subsequently buys other mutual fund shares with a reduced load charge due to the reinvestment right. To the extent the load charge is reduced in the second transaction, the taxpayer cannot consider the original load charge in determining gain or loss in the disposition of the original mutual fund shares (it is considered in the second transaction instead). A reinvestment right is the right to acquire stock in a mutual fund without paying a load charge or with the payment of a reduced charge. This rule prevents taxpayers from claiming a quick loss equal to the load charge on the original shares simply by switching to another fund in the same family.

Example 1I-1 Calculating basis when dividends are reinvested.

The Robert T. Jones Children's Trust purchased 100 shares of Whammo Growth Fund, a mutual fund, for $2,000 in February 2015. In addition, the trust incurred $100 of commission costs. Its beginning cost basis in the mutual fund is thus $2,100, or $21 per share. In January 2016, the trust received a 2015 Form 1099-DIV reflecting a $150 dividend from September 2015, which it had reinvested in Whammo. In January 2017, the trust received a 2016 Form 1099-DIV reflecting a $300 capital gain and a $100 dividend (paid in July 2016), both of which had been reinvested in the fund. The trust sold all of its shares on May 1, 2017 for $3,100 prior to the record date for any 2017 dividends.

The trust's basis in Whammo is determined as follows:

Original cost (including commissions)	$ 2,100
2015 dividend (reinvested in Whammo)	150
2016 capital gain (reinvested in Whammo)	300
2016 dividend (reinvested in Whammo)	100
Total tax basis	$ 2,650

Therefore, the Trust reports a capital gain of $450 ($3,100−$2,650) on its 2017 return [Schedule D (Form 1041) via Form 8949]. The gain associated with the shares acquired (from the reinvested income) on or after May 1, 2016, is short-term; the remainder of the gain is long-term.

Example 1I-2 Long-term gain retained by the fund.

In late 2016, the Ralph Stodgie Testamentary Trust bought 100 shares of Safety First Capital Appreciation Fund for $6,000. In 2017, Safety First realized significant long-term capital gains that were retained by the fund. As a result, the fund paid income tax for 2017 on the retained gains. In early 2018, the trust received a 2017 Form 2439 from Safety First. It showed the trust's share of retained 2017 long-term capital gains was $3,000, and its share of fund-level income tax paid was $1,050.

The trust must report the $3,000 retained long-term capital gain on Form 8949, which is then included on Schedule D (Form 1041). It also receives a tax credit of $1,050 that is reported on the "Form 2439" line in the

"Tax and Payments" section of page 1 of Form 1041. To substantiate this credit, Copy B of the Form 2439 received from the fund must be attached to the trust's return. The trust's basis in its Safety First shares is increased by the $3,000 retained gain and decreased by the $1,050 of taxes paid by the fund on its behalf.

Three methods exist for determining the basis of mutual fund shares when taxpayers sell less than their entire holdings in a particular fund: (1) the first-in, first-out (FIFO) method, (2) the average basis method, and (3) the specific identification method.

For mutual fund shares acquired or transferred after December 31, 2011 (covered securities), every broker that is required to file an information return reporting the gross proceeds of a mutual fund share sale must include in the return the customer's adjusted basis in the fund shares and whether any gain or loss with respect to the fund share's sale is short-term or long-term. The broker can choose its default method (average basis, FIFO, or specific identification) for identifying shares sold. This default method is used unless the taxpayer notifies the broker and properly elects another permissible method. Taxpayers must report gain or loss using the broker's default method unless they properly elect another method.

FIFO Method. The *first-in, first-out (FIFO)* method is used if the taxpayer does not elect the average basis method or does not use the specific identification method.

Example 1I-3 FIFO basis computation.

The Joe Jones Children's Trust purchased 100 shares of No Limit Growth Fund, a mutual fund, for $10 per share, or $1,000, on February 1, 2011. On March 1, 2011, a $55 dividend was declared. The trust had designated all dividends to be reinvested, and this $55 dividend resulted in a purchase of five additional shares. On February 1, 2017, it purchased an additional 100 shares for $12 per share. On December 1, 2017, the trust sold 125 shares for $15 per share.

To compute the trust's basis in the shares sold using the FIFO method, its transactions are summarized as follows:

Transactions	No. of Shares	Total Basis	Basis per Share
2/1/11, 100 shares—original purchase	100	$ 1,000	$ 10
3/1/11, 5 shares—dividend reinvestment	5	55	11
2/1/17, 100 shares—second purchase	100	1,200	12
Total Basis		$ 2,255	
FIFO basis of 125 shares sold:			
100 shares bought 2/1/11 (100 × $10)		$ 1,000	
5 shares bought 3/1/11 (5 × $11)		55	
20 shares bought 2/1/17 (20 × $12)		240	
Total FIFO basis of 125 shares sold		$ 1,295	

The trust has 80 shares remaining from its February 1, 2017 block. These shares have a basis of $12 each. On its 2017 return, the trust will report a long-term gain of $520 ($1,575 proceeds − $1,055 basis) on the 105 shares acquired in 2011 and a short-term gain of $60 ($300 proceeds − $240 basis) on the 20 shares acquired on February 1, 2017.

Average Basis Method. The *average basis method* of calculating mutual fund share basis can be used if the shares are in an account handled by a custodian or agent who acquires or redeems shares. In general, average basis is determined by averaging the basis of all identical shares in an account regardless of holding period. The basis of each share of identical stock in the account is the total basis of all shares of that stock in the account divided by the total number of shares. Generally, an identical share means shares with the same Committee on Uniform Security Identification Procedures (CUSIP) number. The FIFO method is used to determine the holding period of the shares.

For sales of mutual fund shares acquired before 2012 (noncovered securities), the election to use the average basis method is made by indicating on the tax return for the year the election is first effective.

For sales of mutual fund shares acquired after 2011 (covered securities), the election to use the average basis method is made by notifying the custodian or agent in writing by any reasonable means including electronic format. The election can be made at any time and takes effect for sales that occur after the election is made.

Beginning in 2012, taxpayers who elect to average the basis of mutual fund shares will compute separate averages for fund shares held in different accounts. They will also be able to choose to average the basis of mutual fund shares in one account, but not average them in another account.

Mutual fund shares acquired before 2012 (noncovered securities) are treated as being held in a separate account from shares that are covered securities (acquired after 2011). However, an election can be made to treat all identical shares of stock as held in a single account. The single-account election is irrevocable but is void if the average basis election is revoked.

Example 1I-4 Average basis method.

Assume the same facts as in Example 1I-3, except the trust uses the average basis method. Although the shares are held in the same account, the 105 shares acquired in 2011 are treated as though they are held in a separate account from the 100 shares acquired in 2017. Thus, the average of the share basis for those acquired in 2011 must be made separately from the shares acquired in 2017. The average cost per share acquired in 2011 is $10.05 ($1,055/105 shares), and the average cost per share acquired in 2017 is $12 ($1,200/100 shares).

Using the FIFO method to determine holding periods for the 125 shares sold, 100 shares were acquired on February 1, 2011, five shares on March 1, 2011, and 20 shares on February 1, 2017. On its 2017 return, the trust will report a long-term gain of $520 (105 shares with a cost of $10.05 per share, sold for $15 per share), and a short-term gain of $60 (20 shares with a cost of $12 per share, sold for $15 per share).

The election to use the average basis method can be revoked by the date of the first sale or other disposition of the shares after the election (or by one year from the date of making the election, if earlier). After the election is revoked, the taxpayer's share basis is the basis before averaging.

A change from the average basis method to another permissible method must be made on a prospective basis. There is no limit on the number of times or frequency taxpayers can change their basis determination method. After a change, however, the taxpayer's share basis remains the same as the basis immediately before the change.

Specific Identification Method. Specific identification allows the fiduciary to sell the shares purchased in a particular transaction. Some mutual funds will not allow use of the specific identification method because of the required recordkeeping. The investor can usually determine if specific identification is allowed by calling the fund's toll free number. Often, the taxpayer will not hold stock or mutual fund shares in certificate form; instead, the shares will be held in "street name" by the broker. The IRS has long argued that the specific identification method works only if the taxpayer actually holds the share certificates and delivers them to be sold. However, the Tax Court held in *Hall* that even if the taxpayer sells mutual fund shares held in street name by the broker, the use of the specific identification method (to identify the particular shares sold) is possible if—

1. the taxpayer designates to the broker or transfer agent the specific shares to be sold by reference to the date of purchase and the cost, and

2. the broker or transfer agent sends the taxpayer a written confirmation of these instructions within a reasonable time.

Transition Rule from the Double-category Method. If the taxpayer uses the double-category method under former Reg. 1.1012-1(e)(3) for shares acquired before and sold after April 1, 2011, the average basis of these shares is calculated by averaging together all identical shares in the account on April 1, 2011, regardless of holding period.

Wash Sales. Mutual fund shares are subject to the wash sale rules of IRC Sec. 1091. A wash sale occurs when shares are sold at a loss within 30 days before or after a taxpayer acquires substantially identical securities. The wash sale loss is disallowed, and the disallowed loss is added to the basis of the substantially identical shares. In the context of mutual fund shares, clients are often unaware that transferring from one mutual fund to another is a sale. When the client has authorized dividends to be reinvested, a wash sale is quite likely to occur unless the client has moved completely out of the mutual fund in question (because the reinvested dividends from the remaining interest in the fund will cause additional shares to be acquired—sometimes as often as monthly). The wash sale rules do not apply if the sale produces a gain.

If the taxpayer is using the single-category average cost method, the basis adjustment is spread among all of the remaining shares. If the double-category method is used, a wash sale of stock held in the short-term category results in an increase in the aggregate basis of all shares remaining in the short-term category.

Special Rules for Certain Short-term Losses. If an estate or trust receives, or was considered to have received, a capital gain distribution (i.e., long-term capital gain) on mutual fund shares it held for six months or less and sold at a loss, only the loss in excess of the capital gain distribution is treated as a short-term loss. Any part of the loss that is not more than the capital gain distribution is reported as a long-term capital loss.

If an estate or trust receives tax-exempt interest on mutual fund shares it held for six months or less and sold at a loss, only the part of the loss in excess of the tax-exempt interest can be claimed as a short-term loss. Any loss to the extent of the tax-exempt interest received is disallowed.

The Sale or Exchange of Property between Related Parties

Losses on sales or exchanges of property, directly or indirectly between related parties, are disallowed. The purpose of the loss-disallowance rules is to prevent taxpayers from manipulating recognition of losses for tax purposes when an economic loss has not actually been realized. [The one exception to the rules applies to complete corporate liquidations.] The disallowance rules apply to any sale or exchange, even if the sale is bona fide and the terms are determined on a fair market basis. These rules have also been applied to involuntary sales. Nonrecognition on related-party sales does not extend to gains.

Related parties, for the loss-disallowance rules, include the following relationships (among others):

1. A grantor and a fiduciary of any trust.
2. A fiduciary of a trust and a beneficiary of such trust.
3. A fiduciary of a trust and a fiduciary of another trust, if the same person is grantor of both trusts.
4. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts.
5. A corporation and the fiduciary of a trust, if more than 50% of the stock of the corporation is owned (directly or indirectly, as discussed below) by the trust or grantor of the trust.
6. An estate and its beneficiaries, except for a sale or exchange in satisfaction of a pecuniary bequest.

Indirect ownership of stock occurs when an individual is deemed to own stock actually owned by another person. Stock owned by one person is deemed to be owned by another in the following situations:

1. Shareholders, partners, or beneficiaries are deemed to own their proportionate share of stock owned (directly or indirectly) by their corporation, partnership, estate, or trust.
2. An individual is considered to own the stock owned by family members (brothers, sisters, spouse, ancestors, and lineal descendants).
3. An individual who is a member of a partnership will be deemed to own corporate stock owned (directly or indirectly) by another partner in the same partnership, but only if the individual also directly owns stock in the same corporation.

Example 1J-1 Attribution rules do not apply in reverse.

The Robert Smith Testamentary Trust owns 25% of the outstanding stock of Essco, Inc. Bobby Smith, Jr. and his sister, Jane, the beneficiaries of the trust, each own 25% of the stock. The remaining 25% is owned by an unrelated person. In the current year, the trust sold a parcel of land to Essco for its fair market value (FMV) of $62,000; its basis in the land was $70,000. The trust thus realized a loss of $8,000.

No deduction is allowed for a loss on the sale between a trust and a corporation if the trust directly or indirectly owns more than 50% of the corporate stock. Therefore, the issue in this example is whether the trust owns, under the attribution rules, more than 50% of the stock.

Based on IRC Sec. 267(c)(1), stock owned directly or indirectly by a trust is treated as owned by its beneficiaries. However, there is no reverse attribution from the beneficiaries to trusts (i.e., that treat stock owned by beneficiaries as owned by the trust). Therefore, the attribution rules do not cause the trust to indirectly own more than 50% of the stock, and the loss will be reported on the trust's Form 8949 and Schedule D (Form 1041).

Nonaggregation of Gains and Losses

If several properties are sold in one transaction to a related party, gain or loss must be computed separately for each item. Gains on some items cannot offset the losses on other items. As a result, the gains are recognized and the losses are disallowed even if the items are sold at the same time. Case law has strongly established this nonaggregation position, which prevents the circumvention of the loss-disallowance rules through combinations of sales.

Subsequent Sale after Disallowed Loss

A disallowed loss may reduce the related buyer's gain on a subsequent sale. However, if the related buyer subsequently sells the property for a loss, the loss disallowed on the original sale to the related party is never recognized.

Example 1J-2 Gain on subsequent sale by related party.

Several years ago, Ben sold an asset to the Ben Wheeler Family Trust, of which he was the grantor, resulting in a realized, yet unrecognized, loss of $10,000 to Ben. In the current year, the trust sold the asset for a $15,000 profit (its basis was its purchase price when it bought the asset from Ben).

The trust recognizes a gain of $5,000 from the sale, which is the $15,000 realized gain reduced by the $10,000 loss to Ben disallowed in an earlier year under IRC Sec. 267. To report $5,000 rather than $15,000 of gain, the trust presumably increases its original basis on Form 4797 or enters a negative adjustment on Form 8949, Part II, line 1, column (g) for the $10,000 previously disallowed loss to Ben with an "O" in column (f).

Related Party Sales of Depreciable Property

If the property sold or exchanged between related parties is depreciable by the buyer (regardless of whether the property was depreciable by the seller), any gain recognized on the sale or exchange must be treated as ordinary income. If a sale or exchange includes depreciable and nondepreciable property, any gain is allocated between the properties, and only the gain allocable to the depreciable property is subject to the ordinary income rule. Related parties include a taxpayer and any trust in which the taxpayer or spouse is a beneficiary. Related parties also include an estate and its beneficiaries except for a sale or exchange in satisfaction of a pecuniary bequest.

Example 1J-3 Gain on sale of depreciable property between related parties.

Bill Smith is a current income beneficiary of the James B. Smith Testamentary Trust. In January of the current year, the trust sold Bill land and a building it had acquired and held for speculative purposes in October 1995. The trust realized a $7,000 gain on the sale, with $5,000 allocated to the land and $2,000 allocated to the building. Bill intends to hold the property for rental purposes.

The $5,000 gain allocated to the land is treated as a long-term capital gain, reported on Form 8949 and Schedule D (Form 1041), and the $2,000 gain allocated to the building is ordinary income reported in Part II of Form 4797 because it is depreciable property in Bill's hands. If the sale had not been to a related party, the entire gain would have been reported on Form 8949 and Schedule D.

Installment Sales between Related Parties

In addition to having potential capital gains converted into ordinary income, sales of depreciable property between related persons may not be deferred using the installment method. The entire amount of the installment note is deemed to be received in the year of the sale (unless part or all of the payments are contingent amounts and their FMV cannot be reasonably ascertained). Further, the purchaser cannot increase the basis of the property until the income has been reported by the seller.

An exception to the gain recognition requirement allows installment reporting if the taxpayer can demonstrate that a principal purpose of the transaction was not the avoidance of federal income taxes. Lack of a significant tax deferral can establish that tax avoidance was not the principal purpose of the transaction.

If an installment sale between related parties involves both depreciable and nondepreciable property, the gain must be allocated between the two types of property, as discussed in Example 1J-3. The installment method may be used on the nondepreciable property.

Example 1J-4 Installment sale of depreciable property between related parties.

The Mark S. Willibe Testamentary Trust owns an office building and land used for rental purposes. The trust sold the land and building to David Willibe, a beneficiary of the trust, in 2017 for $190,000. The trust received $40,000 in cash in 2017 and a three-year, interest-bearing note. The land and building were individually appraised at $30,000 and $160,000, respectively. The adjusted basis at the time of the sale was $15,000 for the land and $75,000 for the building.

The total gain realized from the sale of the land and building is $100,000 [$190,000 − ($15,000 + $75,000)]. Normally, the trust could treat the sale as an installment sale and report the gain as the cash proceeds are received. However, since the sale was to a related person and involved depreciable property, the installment method cannot be used to report the gain attributable to the sale of the building. Therefore, the entire $85,000 ($160,000 less $75,000) gain attributable to the sale of the building is recognized as ordinary income in 2017. The trust would report this gain on Part II of Form 4797 (Sales of Business Property).

In addition, the trust is required to recognize a portion of the gain attributable to the sale of the land. Since the land is nondepreciable property, the installment method is used (unless the trustee elects not to use installment reporting). The gain realized on the sale of the land is $15,000 ($30,000 less $15,000). Therefore 50% (the gross profit percentage) of the proceeds attributable to the land will be included in gross income of the trust each year as the proceeds are received.

The proceeds received during the year are allocated between the sale of the land and the building based on their relative fair market values (FMVs). Thus, $6,316 [$40,000 × ($30,000 ÷ $190,000)] of the proceeds received during 2017 is allocated to the sale of the land. Of this amount, $3,158 (50% gross profit percentage) is recognized as income by the trust. The gain attributable to the land is reported on Form 6252 (Installment Sale Income). This amount is then posted to Part I of Form 4797 (Sales of Business Property). The trust is required to file Form 6252 for 2017 and for each year proceeds from the installment note are received.

The trust's total gain recognized during 2017 is as follows:

Gain on building	$ 85,000
Gain on land (installment basis)	3,158
Total gain recognized	$ 88,158

IRS Scrutiny of Related-party Transactions

Because they are not conducted at arm's length, transactions between related parties often come under close scrutiny by the IRS. If the amounts involved in the transaction do not represent fair market values, the IRS can change the characteristics of the transaction to reflect its actual nature. According to IRC Sec. 482, the IRS can allocate gross income, deductions, credits or allowances between organizations, trades, or businesses directly or indirectly controlled by the same interests. Further, the IRS can recharacterize a transaction in accordance with its substance, regardless of its form.

Example 1J-5 IRS can reclassify related-party transaction.

Jake is a beneficiary of the Smith Family Trust. Jake sells property with a FMV of $250,000 to the trust for $300,000 (e.g., to convert ordinary income into a capital gain). The IRS can reclassify the transaction to show the property was purchased by the trust for its FMV, $250,000. The trust's basis for depreciation and Jake's sales price for gain or loss purposes becomes $250,000. The additional $50,000 Jake receives from the trust would then be recharacterized by the IRS as a distribution to Jake.

Related-party Exchanges

A special rule applies for like-kind exchanges between related persons. For this purpose, related persons include basically the same parties as described at the beginning of this discussion.

If a taxpayer exchanges like-kind property with a related person and either of them disposes of the property received in the exchange within two years after the date of the last transfer that was part of the exchange, gain or loss is recognized on the original exchange (i.e., IRC Sec. 1031 will not apply). However, any gain or loss recognized as a result of this rule is taken into account in the tax year of the disqualifying disposition, rather than in the year of the original exchange.

Several important exceptions apply to this rule. A disposition during the two-year period will not trigger recognition of gain or loss if it is—

1. after the death of the taxpayer or the related person;
2. in a compulsory or involuntary conversion, as long as the exchange occurred before the threat or imminence of the conversion; or
3. established to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes.

Example 1J-6 Related-party exchange.

Max owns a parcel of real estate with a basis of $20,000 and a FMV of $50,000. He is the beneficiary of the Joe Factor Testamentary Trust that owns a similar parcel with a basis of $40,000 and a FMV of $50,000. Max and the trust exchange properties. After the exchange, Max's basis in his new property is $20,000 and the trust's basis is $40,000.

If the trust sells its property one year after the exchange, IRC Sec. 1031 no longer applies. As of the date of the sale, both the trust and Max must recognize gain. Each party's gain is the excess of FMV of the asset received ($50,000 for both Max and the trust) over the adjusted basis of the asset surrendered in the original exchange ($20,000 for Max and $40,000 for the trust). Thus, Max would recognize a gain of $30,000, and the trust would recognize a gain of $10,000. Rather than amending each tax return that reported the original exchange, each taxpayer reports the gain in the year the trust sold the property. The new basis for each party would be $50,000.

Transactions Involving a Personal Residence

$250,000 Gain Exclusion for Sale of a Personal Residence

For sales of personal residences by individuals, a $250,000 exclusion of gain ($500,000 if married and filing jointly) is available every two years if certain ownership and holding period rules are met. When the sale of a personal residence is completed and the proceeds are collected before the death of a taxpayer, the exclusion is claimed on the decedent's final Form 1040. Property owned by estates and irrevocable trusts will generally not qualify for exclusion of gains on the sale of a personal residence. However, property transferred to a revocable (grantor) trust is eligible for the exclusion of gain. Personal residence trusts and qualified personal residence trusts (discussed later in this lesson) are not revocable trusts and thus, do not qualify for the exclusion.

Estates created in 2010 for which the executor elected the modified carryover basis rules are also eligible for the gain exclusion. This applies to property sales by the decedent's estate, a trust that immediately before death was a qualified revocable trust [as defined under IRC Sec. 645(b)(1)], or any individual who inherited the property. To qualify for the exclusion, the decedent must have used the property as a principal residence for two or more years during the five-year period prior to the sale. Up to $250,000 gain can be excluded, regardless of whether the estate's (or other recipient's) basis in the property has been increased by the $1.3 million aggregate or $3 million spousal property basis increase.

The Section 121 gain exclusion is also available to a beneficiary (other than the grantor) who is treated as the owner of a portion of a trust because he has the power (exercisable solely by himself) to vest principal (the home) in himself or has partially released such a power. Without this power, the beneficiary is not considered the owner of the residence for income tax purposes. A beneficiary with the noncumulative right to annually withdraw the greater of $5,000 or 5% of a trust assets' value (which included a personal residence's value) was treated as the owner of the prorata share of the residence that was subject to the unexercised and released powers.

Loss on the Sale of a Personal Residence

A capital loss on the sale of a decedent's personal residence (for example, due to selling costs or a market decline below the date of death tax basis) should be deductible as a loss on the sale of a capital asset by the estate on Form 1041 subject to the usual capital loss limitation rules as long as the residence is no longer used as a personal residence by a beneficiary after the decedent's death. Also, a loss on the sale of a residence after an immediate attempt to sell the residence of the decedent upon the decedent's death is deductible. (It may be preferable to deduct selling expenses that are administration expenses on Form 706 rather than on Form 1041.)

A loss on the sale is allowable if the former residence is converted to income-producing property status (i.e., rental or business property) sufficiently prior to its sale. However, in a Service Center Advice, the IRS held that the estate's mere holding of the property for sale, in the normal course of distributing its assets, is not enough to be considered a "transaction entered into for profit." This position seems to be contrary to the Schedule D (Form 1041) instructions, which indicate that each item of property held by an estate or trust is a capital asset except for the specific items listed in the instructions. The listed assets comprise items classified as business, rather than capital, assets in the hands of the fiduciary. None of the assets listed include items classified as personal assets, presumably because a fiduciary, by definition, can hold no such assets.

Additionally, there is some authority for an estate or trust to recognize a loss on property that would have been a nondeductible personal loss if the loss had been realized by an individual grantor or by a decedent prior to death. The character of a particular asset (personal, investment, or business) is determined by looking to the nature of the entity owning that asset. There have been cases concluding that if inherited property is not used for personal purposes or intended to be used for such purposes, but is put up for sale, any loss on the sale is deductible. Such property is considered as acquired in a transaction entered into for profit by the estate or heir.

While a Chief Counsel memorandum is not authoritative as to the application of a tax ruling, it does provide insight as to the IRS's position. Given this internal position of the IRS, practitioners should be aware of possible scrutiny by the IRS on this issue in more recent instances.

If the loss is deductible (because the property is not considered personal), the entire loss should be reported on Form 1041. According to SCA 1998-012, if property sold was left by will to a named person or persons and was sold

to satisfy the estate's obligations, only the portion of the loss associated with the sales proceeds used to satisfy the estate's obligations is reported on Form 1041. The balance of the loss is reported by the devisees.

Selling Expenses on the Sale of a Personal Residence

Often an estate will incur selling expenses related to the sale of a decedent's personal residence. When such selling expenses qualify as estate administration expenses under IRC Sec. 2053 or 2054, they can be deducted on Form 706 unless the executor elects to deduct them on Form 1041. Expenses of selling estate property are included in administration expenses if the sale is necessary to pay the decedent's debts, expenses of administration, or taxes; to preserve the estate; or to distribute the assets. To deduct administration expenses on Form 1041, executors must elect to waive the right to deduct such expenses on Form 706. If the waiver is properly made, the selling expenses are reported as an adjustment to the gain or loss on Form 8949, Part I or II, column (g), with the appropriate adjustment code entered in column (f).

If the selling expenses do not qualify as administration expenses under IRC Sec. 2053 or 2045, they cannot be deducted on Form 706. Instead, they are deducted on Form 8949 or Schedule D (Form 1041) as an adjustment to the gain or loss.

Example 1K-1 Selling expenses cause loss on sale of personal residence.

In November of the current year, the Estate of Jon White, which was created in the prior year, sold Jon's personal residence for $100,000. The estate's basis in the residence was $97,000 (the FMV on date of death), and selling expenses were $7,500. The sale was necessary to distribute the assets to the beneficiaries, and thus, the selling expenses qualify as estate administration expenses.

Because the estate was not subject to federal estate tax, the executor elected to waive the right to deduct the expenses on Form 706. The selling expenses are included in Part II of Form 8949, column (g) as a reduction of the gain on the sale of the residence, resulting in a $4,500 capital loss.

Personal Residence Trusts

IRC Sec. 677 applies to personal residence trusts, causing them to be grantor trusts for income tax purposes. Grantor trusts are not taxed according to the general rules for the income taxation of trusts and estates contained in Subchapter J.

There are several income tax benefits from the grantor being treated as the owner of the entire trust. Transactions between the trust and the grantor are disregarded. For example, a grantor can transfer a home with mortgage debt in excess of basis to the trust without triggering gain. Also, income tax deductions for interest and property taxes are available to the grantor. An in-depth discussion of personal residence trusts is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

Redeeming Stock to Pay Estate Taxes

A shareholder can treat a distribution of cash or property in partial or complete redemption of stock as an exchange if the stock's value has been included in the gross estate for determining the federal estate tax of a decedent. The intent is to allow the funds of a corporation to be used to pay death taxes and administration expenses, without incurring dividend treatment upon the extraction of the funds from the corporation. If the criteria of IRC Sec. 303 are met, there generally will be little or no gain upon the redemption due to the stepped-up tax basis of the stock included in the decedent's taxable estate.

Qualification for Section 303 Redemption

To qualify the redemption for exchange treatment under IRC Sec. 303, the following criteria must be met:

1. Section 303 treatment is limited to the amount of estate and inheritance taxes imposed as a result of the decedent's death plus the amount of funeral and administration expenses associated with the estate. The

redemption must occur after the decedent's death and before 90 days after the statute of limitations expires for assessment of the federal estate tax, subject to an extension of this period for redetermination of the estate tax via a Tax Court matter or, if so elected, within the time determined under IRC Sec. 6166 to use an installment payment of estate tax.

2. The value of the corporate stock included in the decedent's estate must exceed 35% of the adjusted gross estate; if the decedent owned stock in two or more corporations, the stock is treated as that of a single corporation for purposes of this test if 20% or more in value of the outstanding stock of each corporation is included in the value of the decedent's gross estate.

3. The redemption qualifies only to the extent that the interest of the shareholder has been reduced directly by estate taxes or funeral and administration expenses. In other words, the shareholder whose stock is redeemed must actually bear the burden of such expenses in an amount at least equal to the redemption proceeds.

Unintended Dividend Treatment

The third criteria in the prior paragraph is particularly critical if a Section 303 redemption is to be made from a beneficiary of the estate, rather than directly from the estate, since the party whose shares are redeemed must have the liability for estate taxes and funeral and administration expenses. For example, if a decedent's estate incurs taxes and administration expenses and a redemption of stock is subsequently transacted with the surviving spouse, it is possible that, due to the unlimited marital deduction and the provisions of the decedent's will, the surviving spouse's share of the estate incurred no charges for tax or administration expenses, and accordingly, would be ineligible for Section 303 treatment. Such a redemption could result in taxable dividend treatment (assuming the existence of underlying corporate earnings and profits) since the surviving spouse's interest was not directly reduced by taxes or qualifying expenses.

Sales of Property and the Effect of the IRD Rules

When an individual dies, his or her property is normally included in the gross estate at fair market value (FMV) at the date of death or alternate valuation date. When such property is sold by the estate or successor, any gain is measured by the excess of the sales proceeds over the estate tax value (i.e., FMV as of the date of death or alternate valuation date). However, assets acquired from a decedent who died in 2010 are subject to the modified carryover basis rules of former IRC Sec. 1022, rather than the stepped-up (or stepped-down) basis rules of IRC Sec. 1014, if the executor elected out of federal estate taxes. In that case, the gain recognizable by the estate or successor upon the sale of the property will be the excess of the sales proceeds over the modified carryover basis (i.e., the decedent's basis plus the amount of the basis increase, if any, allocated by the executor).

If the decedent entered into a sales agreement prior to death but died before the sale is closed, proper tax treatment depends on whether the decedent had substantially fulfilled the prerequisites to consummating the sale.

If the decedent had entered into a legally binding contract and fulfilled all substantial prerequisites, the asset actually owned at the time of death is a claim to the proceeds of the sale, and the gain will be income in respect of a decedent (IRD) upon receipt of the proceeds. The significance of IRD characterization is twofold:

1. The property is not eligible for either the traditional step-up in basis to FMV under IRC Sec. 1014 as of the decedent's date of death or the basis increase under the modified carryover basis rules of former IRC Sec. 1022 (for estates created in 2010 that elected the modified carryover basis rules instead of federal estate tax). In either situation, this will cause the gain to be measured using the decedent's basis prior to death.

2. To the extent estate tax is attributable to the inclusion of the IRD claim in the gross estate, an income tax deduction is allowed for the estate tax in the year the IRD is included in taxable income.

When inherited S corporation shares are sold, exchanged, or otherwise disposed of, the tax basis of the shares is reduced by the amount to which the value of the stock is attributable to IRD items.

IRD and the Maximum Tax on Capital Gains

When IRD consists of long-term capital gains or qualified dividends, resulting in a preferential capital gain rate (e.g., 15%, 20%, 25%, or 28% in 2017), and a Section 691(c) deduction is available for the estate tax attributable to that IRD, the amount of gain subject to tax is reduced (but not below zero) by the amount of any deduction for estate tax attributable to the gain. Rather than allowing the Section 691(c) deduction at ordinary (i.e., higher) tax rates, the Section 691(c) deduction reduces IRD taxed at preferential capital gain rates first. This prevents the estate or trust (or heirs) from receiving the double benefit of a lower capital gains rate on the IRD and the ordinary income (i.e., higher tax rate) deduction allowed for estate tax attributable to that IRD. No adjustment is necessary if all of the trust's income will be taxed at ordinary rates.

Example 1M-1 Capital gains tax rate applies to IRD reduced by estate tax deduction.

In the current year, the Bert Jones Estate earned $15,000 of taxable interest income and realized $5,000 of long-term capital gain from an installment sale when the final payment was collected on March 31 of that year. The gain is IRD, and the estate is entitled to an income tax deduction for federal estate tax paid on the gain in the amount of $2,000.

The net taxable gain reported in Part II, Schedule D, is $3,000 ($5,000 − $2,000). The Schedule D instructions require the gain to be reduced by the $2,000 deduction for estate tax paid. Therefore, the capital gain tax is to be computed on $3,000 and the remaining $14,400 of taxable income ($15,000 less $600 exemption) is taxed at the regular rates. In the "Tax Computation" section (Schedule G) of page 2 of Form 1041, the tax computed on Schedule D is posted to line 1a. In addition, the estate will be subject to the 3.8% net investment income tax (NIIT) on its undistributed net investment income.

The same rule applies to qualified dividends received as IRD, i.e., the qualified dividends are reduced by the Section 691(c) deduction. 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.

IRD and the Capital Loss Deduction

Similar to the reduction of capital gains subject to a preferential tax rate, the $3,000 capital loss limitation must also be computed with capital gains being reduced by the deduction for estate tax paid.

Example 1M-2 Capital loss limitation computed after deduction for estate tax paid.

Assume the same facts as in Example 1M-1, except the estate also sustained a $9,000 capital loss.

The $2,000 deduction for estate tax paid reduces the $5,000 capital gain before gains and losses offset. The $2,000 deduction first reduces the $5,000 gain, and the net gain of $3,000 is offset against the $9,000 capital loss. The resulting $6,000 net capital loss is limited to $3,000 for the year.

Interest income accrued but unpaid on the date of death is usually income in respect of a decedent, but there are exceptions to the general rule.

Example 1M-3 Sale of series EE savings bonds by an estate.

Paula Nizar died on June 23 of the current year, owning $30,000 (face value) of unmatured Series EE bonds. On the date of her death, the redemption price of the bonds (purchase price of $15,000 plus accrued interest) was determined to be $28,000 using Treasury Form FS-3600. Paula had never elected to include in her gross income for any taxable year the ratable portion of the excess of the redemption price ($30,000) over the purchase price ($15,000) of the zero coupon savings bonds (or any other such bonds).

Income tax planning considerations on her final Form 1040 indicated that it would be beneficial to the estate and her beneficiaries to increase the gross income on her final return. Accordingly, the executor made a Section 454 election, increasing the gross income on the final return by $13,000 ($28,000 less $15,000; in the year of election, the taxpayer must report the cumulative increase in redemption price from the date of

acquisition). Recognizing the $13,000 of interest income on the final Form 1040 increased the estate's basis of the bonds to $28,000 ($15,000 originally paid plus $13,000 of interest included in gross income but uncollected).

Once the bonds matured, the estate redeemed them for $30,000 on the redemption date and reported the additional $2,000 of interest income ($30,000 proceeds less $28,000 basis) in the estate's income tax return for the redemption year. The $2,000 is not IRD to the estate since it accrued after the date of death.

Variation: If the Section 454 election had not been made on the final return, the $13,000 accrued but unpaid interest as of the date of death would have been IRD to the estate when the estate collected the proceeds upon redemption. If the bonds in question had been U.S. Treasury Bonds, any accrued but unpaid interest as of the date of death (not more than six months' interest since such bond interest is paid twice a year) would have been IRD when collected, since there is no election equivalent to the Section 454 election for U.S. Treasury Bond interest.

Sale of Stock Acquired by the Exercise of Stock Options

Incentive Stock Options (ISOs). The basis of unexercised incentive stock options acquired from a decedent will generally be the FMV at the decedent employee's death (or alternate valuation date, if applicable) less the option price. If acquired from a decedent who died in 2010 for which the executor elected the modified carryover basis rules, the unexercised ISOs will be the decedent's carryover basis, which will generally be zero. This is because the recipient of an ISO recognizes no income for regular tax purposes upon the grant (when the option is received).

If the estate or another party who acquired the ISOs exercises them, no IRD is triggered. In other words, the estate (or other successor in interest) does not realize taxable income upon exercise of the ISOs.

Any subsequent disposition of the stock by the estate or other successor is eligible for capital gain treatment. The basis of the stock will be the date of death fair market value (traditional basis under IRC Sec. 1014) of the option plus the exercise price. Alternatively, if the ISOs were acquired from a decedent who died in 2010 and the executor of the decedent's estate elected out of federal estate tax laws, the basis of the stock will be the decedent's modified carryover basis. The estate or other beneficiary's holding period for stock acquired by exercise of incentive stock options begins with the date of exercise.

Employee Stock Purchase Plans (ESPPs). Stock acquired through employee stock purchase plans receive favorable tax treatment if the required holding periods are met. However, a special rule applies when ESPP options are granted that allow the employee to purchase shares at a discount from the stock's FMV. When ESPP shares acquired at a discount are sold or transferred, part of the gain is taxed as compensation income rather than gain from the sale of a capital asset.

If the employee exercised the options before his or her death and held the corresponding stock, which passed to his or her estate, a later sale of the shares by the executor will result in either capital gain or loss. (Any ordinary income should have been recognized by the decedent.) The estate's basis in the ESPP shares is generally determined according to the traditional step-up (or step-down) in value rules of IRC Sec. 1014. However, if property is inherited from a decedent who died in 2010 and the decedent's executor elected out of federal estate tax laws, the basis of the ESPP shares received by the estate is determined according to the modified carryover basis rules of former IRC Sec. 1022.

Options not exercised by the employee before death that pass to the decedent's estate may be exercised by the executor if the ESPP allows it. If the option shares were acquired at a discount, a subsequent disposition (including distribution) will result in the estate recognizing ordinary income for the compensation component. Calculating the basis of the ESPP shares acquired by the estate is a three-step process. The basis of the shares equals—

1. the option price of the shares, plus the basis of the option attributable to the shares, reduced by the excess (if any) of

2. the amount of ordinary compensation income that would have been includable in the employee's gross income under IRC Sec. 423(c) if he or she had exercised the options on the date of his or her death and

held the shares at death, over the amount of ordinary income that actually is includable in gross income under IRC Sec. 423, increased by the excess (if any) of

3. the amount recognized as compensation income on disposition of the shares over the basis of the option attributable to the share.

Nonqualified Stock Options. As is the case for ISOs, unexercised nonqualified stock options at the employee's death are estate assets, but unlike ISOs, they are *not* eligible for a basis step-up under IRC Sec. 1014(a). The basis of unexercised nonqualified stock options will be the difference at the employee's date of death between the FMV and the exercise price (i.e., the bargain element).

When nonqualified stock options are exercised by an estate, trust, or other beneficiary, IRD is triggered under the general rule of IRC Sec. 691 for the income that would have been recognized on their exercise by the decedent (i.e., the spread between the FMV at date of death or alternate valuation date and the exercise price). This IRD will be ordinary income.

Upon the subsequent sale of stock by the estate or beneficiary, capital gain treatment will apply. The basis of the stock will be its FMV on the date of exercise (i.e., the exercise price plus the amount included in ordinary income).

The Sale of Property Used in a Trade or Business

General Rules

Estates and trusts sometimes hold property that when sold results in a Section 1231 gain or loss. A gain on the disposition of Section 1231 property (i.e., property used in a trade or business that is subject to the allowance for depreciation) qualifies for long-term capital gain treatment if the property is held longer than one year. Capital gain treatment is important because gains of this character are eligible for the installment method of reporting. They are also taxed at a maximum rate of 15%, 20%, 25%, or 28%.

Also, many trusts and estates are impacted by the 3.8% net investment income tax, which applies to capital gains on dispositions of nonbusiness assets. This could effectively make the federal long-term capital gain rate as high as 23.8% (for estates and trusts with taxable income in excess of $12,500 in 2017).

Section 1245 depreciation recapture (applicable to personal property) and Section 1250 depreciation recapture (applicable to real property) convert Section 1231 gains into ordinary income that may be taxed at rates up to 39.6% and eliminate eligibility for installment reporting.

Section 1231 sales are initially reported on Form 4797. Gains treated as capital gains will flow to Form 1041, Schedule D, while ordinary income and losses on Section 1231 property dispositions are reported on a line provided in the income section on page 1 of Form 1041.

Example 1N-1 Rental property sold at a loss.

The ABC Trust sold rental property in the current year for $70,000. The trust's adjusted basis in the property was $100,000 ($125,000 purchase price, less straight-line $25,000 depreciation taken on the building). The proceeds and basis are allocated between the land and the building as follows:

	Land	Building	Total
Proceeds	$ 20,000	$ 50,000	$ 70,000
Adjusted Basis	(25,000)	(75,000)	(100,000)
Gain (loss)	$ (5,000)	$ (25,000)	$ (30,000)

The sale of the land and the building is initially reported on Form 4797, and the resulting loss is reported on the line provided for Section 1231 losses in the income section on page 1 of Form 1041. The entire $30,000 Section 1231 loss on the sale is fully deductible.

If Modified Carryover Basis Rules Apply

Although assets transferred by death are generally not subject to Section 1245 or 1250 recapture, they will be if they are acquired from a decedent who died in 2010 and the executor elected to follow the modified carryover basis rules of former IRC Sec. 1022. This is because the tax character of such property is the same as it would have been to the decedent. Thus, if the property had been a capital asset, Section 1231 property (property used in a trade or business and involuntary conversions), Section 1245 property (depreciation recapture upon disposition of certain depreciable property), or Section 1250 property (depreciation recapture upon disposition of certain depreciable real property) to the decedent, the tax character of the property in the hands of the decedent will carry over to the recipient. However, the tax character of the property may be affected by a subsequent change in the recipient's use of the property.

Example 1N-2 Recapture potential carried over to recipient for modified carryover basis property.

Doug owned machinery (Section 1245 property) that he had fully depreciated on his income tax return. The property would have been subject to recapture under Section 1245 if Doug had sold the property prior to his death. Doug died in 2010 and his executor made the Section 1022 election to use the modified carryover basis rules. Doug bequeathed all of his tangible personal property to his daughter, Amy.

Because Amy's basis is determined under former IRC Sec. 1022, the property is Section 1245 property in her hands and will therefore be subject to Section 1245 recapture when she sells it, regardless of whether the property is depreciable property in her hands or whether the executor allocates any basis increase to that property.

Computing and Reporting Depreciation Recapture

A gain on the disposition of Section 1231 business property qualifies for preferential capital gain treatment. This is important because gains of this character are eligible for the installment method of reporting. They are also taxed at rates that are typically lower than the taxpayer's rate on ordinary income. However, Section 1245 depreciation recapture, applicable to personal property, and Section 1250 depreciation recapture, applicable to real property, convert Section 1231 gains into ordinary income that may be taxed at rates up to 39.6% and eliminate eligibility for installment reporting.

Eligibility for capital gain treatment (rather than ordinary income depreciation recapture) for Section 1250 realty depends on the depreciation method under which the asset was originally placed in service.

For depreciable real (Section 1250) property held more than 12 months, gain is taxed as ordinary income to the extent accelerated depreciation claimed exceeds what would have been allowable using the straight-line method. Any gain in excess of this ordinary income recapture is taxed at a maximum rate of 25% to the extent of depreciation claimed on the property. Thus, for property held for more than 12 months and depreciated on a straight-line basis (meaning there is no ordinary income recapture), gain up to the amount of depreciation claimed is taxed at a maximum rate of 25%. Any gain in excess of this amount is taxed at the regular 15% or 20% maximum capital gains rate.

Example 1N-3 Computing and reporting depreciation recapture.

In the current year, the ABC Trust sold nonresidential rental property and all the furnishings, which it had held for several years, for $150,000. The fiduciary provided the following allocation of sales proceeds:

	Land	Building	Furnishing	Total
Proceeds	$ 40,000	$ 100,000	$ 10,000	$ 150,000
Original basis	25,000	125,000	40,000	190,000
Accumulated depreciation	—	(35,000)	(35,000)	(70,000)
Adjusted basis	25,000	90,000	5,000	120,000
Gain (loss)	$ 15,000	$ 10,000	$ 5,000	$ 30,000

The trust is a simple trust with no depreciation reserve maintained. All of the depreciation expense was previously allocated separately to the beneficiaries on their Schedules K-1 from the trust. Straight-line depreciation using MACRS was used on the building.

The $15,000 capital gain on the sale of the land is reported on Form 4797 Part I. The sale of the building is reported on Form 4797 Part I. Since straight-line depreciation was used on the building, the $10,000 gain will flow to Schedule D, resulting in a capital gain subject to a maximum tax rate of 25% since the gain is less than the amount of depreciation taken. The $5,000 gain from the sale of the furnishings is reported on Form 4797 Part III and is ordinary income attributable to depreciation recapture. The ordinary income is reported in the income section on page 1 of Form 1041 and is not separately reported to the beneficiaries.

Nonrecaptured Section 1231 Loss Carryovers

Property used in a trade or business or held for the production of rental income (and capital assets in the case of involuntary conversions) is Section 1231 property if held more than one year. When reporting the disposition of depreciable property, the practitioner first calculates ordinary gain (if any) resulting from depreciation recapture, as discussed previously in this lesson. Any remaining gain is Section 1231 gain. Both are reported on Form 4797.

If Section 1231 losses exceed gains, all Section 1231 gains and losses for the year are ordinary. If Section 1231 gains exceed losses, the entire net Section 1231 gain is treated as a long-term capital gain if no nonrecaptured Section 1231 losses exist from prior years. If there are nonrecaptured prior-year Section 1231 losses, Section 1231 net gains in subsequent years are ordinary income (to the extent of unexpired prior-year nonrecaptured Section 1231 losses).

Nonrecaptured Section 1231 losses are the aggregate net Section 1231 losses deducted in the five preceding tax years that have not offset Section 1231 gains. These losses are considered recaptured in chronological order (i.e., FIFO), and expire if, after five years, they have not been recaptured. Nonrecaptured Section 1231 losses cannot be carried back to affect the character of prior-year Section 1231 gains; they can only be carried forward.

A nonrecaptured Section 1231 loss carryover schedule should be maintained to keep the necessary information.

Example 1N-4 Tracking nonrecaptured Section 1231 loss carryovers.

The Dunbar Testamentary Trust has the following net Section 1231 gains and losses:

Year	Gain	Loss
2010	$ 15,000	$ —
2011	—	20,000
2012	8,000	—
2013	5,000	—
2014	—	—
2015	6,000	—
2016	—	—
2017	5,000	—

The trust had no Section 1231 gains or losses before 2010. The nonrecaptured Section 1231 loss carryover rules affect subsequent Section 1231 gains as follows.

The 2010 gain is not affected by the 2011 loss since nonrecaptured losses cannot be carried back. In 2012 and 2013, the $8,000 and $5,000 gains are ordinary income from the $20,000 nonrecaptured Section 1231 loss carryover from 2011. In 2015, the $6,000 gain is ordinary due to the $7,000 ($20,000 − $8,000 − $5,000) nonrecaptured Section 1231 loss carryover remaining after 2013. Since no Section 1231 transactions occurred in 2016, the $1,000 remaining nonrecaptured Section 1231 loss carryover originating in 2011 expires at the end of the 2016 tax year. In 2017, the $5,000 gain is treated entirely as a long-term capital gain.

In 2017, Section 1231 gains can be subject to a maximum rate of either: (1) 15% (20% if the estate or trust is in the 39.6% ordinary income tax bracket) if held for more than 12 months or (2) 25% for gain that is unrecaptured Section 1250 gain.

Interaction of Unrecaptured Section 1250 Gain and Capital Gain Tax Rates for Installment Sales

For purposes of the 25% maximum capital gains rate, unrecaptured Section 1250 gain equals the property's depreciation in excess of the depreciation subject to ordinary income recapture. For sales of depreciable real property, unrecaptured Section 1250 gain is taxed at a maximum rate of 25% if the property was held more than 12 months. The balance of the capital gain is taxed at a maximum 15% (20% if the estate or trust is in the 39.6% ordinary income tax bracket) capital gain rate. Unrecaptured Section 1250 gain from an installment sale is taken into account in full before any gain is taxed at the 15% rate.

Example 1N-5 Installment sale with 20% and 25% gain components.

In 2017, the Wilma Hart Trust sold land and a building (income-producing property) for $120,000 (appraised at $20,000 for the land and $100,000 for the building), with payment (including adequate interest) to be collected in 10 equal annual installments beginning in 2017. Assume that during this 10-year period the trust's ordinary income tax rate is 28% and that there are no other capital or Section 1231 gains or losses.

The trust acquired the property several years ago for $60,000 ($10,000 for the land and the rest for the building) and claimed $30,000 of straight-line depreciation on the building before its sale. At the time of the sale, the adjusted basis in the property is $30,000: $10,000 for the land and $20,000 ($50,000 − $30,000) for the building. Thus, there is a gain of $90,000 ($120,000 − $30,000) to be recognized over the 10-year period during which the installment payments are collected.

Typically, a building and its underlying land sell as a package, but there are actually two separate assets. Only gain allocable to the building can potentially produce unrecaptured Section 1250 gain taxable at a 25% maximum rate.

In this case, the gain on each $12,000 installment payment is $9,000 [($90,000÷$120,000)×$12,000], allocable $1,000 to the land and $8,000 to the building (for a total gain of $10,000 on the land and $80,000 on the building). The unrecaptured Section 1250 gain is $30,000, which is the lesser of the gain on the building ($80,000) or the depreciation claimed on the property that was not recaptured as ordinary income under IRC Sec. 1250 ($30,000).

Because each year's payment includes $8,000 of gain allocable to the building, $8,000 of the installment gain in 2017 will be taxed at a maximum rate of 25% (up to the $30,000 of prior depreciation). The other $1,000 of gain should be taxed at a 20% maximum rate because it relates to the land. [This assumes that the trust is in the highest (39.6%) ordinary income tax bracket. If in a lower ordinary tax bracket, the maximum capital gain rate would be 15%.] The Wilma Hart Trust's gain from selling the property is taxed as follows:

	Land	Building	25% Gain	20% Gain	Total Gain
Sales Price	$ 20,000	$ 100,000			$ 120,000
Original Basis	(10,000)	(50,000)			(60,000)
Depreciation		30,000			30,000
Gain	$ 10,000	$ 80,000			$ 90,000
Gain Recognized in:					
2017	$ 1,000	$ 8,000	$ 8,000	$ 1,000	$ 9,000
2018	1,000	8,000	8,000	1,000	9,000
2019	1,000	8,000	8,000	1,000	9,000
2020	1,000	8,000	6,000	3,000	9,000
2021	1,000	8,000		9,000	9,000
2022	1,000	8,000		9,000	9,000
2023	1,000	8,000		9,000	9,000
2024	1,000	8,000		9,000	9,000
2025	1,000	8,000		9,000	9,000
2026	1,000	8,000		9,000	9,000
Totals	$ 10,000	$ 80,000	$ 30,000	$ 60,000	$ 90,000

To obtain the results shown in the table, the trust should report the sale of the land and building on separate Forms 6252.

Interaction of Section 1250 Gains and Section 1231 Nonrecaptured Losses

As discussed previously in this lesson, taxpayers must treat net Section 1231 gain as ordinary income (rather than capital gain) to the extent of the taxpayer's nonrecaptured net Section 1231 losses for the preceding five years. The regulations explain how the unrecaptured Section 1250 gain rule interacts with the Section 1231 nonrecaptured losses rule.

Example 1N-6 Installment sale with unrecaptured Section 1250 gain and nonrecaptured Section 1231 losses from prior years.

Assume the same facts as in Example 1N-5, except that in 2017, the Wilma Hart Trust has nonrecaptured net Section 1231 losses from the previous five years of $10,000. As a result, all $9,000 of the installment gain for 2017 ($8,000 from the building sale and $1,000 from the land) is recaptured as ordinary income under IRC Sec. 1231(c). The regulations provide that gain recaptured as ordinary income under Section 1231(c) is treated first as reducing the taxpayer's unrecaptured Section 1250 gain. Thus, after 2017, the trust has $22,000 remaining unrecaptured Section 1250 gain to recognize ($30,000 – $8,000 treated as recognized in 2017 related to the building). In addition, it has $1,000 of nonrecaptured net Section 1231 losses that will cause part of the installment gain in 2018 to be reclassified as ordinary gain.

In 2018, the $9,000 of installment gain is taxed as follows:

Description	Amount	Maximum Tax Rate
First $1,000 of gain on building	$ 1,000	Ordinary income rates
Balance of gain on building	7,000	25% rate
Gain related to the land	1,000	20%

Although only $7,000 of the gain is taxed at a 25% maximum rate, the unrecaptured Section 1250 gain is reduced by $8,000 (from $22,000 to $14,000) at year-end because of the $1,000 of gain treated as ordinary income under IRC Sec. 1231(c).

The regulations also address the situation where a taxpayer has a net Section 1231 loss for the year and unrecaptured Section 1250 gains, with a similarly favorable result.

Example 1N-7 Installment sale with unrecaptured Section 1250 gain and nonrecaptured Section 1231 loss from current year.

Assume the same facts as in Example 1N-6, except that rather than a nonrecaptured Section 1231 loss from prior years, the Wilma Hart Trust has a current-year Section 1231 loss of $10,000. This loss will fully offset the $9,000 of gain from the installment sale, causing both the gain and loss to be treated as ordinary. Nonetheless, as in Example 1N-6, the unrecaptured Section 1250 gain balance is still reduced by $8,000 (the portion of the $9,000 installment gain related to the building).

The Sale of Qualified Small Business Stock

Depending on when the stock was issued, noncorporate taxpayers can exclude a portion of any gain realized on the sale or exchange of qualified small business stock (QSBS) (also referred to as Section 1202 stock) if held for more than five years. The 28% maximum capital gains rate applies to this stock. Thus, if the gain exclusion rate is 50%, the effective maximum capital gains rate is only 14%. However, 7% of the excluded gain is an AMT preference item. Thus, for estates or trusts subject to the 28% AMT rate, the effective rate on gains from QSBS is 14.98% [28% × (50% plus 7% × 50%)].

For QSBS issued after August 10, 1993 and before February 18, 2009, 50% of the gain can be excluded. The gain exclusion rate was increased to 75% for QSBS for shares acquired after February 17, 2009 and before September

28, 2010. For QSBS acquired after September 27, 2010, the gain exclusion rate was increased to 100% for QSBS shares held more than five years. Furthermore, the gain on such sales or exchanges of QSBS are exempt from the alternative minimum tax (AMT) inclusion requirement.

The exclusion was scheduled to be limited to 50% of gain for stock acquired after December 31, 2014, and 7% of the excluded gain was to be an alternative minimum tax preference. However, the Protecting Americans From Tax Hikes (PATH) Act of 2015 retroactively and permanently extends the 100% gain exclusion (within limits) for sales of QSBS and the exception from minimum tax preference treatment.

A qualified small business is a C corporation other than a—

- DISC or regulated investment company,
- real estate investment trust or REMIC, or
- cooperative, or corporation that has a Section 936 (Puerto Rico and possessions tax credit) election in effect.

Additionally, 80% of the corporation's assets must be used in the active conduct of one or more trades or businesses other than—

- banking, insurance, financing, leasing, investing;
- farming; oil and gas; mining; operation of a hotel, motel, or restaurant; or
- performing services where the principal asset of the business is the reputation or skill of one or more employees (e.g., law, accounting, or health services).

Gain eligible for the exclusion is limited to the greater of $10 million for each qualified business or 10 times the taxpayer's basis of the stock disposed of during the year. However, the gain realized on the sale of the QSBS may be eligible for rollover treatment if the taxpayer purchases other qualified stock.

If otherwise deductible charitable contributions consist of amounts excluded under IRC Sec. 1202, the charitable deduction must be reduced by the amount of gain excluded.

If capital gain is included in distributable net income (DNI), the gain excluded under IRC Sec. 1202 is added back when computing DNI.

Additionally, if the qualified small business stock is sold before death but the gain is recognized by the estate or heir, the gain is income in respect of a decedent (IRD). To calculate the excluded gain in this situation, the gain is first reduced (but not below zero) by the deduction for federal estate tax attributable to the gain.

Dealing with Installment Sales

If property is sold at a gain, and at least one payment is received after the close of the tax year of the sale, installment reporting is required unless the taxpayer elects out of the installment method or the sale is between related parties.

Installment reporting does not apply to losses. Also, a number of restrictions exist on the use of the installment method of reporting gain from the sale of real property. An installment gain AMT adjustment often arises because of different adjusted bases in the asset due to separate depreciation methods. Even if the installment method is used to report gain from the sale of property, all ordinary income recapture must be included in income in the year of sale.

Nondealers with installment sales in excess of $150,000 are subject to special interest payment and pledge rules. Installment obligations pledged as security on a debt can trigger deemed installment payments. If an obligation

arising from the disposition of real property to which IRC Sec. 453A applies is outstanding at the close of the year, the estate or trust must report the interest due on the tax deferral on line 7 of Schedule G of Form 1041 with the notation "Section 453A(c)" interest. A schedule must also be attached to Form 1041 showing the interest computation.

An electing small business trust (ESBT) will cease to be an ESBT if it disposes of all its S corporation stock. If the disposition is reported using the installment method, ESBT status is lost on the day after the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

The transfer of an installment obligation to an irrevocable trust triggers income recognition to the transferor, provided he or she is not the owner of any part of the trust, even if there is a reversion of the installment obligation to him or her when the trust terminates. However, the transfer of an installment obligation to a grantor trust does not trigger income recognition.

For more information on installment notes and the sale of property, see *PPC's 1041 Deskbook*. For a detailed discussion on installment sales, see *PPC's 1040 Deskbook*.

SELF-STUDY QUIZ

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

7. Basis in mutual fund shares would be reduced for which of the following?

   a. Return capital distributions.

   b. Reinvested dividends.

   c. Undistributed long-term capital gains.

   d. Reinvested capital gains.

8. Which of the following pairs would be considered related parties under the loss-disallowance rules?

   a. John is the grantor of Trust A, and Rose is one of Trust A's beneficiaries.

   b. Caroline is the fiduciary of Trust B, and Michael is the fiduciary of Trust C, which has a different grantor.

   c. Leonard is the grantor of Trust D, which owns 25% of the stock of SmallCo.

   d. Sarah is the remainder beneficiary of the Smythe Estate.

9. The disposition within two years of like-kind property exchanged between related parties will trigger recognition gain or loss if which of the following occurs?

   a. One of the related parties dies after the exchange.

   b. The disposition is an involuntary conversion.

   c. The disposition occurs within two years of the exchange.

   d. Tax avoidance is not considered a principal purpose of the disposition.

10. What is one condition that must be met to qualify a redemption of stock for Section 303 exchange treatment?

    a. The amount must fall below the $1 million maximum.

    b. The value of corporate stock must be 35% or less.

    c. The shareholder must be responsible for at least some taxes, funeral, or administration expenses.

    d. The redemption must be for the complete amount of stock owned by the estate.

11. When would gain from the sale of property be income in respect of a decedent (IRD)?

    a. The property was included in the decedent's estate at the date of death.

    b. The decedent had entered into a binding sale and fulfilled all prerequisites before dying.

    c. The decedent died in 2010 and was subject to the modified carryover basis rules.

    d. The assets in question are S corporation shares.

12. When are assets transferred by death subject to Section 1245 or 1250 recapture?

    a. They were acquired from a decedent who died in 2010 and the modified carryover basis was elected.

    b. The assets are considered ordinary income and taxed at a maximum of 39.6%.

    c. The property has associated Section 1231 losses that were deducted in the five preceding tax years and did not offset Section 1231 gains.

    d. Gain on the property equals its depreciation in excess of the depreciation subject to ordinary income recapture.

13. Which of the following would be considered a qualified small business?

    a. A regulated investment company.

    b. A real estate investment trust.

    c. A cooperative.

    d. A C corporation.

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. Basis in mutual fund shares would be reduced for which of the following? **(Page 135)**

   a. **Return capital distributions. [This answer is correct. When mutual funds are sold, exchanged, or redeemed, their basis must be determined. The original cost of the shares is the starting point, and then it is increased or decreased based on specific items. The reductions to basis include (1) distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV) and (2) fund-level income tax paid on retained long-term capital gains (reported on Form 2439).]**

   b. Reinvested dividends. [This answer is incorrect. Reinvestment of income and gains resulting in additional fund shares or because of retention of long-term gains by the fund are considered additions to basis. An example of this is reinvested dividends (included in income reported on Form 1099-DIV).]

   c. Undistributed long-term capital gains. [This answer is incorrect. When determining the basis in mutual fund shares, the original price of the shares would be increased (not reduced) by undistributed long-term capital gains (reported as income on Form 2439).]

   d. Reinvested capital gains. [This answer is incorrect. Reinvested capital gains (included in income reported on Form 1099-DIV) are added to basis, not reduced from it.]

8. Which of the following pairs would be considered related parties under the loss-disallowance rules? **(Page 136)**

   a. John is the grantor of Trust A, and Rose is one of Trust A's beneficiaries. [This answer is incorrect. Under the loss-disallowance rules, a grantor and a fiduciary of any trust are considered related parties. A fiduciary of a trust and a beneficiary of such trust are also considered related parties. However, the grantor is not considered a related party toward the beneficiary under these rules. Therefore, John and Rose are not related parties.]

   b. Caroline is the fiduciary of Trust B, and Michael is the fiduciary of Trust C, which has a different grantor. [This answer is incorrect. According to the loss-disallowance rules, a fiduciary of a trust and the fiduciary of another trust are considered related parties if the same person is the grantor of both trusts. Since that is not the case in this scenario, Caroline and Michael are not related parties.]

   c. Leonard is the grantor of Trust D, which owns 25% of the stock of SmallCo. [This answer is incorrect. A corporation and the fiduciary of a trust, per the loss-disallowance rules, are considered related parties if more than 50% of the stock of the corporation is owned (directly or indirectly) by the trust or grantor of the trust. Since only 25% is owned in this case, Leonard and SmallCo are not considered related parties.]

   d. **Sarah is the remainder beneficiary of the Smythe Estate. [This answer is correct. For the loss-disallowance rules, an estate and its beneficiaries are considered related parties, except for the sale or exchange in satisfaction of a pecuniary bequest.]**

9. The disposition within two years of like-kind property exchanged between related parties will trigger recognition gain or loss if which of the following occurs? **(Page 141)**

   a. One of the related parties dies after the exchange. [This answer is incorrect. According to IRC Sec. 1031(f)(2), a disposition during the two year period will *not* trigger recognition of gain or loss after the death of the taxpayer or the related person.]

   b. The disposition is an involuntary conversion. [This answer is incorrect. Per IRC Sec. 1031(f)(2), if the disposition is a compulsory or involuntary conversion, as long as the exchange occurred before the threat or imminence of the conversion, gain or loss will *not* be triggered.]

c. The disposition occurs within two years of the exchange. [This answer is correct. If a taxpayer exchanges like-kind property with a related person and either of them disposes of the property received in the exchange within two years after the date of the last transfer that was part of the exchange, gain or loss is recognized on the sale, according to IRC Sec. 1031(f)(1).]

d. Tax avoidance is not considered a principal purpose of the disposition. [This answer is incorrect. If it is established to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principle purposes, per IRC Sec. 1031(f)(2), gain or loss will *not* be triggered.]

10. What is one condition that must be met to qualify a redemption of stock for Section 303 exchange treatment? **(Page 144)**

a. The amount must fall below the $1 million maximum. [This answer is incorrect. Section 303 treatment is limited to the amount of estate and inheritance taxes imposed as a result of the decedent's death plus the amount of funeral and administration expenses associated with the estate. There is no specific dollar limitation that applies to all cases (e.g., $1 million).]

b. The value of corporate stock must be 35% or less. [This answer is incorrect. The value of corporate stock included in the decedent's estate must *exceed* 35% of the adjusted gross estate to quality for Section 303 treatment.]

c. The shareholder must be responsible for at least some taxes, funeral, or administration expenses. [This answer is correct. According to IRC Sec. 303(b)(3), the redemption qualifies only to the extent that the interest of the shareholder has been reduced directly by estate taxes or funeral and administration expenses. In other words, the shareholder whose stock is redeemed must actually bear the burden of such expenses in an amount at least equal to the redemption proceeds.]

d. The redemption must be for the complete amount of stock owned by the estate. [This answer is incorrect. A shareholder can treat a distribution of cash or property in partial or complete redemption of stock as an exchange if the stock's value has been included in the gross estate for determining the federal estate tax of a decedent, per IRC Sec. 303. Therefore, either a partial or complete redemption of stock will qualify.]

11. When would gain from the sale of property be income in respect of a decedent (IRD)? **(Page 142)**

a. The property was included in the decedent's estate at the date of death. [This answer is incorrect. When an individual dies, his or her property is normally included in the gross estate at fair market value (FMV) at the date of death or an alternate valuation date. When such property is sold by the estate or successor, any gain is measured by the excess of the sales proceeds over the estate tax value (not considered IRD), per IRC Sec. 1014.]

b. The decedent had entered into a binding sale and fulfilled all prerequisites before dying. [This answer is correct. If the decedent had entered into a legally binding contract to sell and fulfilled all substantial prerequisites prior to death, the asset actually owned at the time of death is a claim to the proceeds of the sale, and the gain will be IRD upon receipt of the proceeds, per IRC Sec. 691(a).]

c. The decedent died in 2010 and was subject to the modified carryover basis rules. [This answer is incorrect. Assets acquired from a decedent who died in 2010 are subject to the modified carryover basis rules of former IRC Sec. 1022, if the executor elected out of federal estate taxes. In that case, the gain recognizable by the estate or successor upon the sale of the property will be the excess of the sales proceeds over the modified carryover basis, not IRD.]

d. The assets in question are S corporation shares. [This answer is incorrect. When inherited S corporation shares are sold, exchanged, or otherwise disposed of, the tax basis of the shares, per IRC Sec. 1367(b)(4), is reduced by the amount to which the value of the stock is attributable to IRD items. The shares themselves are not necessarily IRD.]

12. When are assets transferred by death subject to Section 1245 or 1250 recapture? **(Page 148)**

    a. They were acquired from a decedent who died in 2010 and the modified carryover basis was elected. [This answer is correct. Although assets transferred by death are general not subject to Section 1245 or 1250 recapture, they will be if they are acquired from a decedent who died in 2010 and the executor elected to follow the modified carryover basis rules of former IRC Sec. 102, per Rev. Proc. 2011-41 and Reg. 1.1245-3(a)(3). This is because the tax character of such property is the same as it would have been to the decedent.]

    b. The assets are considered ordinary income and taxed at a maximum of 39.6%. [This answer is incorrect. Section 1245 and Section 1250 depreciation recapture can convert Section 1231 gains into ordinary income that may be taxed at rates up to 39.6% and eliminate eligibility for installment reporting. However, this is the effect of the Section 1245 or Section 1250 classification, not the cause of it.]

    c. The property has associated Section 1231 losses that were deducted in the five preceding tax years and did not offset Section 1231 gains. [This answer is incorrect. Nonrecaptured Section 1231 losses are the aggregate net Section 1231 losses deducted in the five preceding tax years that have not offset Section 1231 gains. These losses are not the trigger for Section 1245 or Section 1250 recapture.]

    d. Gain on the property equals its depreciation in excess of the depreciation subject to ordinary income recapture. [This answer is incorrect. According to IRC Sec. 1(h)(6), for purposes of the 25% maximum capital gains rate, unrecaptured Section 1250 gain equals the property's depreciation in excess of the depreciation subject to ordinary income recapture. However, this is a result, not a trigger of the Section 1250 (or Section 1245) status.]

13. Which of the following would be considered a qualified small business? **(Page 152)**

    a. A regulated investment company. [This answer is incorrect. DISCs and regulated investment companies are two types of businesses that are specifically excluded from being a qualified small business.]

    b. A real estate investment trust. [This answer is incorrect. Qualified small businesses do not include real estate investment trusts or REMICs.]

    c. A cooperative. [This answer is incorrect. Neither a cooperative or a corporation that has a Section 936 (Puerto Rico and possessions tax credit) election in effect are considered a qualified small business.]

    d. A C corporation. [This answer is correct. A qualified small business is any C corporation that does not fall into a few certain, specific categories.]

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

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 is 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 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.

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.

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.

Pass-through income and gains from partnerships and S corporations that are held for investment or are passive activities (business activities in which the taxpayer does not materially participate), rental income, and royalties may be subject to a 3.8% net investment income tax (NIIT). Additionally, net gain from selling interests in partnerships and S corporations held for investment is subject to the NIIT.

Special considerations apply to 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:

- Recognize how to interpret a partnership's Schedule K-1, how to report partnership income or loss for deceased partners, and what happens when estates and trusts are considered S corporation shareholders.
- Identify the reporting methods for pass-through income or loss from S corporations, how to deal with pass-through income from other fiduciaries, and the rules associated with rental and royalty income.

Interpreting a Partnership's Schedule K-1

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 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.

Amounts reported on Schedule K-1 (Form 1065) to the fiduciary partner are included on the estate or trust's income tax return according to the type of the income, deduction, gain, or loss. Not all items reported on the Schedule K-1 (Form 1065) are reported by the fiduciary partner (e.g., Section 179 expense, as discussed later in this lesson). Understanding how to report the components of income, deduction, gains, and losses is also important because the fiduciary partner may be subject to net investment income tax (NIIT) on the pass-through net income and net gain from the partnership.

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 trust's share of book income (from its Schedule K-1 capital account allocation) is 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 $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, less the $4,000 distribution). Because the partnership books are maintained on the tax basis, the increase and decrease items reported to the trust in its Schedule K-1 capital account reconciliation for the current year 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. Distributions of marketable securities are included in this treatment (to the extent of their FMV upon 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 of the at-risk limitation later in this lesson.)

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. If the activity is profitable in a taxable year, there is no at-risk limitation.

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, the holding of real property (other than mineral property) placed in service after 1986, and ownership in a pass-through entity holding realty. However, a special exception (discussed later in this lesson) 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; and

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 is any financing that is—

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 investment 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 2016, 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 2016. 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, 2017, is $75,000 ($5,000 cash contribution plus $75,000 allocable share of partnership debt less the 2016 loss of $5,000). In 2017, 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 2017, 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 that year 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 Example 2A-3, 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, this course recommends 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 generally may not be allocated to trusts or estates. [Exceptions apply for grantor trusts, voting trusts, electing qualified Subchapter S trusts (QSSTs), and certain electing small business trusts (ESBTs), as discussed later in this lesson.] 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.

Reporting Partnership Income or Loss When a Partner Is Deceased

Income in Respect of a Decedent from a Partnership

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 (if filing is required because the threshold was met and/or to make the portability election). (However, executors of estates created in 2010 may have elected to apply the modified carryover basis rules instead of being subject to federal estate tax.) The partnership year terminates with respect to the deceased partner. 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.

A discussion of how income is allocated for distributions of partnership interests from the estate or trust (e.g., specific, pecuniary, or residuary bequests) after the partner's death and whether the partnership year closes as to the estate or trust upon the distribution is beyond the scope of this course, which focuses on reporting partnership income or loss for a deceased partner. However, more information on these alternative topics is available in *PPC's 1041 Deskbook*.

Income in the Year of Death. 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. 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 may be subject to both income and estate tax. 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, which uses a calendar year. Rick died on August 4 of the current year after having received distributions of current year partnership

earnings of $30,000. His share of partnership income as of the date of death was $40,000 and was $100,000 for the entire year. Rick's partnership interest was owned by his estate at December 31.

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. The income through that date is reported on his final Form 1040. The remaining $60,000 of income for the current calendar year 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) payments and are not IRD. 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, 2014. 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 on the date of Bob's death was 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 [Reg. 1.736-1(b)(5)(ii)]. The remaining payments are treated as Section 736(a) payments.

Assume Bob's estate receives $35,000 in 2015, $42,000 in 2016, and $38,000 in 2017 as liquidation payments. The 2015 payment is a Section 736(b) payment. The 2016 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 2016 for the liquidation payments received from the partnership. The entire $38,000 in 2017 is a Section 736(a) payment and is IRD in 2017.

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 in the current year. Her share of partnership income through date of death was $80,000; for the entire year, it was $120,000. She 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 and essentially represents a timing difference that allows the stepped-up basis to be used sooner.

The basis of property acquired from a decedent will generally be the fair market value at the date of death or alternate valuation date, if elected. However, executors of estates created in 2010 may have elected to apply the modified carryover basis rules (i.e., the decedent's adjusted tax basis plus the amount of basis increase elected by the executor) instead of being subject to the estate tax at the date of death. In either situation, property that is considered a right to receive IRD is not eligible for a step-up or increase in basis. 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.

Basis Adjustment Recordkeeping When Section 754 Election Is Made

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.

The partnership must make the Section 754 election by the extended due date of the partnership return for the year in which the partner died. However, if the due date has passed, the partnership can still make the election, with no user fees, by filing an original or amended return within 12 months of the extended due date.

Once notice has been made to a partnership by an estate that is the transferee partner of the decedent partner's interest, 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 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, 2017, 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), which is required to be separately stated on Form 706. 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, 2017 (the day after Lindsay's death), and the estate's Form 706 was calculated using date of death values. 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. In addition to regular income tax, the gain may be subject to net investment income tax.

The following factors indicate that the Section 754 election may be beneficial:

- The deceased partner had a material interest in the partnership.
- The partnership plans to sell assets soon.
- The estate's (or other transferee partner's) outside basis is materially greater than the inside basis of the partnership assets. However, discounts will significantly affect this analysis (i.e., if the outside basis is substantially discounted, the difference between outside basis and inside basis could be minimal).
- The partnership has no plans to redeem the deceased partner's interest.

Basis Adjustment When Section 732(d) Election Is Made

When the Section 754 election has not been made, IRC Sec. 732(d) provides limited relief when partnership property is distributed to the successors of the deceased partner within two years of death. The effect of the Section 732(d) election is that the distributee partner may allocate basis to the distributed property as if the Section 754 election had been properly made at the time of death.

The Section 732(d) election is a partner-level election. It has no effect on the partnership.

Estates and Trusts That Are 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 the 100 shareholder limitation for S corporations. Furthermore, for determining the total number of shareholders, spouses (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 S Corporation Stock While Held by an Estate

For various reasons, the executor may decide to dispose of the stock instead of distributing it to the estate's beneficiaries. Some S 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.

Stock Is Sold. 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. A discussion of how to compute an estate's basis in S corporation stock appears later in this lesson.

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 (redemptions not essentially equivalent to a dividend) or IRC Sec. 303 (redemptions of stock to pay estate taxes).

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 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 step-up in basis under IRC Sec. 1014 or the basis increase under former IRC Sec. 1022 (for estates created in 2010 that elected the modified carryover basis rules).

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 qualified subpart E trust that is a trust 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)

Requirements. 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. Tax reporting to the QSST income beneficiary is discussed later in this lesson. 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.

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.

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

Making the QSST Election. A QSST works well when the objective of the trust is to provide income to a beneficiary, but not allow control and access to principal (as is often the desire when a minor child is the beneficiary), or when the objective is to provide income to one beneficiary but reserve principal for another beneficiary following the death of the first beneficiary.

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 (unless the separate share rule applies, as discussed below), 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. This election is submitted as a separate statement. 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.

If the two minor children each hold a separate and independent share of the trust, the trust will be an eligible shareholder, and two separate trusts will not be necessary. However, a separate QSST election must be made for each separate share.

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.

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). If the QSST election is inadvertently missed, special relief provisions are available.

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, 2017. 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 become an

ineligible shareholder (unless it meets one of the other requirements for being an eligible shareholder), causing termination of the corporation's S election.

Death of the Income Beneficiary. A QSST is not required to terminate on the death of the current income beneficiary, as it may have a successive income beneficiary. As discussed previously, a new (successive) income beneficiary is not required to make an election to continue QSST status. Instead, the successor is considered to have consented to the prior beneficiary's QSST election unless he or she affirmatively revokes it. However, if, on the death of an income beneficiary, the trust no longer satisfies the QSST requirements and is not a grantor trust, the trust can continue until the earlier of—

1. the trust's transfer of the stock, or

2. the expiration of the two-year period beginning on the day of the income beneficiary's death.

Electing Small Business Trusts (ESBTs)

ESBT Requirements. 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 [defined in IRC Sec. 664(d)] 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. If the ESBT election is inadvertently missed, special relief provisions are available, as discussed in *PPC's 1120S Deskbook*.

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 (39.6% for 2017), unless the income qualifies as long-term capital gain, 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."

Eligible ESBT Beneficiaries. In an ESBT, each potential current beneficiary of the trust is counted as a shareholder for 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.

Unexercised powers of appointment are disregarded in determining who are considered potential current beneficiaries of an ESBT. If a trustee or other fiduciary has a power to make distributions from the trust to members of a class of charities allowed to receive distributions, the class of charities will be treated as a single potential current beneficiary until the power is exercised. Once a power 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.

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.

Income Tax Considerations for an ESBT. The taxable income of an ESBT consisting solely of stock in one or more S corporations includes the following:

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 (39.6% for 2017). This is a favorable provision because it reduces the overall income subject to the 39.6% trust-level tax.

Only the non-S corporation portion of income and 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. 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 listed previously. 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.

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.

Grantor Trust as an ESBT. 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.

SELF-STUDY QUIZ

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

14. Which of the following statements best describes an aspect of interpreting a partnership's Schedule K-1?

    a. All items on Schedule K-1 are reported clearly and consistently.

    b. It is important to understand partners' limitations on losses passed through to them.

    c. All items reported on Schedule K-1 are reported by the fiduciary partner.

    d. Pass-through income from items on the Schedule K-1 is exempt from the NIIT.

15. A partner will do which of the following?

    a. Report capital gain on a distribution of money up to the amount of his or her basis in the partnership.

    b. Treat distributions drawn against partnership income as made on the date funds were received.

    c. Reduces his or her basis for distributions before allocating loss items.

    d. Earns gains from distributions, but does not adjust his or her basis for them.

16. Which of the following statements best describes an issue related to reporting partnership income and loss for a deceased partner?

    a. Partnership income in the year of death is not considered IRD, but other income is.

    b. IRD from partnership income is subject to income tax, but not estate tax.

    c. If the partnership has a buy-sell agreement, its tax year will close on the decedent's date of death.

    d. If the deceased partner's interest is liquidated via distributions and the payments have no fixed total, they are considered IRD.

17. Under what circumstances would a Section 754 election most likely be beneficial?

    a. The partnership had indicated that it will redeem a deceased partner's interest.

    b. The deceased partner had a small or minority interest in the partnership.

    c. There is no existing plan for the partnership to sell any of its assets.

    d. The estate's outside basis is much greater than the inside basis of the partnership assets.

18. To be allowed as an S corporation shareholder, a voting trust and its beneficial owners must meet which of the following qualifications (among others)?

    a. The trust was created for multiple purposes.

    b. The trust agreement must ensure each shareholder votes separately.

    c. The beneficial owners must all be residents or citizens of the United States.

    d. The trust must be set up as an ongoing entity with no specific end date.

19. Assuming all other qualifications are met, a trust can hold S corporation stock as a qualified Subchapter S trust (QSST) if which of the following occurs?

    a. The trust has one income beneficiary who is a U.S. citizen.

    b. Termination distributions of principal go to a charitable institution.

    c. Distributions support the grantor's legal obligation to support an income beneficiary.

    d. The trustee makes a QSST election related to the S corporation stock.

20. An electing small business trust (ESBT) can do which of the following?

    a. Deduct net operating loss carryovers for its S corporation portion that the trust received from the residuary testamentary trust.

    b. Deduct any capital losses remaining after its capital gains have been offset.

    c. Use the income distribution deduction to reduce taxable income that comes completely from stock in an S corporation.

    d. Deduct interest expenses on debt that was incurred to purchase S corporation stock after 2006.

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. Which of the following statements best describes an aspect of interpreting a partnership's Schedule K-1? **(Page 159)**

    a. All items on Schedule K-1 are reported clearly and consistently. [This answer is incorrect. Unfortunately, items on Schedule K-1 are often reported inconsistently, and the confusing IRS rules on the reporting of partners' capital accounts makes this a complicated task.]

    b. It is important to understand partners' limitations on losses passed through to them. [This answer is correct. 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.]

    c. All items reported on Schedule K-1 are reported by the fiduciary partner. [This answer is incorrect. Amounts reported on Schedule K-1 (Form 1065) to the fiduciary partner are included on the estate or trust's income tax return according to the type of the income, deduction or loss. *Not* all items reported on the Schedule K-1 are reported by the fiduciary partner (e.g., Section 179 expenses).]

    d. Pass-through income from items on the Schedule K-1 is exempt from the NIIT. [This answer is incorrect. Understanding how to report the components of income, deduction, gains, and losses is important because the fiduciary partner may be subject to the NIIT on pass-through net income and net gain from the partnership.]

15. A partner will do which of the following? **(Page 163)**

    a. Report capital gain on a distribution of money up to the amount of his or her basis in the partnership. [This answer is incorrect. According to IRC Sec. 731(a)(1), 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.]

    b. Treat distributions drawn against partnership income as made on the date funds were received. [This answer is incorrect. Based on the guidance in Reg. 1.731-1(a)(1)(ii), 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.]

    c. Reduces his or her basis for distributions before allocating loss items. [This answer is correct. Per Reg. 1.704-1(d)(2), 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.]

    d. Earns gains from distributions, but does not adjust his or her basis for them. [This answer is incorrect. A partner increases his basis in the partnership interest by his allocable share of partnership items, capital contributions, and his share of increase in partnership liabilities before accounting for the distributions received during the year.]

16. Which of the following statements best describes an issue related to reporting partnership income and loss for a deceased partner? **(Page 164)**

    a. Partnership income in the year of death is not considered IRD, but other income is. [This answer is correct. Partnership income earned in the year of death is reported on the decedent's final Form 1040 and will not be considered 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.]

b. IRD from partnership income is subject to income tax, but not estate tax. [This answer is incorrect. IRD is an asset for estate tax purposes and is reported on Form 706. 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 may be subject to both income and estate tax.]

c. If the partnership has a buy-sell agreement, its tax year will close on the decedent's date of death. [This answer is incorrect. 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.]

d. If the deceased partner's interest is liquidated via distributions and the payments have no fixed total, they are considered IRD. [This answer is incorrect. When liquidating payments are not fixed in total, payments received by a successor in interest are treated first as Section 736(b) payments and are *not* IRD. Any payments in excess of the value of the successor's interest in partnership property are Section 736(a) payments and thus IRD.]

17. Under what circumstances would a Section 754 election most likely be beneficial? **(Page 170)**

a. The partnership had indicated that it will redeem a deceased partner's interest. [This answer is incorrect. A Section 754 election would be beneficial when a partnership has *no* plans to redeem the deceased partner's interest.]

b. The deceased partner had a small or minority interest in the partnership. [This answer is incorrect. A Section 754 election is more likely to be beneficial when the deceased partner had a *material* interest in the partnership.]

c. There is no existing plan for the partnership to sell any of its assets. [This answer is incorrect. It is more like that a Section 754 election would be beneficial if the partnership is planning to sell assets soon.]

d. The estate's outside basis is much greater than the inside basis of the partnership assets. [This answer is correct. Based on the information in the Code, it is more likely that a Section 754 would prove beneficial when the estate's (or other transferee partner's) outside basis is materially greater than the inside basis of the partnership assets. However, discounts will significantly affect this analysis (i.e., if the outside basis is substantially discounted, the difference between outside basis and inside basis could be minimal).]

18. To be allowed as an S corporation shareholder, a voting trust and its beneficial owners must meet which of the following qualifications (among others)? **(Page 171)**

a. The trust was created for multiple purposes. [This answer is incorrect. To be allowed to be an S corporation shareholder under IRC Sec. 1361(c)(2), the voting trust must have been created primarily to exercise the voting power of the S corporation block.]

b. The trust agreement must ensure each shareholder votes separately. [This answer is incorrect. According to Reg. 1.1361-1(h)(1)(v), the written trust agreement entered into by shareholders must delegate the right to vote to one or more trustees, not every shareholder.]

c. The beneficial owners must all be residents or citizens of the United States. [This answer is correct. For a voting trust to be allowed to be an S corporation shareholder under IRC Sec. 1361(c)(2), the beneficial owners of the trust must be treated as the owners of their portion of the trust, and they must be citizens or residents of the United States.]

d. The trust must be set up as an ongoing entity with no specific end date. [This answer is incorrect. Per Reg. 1.1361-1(h)(1)(v), the written trust agreement entered into by the shareholders must, among other things, terminate, under its terms or by state law, on or before a specific date or event.]

19. Assuming all other qualifications are met, a trust can hold S corporation stock as a qualified Subchapter S trust (QSST) if which of the following occurs? **(Page 172)**

    a. **The trust has one income beneficiary who is a U.S. citizen. [This answer is correct. According to IRC Sec. 1361(d), one of the conditions that must be met for a trust to be able to hold S corporation stock as a QSST, is that the trust has only one income beneficiary during the life of the current income beneficiary, and that the beneficiary is a U.S. citizen or resident.]**

    b. Termination distributions of principal go to a charitable institution. [This answer is incorrect. Under IRC Sec. 1361(d), any principal distributions, including a termination distribution, must go to the income beneficiary if made during the beneficiary's lifetime.]

    c. Distributions support the grantor's legal obligation to support an income beneficiary. [This answer is incorrect. No distribution (income or principal) by the trust can satisfy the grantor's legal obligation to support the income beneficiary.]

    d. The trustee makes a QSST election related to the S corporation stock. [This answer is incorrect. An income beneficiary, not the person in charge of the trust, must make a QSST election related to the stock of each S corporation held by the trust.]

20. An electing small business trust (ESBT) can do which of the following? **(Page 175)**

    a. Deduct net operating loss carryovers for its S corporation portion that the trust received from the residuary testamentary trust. [This answer is incorrect. The IRS has indicated that an ESBT *cannot* deduct any portion of a net operating loss carryover for the S corporation portion of the EBST that the trust acquired from the residuary testamentary trust.]

    b. Deduct any capital losses remaining after its capital gains have been offset. [This answer is incorrect. According to IRC Sec. 1211(a), an ESBT is only allowed capital losses to the extent of its capital gains.]

    c. Use the income distribution deduction to reduce taxable income that comes completely from stock in an S corporation. [This answer is incorrect. Per IRC Sec. 641(c)(2), the income distribution deduction and the personal exemption *cannot* reduce taxable income of an ESBT consisting solely of stock in an S corporation.]

    d. **Deduct interest expenses on debt that was incurred to purchase S corporation stock after 2006. [This answer is correct. Based on the guidance in 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 (39.6% for 2017). This is a favorable position because it reduces the overall income subject to the 39.6% trust-level tax.]**

Reporting an S Corporation's Pass-through Income or Loss

Practitioners must identify the tax consequences of items and amounts reported to the S corporation shareholder on Schedule K-1 and 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. Amounts reported on Schedule K-1 (Form 1120S) to the fiduciary shareholder are included on the estate or trust's income tax return according to the type of the income, deduction, gain, or loss.

Not all items reported on the Schedule K-1 (Form 1120S) are reported by the fiduciary shareholder (e.g., Section 179 expense, as discussed later in this lesson). Understanding how to report the components of income, deduction, gains, and losses is also important because the fiduciary shareholder may be subject to net investment income tax on the pass-through net income and net gain from the S corporation.

This lesson discusses how to report items on Form 1041 that are reported on a Schedule K-1 from an S corporation.

Not all trusts are permissible S corporation shareholders. The types of trusts permitted to be S corporation shareholders were discussed earlier in this lesson. Certain trusts owning S corporation stock are treated as grantor trusts when 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, as explained earlier in this lesson.

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 and the at-risk limitations, which are the same as for partnerships, were discussed earlier in this lesson. An in-depth discussion of passive activity losses is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook.*

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) provides 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-to-date stock basis records. 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 or alternate valuation date. However, estates created in 2010, for which the executor elected out of federal estate tax laws, the basis in stock acquired from the decedent is subject to the modified carryover basis rules.

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 not 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.

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 deductions. 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 a few years ago) has beginning 2017 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	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	(6,000)
Basis, end of year	$ -0-

Because the basis must be reduced for nondeductible, noncapital expenses 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, in *Leavitt,* (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 guidance on the transfer at death of S corporation losses that were suspended by at-risk limitations. Such suspended losses do not seem to carry over to the estate or an heir. The at-risk limitations were discussed at the beginning of this lesson.

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 2016. 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 2017. The corporation also owes the estate $15,000 from loans Ed made during his lifetime. During 2017, 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 2017	(30,000)
Excess loss carryover to 2018	$ (5,000)

The loss for 2017, 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 2017 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 2017	—	(20,000)	(20,000)
Excess loss carryover to 2018	$ -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 2018 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 2017). If the S corporation passes through $18,000 of income to the estate for 2018, 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 2018 for the $5,000 carryforward loss from 2017.

Losses that are currently nondeductible because of insufficient basis carry forward indefinitely. The carryover losses become deductible when sufficient stock or debt basis is acquired through subsequent corporate profits, shareholder contributions to the capital account, or shareholder loans to the corporation. 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 or, if earlier, when the beneficiary has passive income from this or other passive activities.

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 income is allocated on the Form 1120S (Schedules K-1) 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 shareholders. 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 ordinary 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.

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

Reporting S Corporation Items for an Estate

As discussed earlier in this lesson, 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 trust's are eligible S corporation shareholders. The types of trust that can hold S corporation stock were discussed earlier in this lesson. The discussion in this section 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 39.6% for 2017. However, being taxed at the highest individual tax rate may not be a significant issue because ordinary trust income is taxed at 39.6% once taxable income is over $12,500 (for 2017). A distribution deduction is allowed in the normal way for non-S corporation income, and capital gains qualify for preferential income tax treatment. A discussion of capital gains appeared in Lesson 1.

When calculating the net investment income tax for ESBTs, special rules apply.

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 (assume all passive income) and $125,000 of net long-term capital gain (20%) in 2017 because the trust is in the highest marginal tax bracket. No trustee fees or other expenses were incurred for the year. 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 39.6%) and the $125,000 of long-term capital gain (taxed at 20%). Therefore, the trust would pay a total of $142,528 ($124,000 in income tax for the S corporation items, $4,183 for the regular taxable income of $14,900, and $14,345 of net investment income tax). The ESBT's income from the S corporation is not a component of the trust's DNI.

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 and the Form 1041 for the trust will report the S corporation income to the beneficiary on a grantor letter attached to the Form 1041 instead of on a Schedule K-1 (Form 1041).

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). The Form 1041 for the trust in this case will include both a grantor letter reflecting the S corporation activity and a Schedule K-1 (Form 1041) reflecting the activity from the other (i.e., non-S corporation) assets held in the trust. According to the IRS instructions for Form 1041, the optional filing methods for grantor trusts are not allowed. 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.

Because net investment income (NII) includes passive income, the practitioner must understand if the income and/or losses reported by the S corporation are passive. The determination of whether an activity is passive is made at the taxpayer level. The items of passive or investment income, gains, deductions, and losses that are attributable to the portion of the trust treated as a grantor trust are not subject to the net investment income tax (NIIT) at the trust level. Instead, any net investment income flows through to the grantor/owner's income tax return, and the NIIT will be applied to him or her (using the relevant individual threshold amounts). Although an ESBT pays the tax on income from an S corporation, there has been no official guidance on how to measure participation in ESBTs.

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. Olivia will use this information when determining her income tax and net investment income tax (NIIT) liability.

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 is entitled to an income distribution deduction for $40,000. Although this portion of

the trust is not considered a grantor trust (i.e., it is a simple trust, which is required to distribute all income currently), the trust will not be subject to the NIIT because its investment income is fully offset by the $40,000 income distribution deduction. Thus, the $40,000 bond interest income distributed to Olivia will be passed through to her for potential exposure to the NIIT, using her applicable threshold amount.

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, rather than the beneficiary, 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.

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 (long-term)	125,000
Less: Distributions	(375,000)
Basis at time of sale	$ 3,945,000

Therefore, the gain recognized by the trust and reported on Schedule D of Form 1041 is $55,000 ($4,000,000 − $3,945,000). The gain is subject to both capital gain tax and the net investment income tax. 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 Reg. 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 earlier in this lesson 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 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. This situation is different from that in IRC Sec. 1361(d)(1)(C) and Reg. 1.1361-1(j)(8) where the S corporation stock is disposed of by the trust. As a result, it is probable that any suspended losses should carry over and be used by the trust when determining taxable income from the S corporation under its new status as an ESBT. A schedule should be included with the return showing the carryover losses used during the current year and the year(s) from which they were carried.

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 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). Despite the lack of guidance, any suspended losses should carry over and be used by the QSST trust beneficiary when determining taxable income from the S corporation. A schedule should be included with the return showing the carryover losses used during the current year and the year(s) from which they were carried.

Section 179 Expense

Section 179 expense is generally not available to trusts or estates. Therefore, a trust or estate that is a shareholder in an S corporation generally 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.

Although the estate or trust is normally considered the shareholder of S corporation stock it holds (and thus, is ineligible for the Section 179 deduction), the deemed owners of certain trusts are considered the shareholders of the S corporation. Because the stock is treated as owned by the beneficiary as a deemed grantor, the Section 179 deduction presumably should be allowed by the deemed owners. For S corporation stock held by the following trusts, the deemed owners are considered the shareholders:

- A qualified subpart E trust (i.e., a grantor trust).
- A qualified voting trust.
- A qualified Subchapter S trust (QSST).

Additionally, if stock is owned by an electing small business trust (ESBT), each potential current beneficiary of the trust is treated as a shareholder, except that the trust is treated as the shareholder during any period in which there is no potential current beneficiary of the trust. Therefore, the potential current beneficiary of an ESBT should also be eligible to deduct Section 179 expense. However, only the grantor portion, if any, of the ESBT is treated as a grantor trust and eligible for pass-through deductions, including Section 179 expense.

Pass-through Income That Comes 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).

Passive or investment income, deductions, gains, or losses passed through to the estate or trust from another fiduciary must be included in determining whether the net investment income tax (NIIT) applies. However, only

those losses and deductions allowed in the current tax year for regular tax purposes can reduce net investment income for the NIIT calculation. For example, if passive losses are not allowed currently for regular tax purposes, they cannot reduce gross investment income for the NIIT calculation until allowed for regular tax.

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).

Rules for 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 Form 1041 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. An in-depth discussion of the passive activity rules is beyond the scope of this course, but more information is available in *PPC's 1041 Deskbook*.

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.

An estate or trust's income from rents, passive business activities, and royalties, reduced by properly allocable deductions, must be included in the calculation of net investment income when determining if the net investment income tax (NIIT) applies. Only those losses and deductions allowed in the current tax year for regular tax purposes can reduce net investment income for the NIIT calculation, however.

Decedent's Former Residence

Rental of 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.

21. At year end, a shareholder's stock basis in S corporation stock will be increased by which of the following?

    a. Charitable contributions.

    b. Separately stated tax-exempt income.

    c. Nondeductible business meals.

    d. The deduction for oil and gas property.

22. Assuming all other requirements are met, when might an ESBT trust be eligible to convert to a QSST?

    a. The trust converted from a QSST to an ESBT within the past six months.

    b. The effective date of the QSST election within two years of the date the election is filed.

    c. The trust meets all of the qualifications of a QSST under the Code.

    d. The QSST election is made on an individual basis with respect to the stock of each S corporation that the trust holds.

23. Which of the following statements best describes an aspect of reporting pass-through income from other fiduciaries?

    a. Passive income will be included when determining if the NIIT applies.

    b. Passive losses disallowed for regular tax purposes can be used to offset net investment income for the NIIT.

    c. When a beneficiary dies, income distributed after his or her death is taxable to the decedent.

    d. A fiduciary's passive activity items are held separate from those passed through from a different fiduciary.

24. After Sean's death, his estate rents his former residence. Sean used the property as his personal residence. His beneficiaries use it occasionally as a vacation home (less than 10% of the time it is rented), and the beneficiaries do not pay rent. How will this be treated for tax purposes?

    a. It will be treated as a personal residence based on Sean's use.

    b. It will be taxed as a mixed-use vacation home.

    c. If sold, the beneficiaries will deduct any associated losses.

    d. It will be *treated* as personal use property based on the beneficiary's use.

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. At year end, a shareholder's stock basis in S corporation stock will be increased by which of the following? **(Page 183)**

    a. Charitable contributions. [This answer is incorrect. Under IRC Sec. 1367, a shareholder's basis is *decreased* for specific items, including separately stated items of deduction or loss, including charitable contributions.]

    b. Separately stated tax-exempt income. [This answer is correct. 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, which is then increased and decreased for particular items. The basis is increased by (1) nonseparately stated income; (2) separately stated items of income, including tax-exempt income; (3) 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 (4) recapture of general business credits under IRC Sec. 50(a)(1) to the extent such recapture causes an increase to an asset's basis.]

    c. Nondeductible business meals. [This answer is incorrect. According to the rules in IRC Sec. 1367, basis is *decreased* by the stockholder's share of certain items, such as 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 deduction for oil and gas property. [This answer is incorrect. Basis is *decreased*, per IRC Sec. 1367, for 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.]

22. Assuming all other requirements are met, when might an ESBT trust be eligible to convert to a QSST? **(Page 191)**

    a. The trust converted from a QSST to an ESBT within the past six months. [This answer is incorrect. According to Reg. 1.1361-1(m)(7), to be eligible to convert from an ESBT to a QSST, the trust must *not* have converted from a QSST to an ESBT in the 36-month period preceding the effective date of the new QSST election.]

    b. The effective date of the QSST election within two years of the date the election is filed. [This answer is incorrect. Under Reg. 1.1361-1(m)(7), the effective date of the new QSST election cannot be 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.]

    c. The trust meets all of the qualifications of a QSST under the Code. [This answer is correct. Per Reg. 1.1361-1(m)(7), a trust is eligible to convert from an ESBT to a QSST if four requirements are met. One of those requirements is that the trust must meet all of the requirements of a QSST, as outlined in the Code.]

    d. The QSST election is made on an individual basis with respect to the stock of each S corporation that the trust holds. [This answer is incorrect. As noted in Reg. 1.1361-1(m)(7), the trustee and the current income beneficiary must make the QSST election with respect to the stock of each S corporation held by the trust (i.e., they cannot pick and choose).]

23. Which of the following statements best describes an aspect of reporting pass-through income from other fiduciaries? **(Page 190)**

    a. Passive income will be included when determining if the NIIT applies. [This answer is correct. Under the Code, passive or investment income, deductions, gains, or losses passed through to the estate or trust from another fiduciary must be included in determining whether the NIIT applies.]

    b. Passive losses disallowed for regular tax purposes can be used to offset net investment income for the NIIT. [This answer is incorrect. Under the Code, only those losses and deductions allowed in the current tax year for regular tax purposes can reduce net investment income for the NIIT calculation. For example, if passive losses are not allowed currently for regular tax purposes, they cannot reduce gross investment for the NIIT calculate until allowed for regular tax.]

    c. When a beneficiary dies, income distributed after his or her death is taxable to the decedent. [This answer is incorrect. 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.]

    d. A fiduciary's passive activity items are held separate from those passed through from a different fiduciary. [This answer is incorrect. If another 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.]

24. After Sean's death, his estate rents his former residence. Sean used the property as his personal residence. His beneficiaries use it occasionally as a vacation home (less than 10% of the time it is rented), and the beneficiaries do not pay rent. How will this be treated for tax purposes? **(Page 191)**

    a. It will be treated as a personal residence based on Sean's use. [This answer is incorrect. The tax reporting depends on how the property is used *after* the owner's death. The way in which the residence was used by Sean (the decedent) prior to his death does not automatically carry over to the beneficiaries.]

    b. It will be taxed as a mixed-use vacation home. [This answer is correct. Because Sean's beneficiaries used the property without paying a fair rent, it will be taxed as a mixed-use vacation home. The fiduciary will report fair rental payments according to the passive activity rules.]

    c. If sold, the beneficiaries will deduct any associated losses. [This answer is incorrect. 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, not the estate. However, as there was personal use of the property by Sean's beneficiaries, this tax treatment would not be appropriate.]

    d. It will be treated as personal use property based on the beneficiary's use. [This answer is incorrect. 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 a fair rent. However, because Sean's beneficiaries do not use it more than 10% of the time it is rented, the personal use property classification does not apply.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1041 Deskbook—Course 2—Capital Asset Transactions, Rents, Royalties, and Pass-through Income (T41TG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This 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 the course, 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.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** 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 of $89 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 email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. 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. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     T41TG172 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with 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. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three 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 $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **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

Companion to PPC's 1041 Deskbook—Course 2—Capital Asset Transactions, Rents, Royalties, and Pass-through Income (T41TG172)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. What is added to net capital gain in order to calculate *adjusted net capital gain*?

   a. Qualified dividend income.

   b. 28% rate capital gains.

   c. Unrecaptured depreciation on Section 1250 property.

   d. Gain from selling or exchanging collectibles.

2. When should an estate or trust use Form 4797 to report gains and losses from the sale of a capital asset?

   a. There are multiple category types of long-term capital gains.

   b. Capital gains will be distributed to beneficiaries.

   c. It received qualified dividend income.

   d. The gain resulted from the sale of business property.

3. When are capital gains or losses reported by the beneficiaries instead of the fiduciary?

   a. The trust instrument defines them as principal instead of income.

   b. They are included in distributable net income (DNI).

   c. Only a portion of the gains are distributed to the beneficiaries in the current year.

   d. Any year that is not considered a termination year for the fiduciary.

4. What benefit is realized when an estate has the ability to make a distribution of capital gains?

   a. The fair market value of the property is determined at the acquisition date.

   b. The assets that produce a loss carryforward will be considered community property.

   c. The capital loss carryover can be deducted on the decedent's final tax return.

   d. The income in respect of a decedent (IRD) will be eligible for a step-up in basis.

5. When would an estate and its beneficiaries **not** be considered related parties when a distribution is treated as a sale?

   a. The sale satisfied a pecuniary bequest.

   b. Basis in the property is less than fair market value (FMV).

   c. Losses are passed through to the beneficiaries in the year of termination.

   d. Associated net capital losses are allocated to principal.

6. Marcia acquires a piece of property as a gift from a trust. What is her basis in that property for the purposes of determining gain?

   a. The FMV on the date she receives the property.

   b. The FMV on the date that she disposes of the property.

   c. The same amount as the basis of the previous owner for whom it was not gifted.

   d. The amount of the previous owner's basis plus additional FMV on the date of receipt.

7. Which of the following statements best describes the basis of property distributed in kind from a trust?

   a. It has the same basis for the distributee as it did in the trust.

   b. It is not affected by any gain or loss the trust recognizes on the distribution.

   c. The trust automatically recognizes debt relief for property debt assumed by the distributee.

   d. DNI is considered the greater of the property's FMV at distribution or the distributee's adjusted basis.

8. A fiduciary can elect to give a beneficiary what type of basis in noncash property distributions?

   a. Original purchase price.

   b. Fair market value.

   c. The donor's basis.

   d. Gain on the distribution.

9. When John dies, the fair market value of his home is $200,000. The $200,000 includes $50,000 of improvements John made to the property before his death. What is the estate's basis in this property?

   a. $50,000.

   b. $80,000.

   c. $120,000.

   d. $200,000.

10. If the basis consistency rule applies to a taxable estate, how long does the executor have to provide a statement to the IRS?

    a. Within 30 days of the decedent's death.

    b. Within 30 days of the due date or the Form 706 filing.

    c. By July 31 of the tax year.

    d. By December 31 of the tax year.

11. Which considerations affect the basis of property that passes to a surviving joint tenant?

    i. The amount each tenant contributed to the purchase of the property.
    ii. Whether the tenants were legally married.
    iii. Whether the property resides in a community property state.
    iv. The FMV of the property on the date of the deceased tenant's death.
    v. The date the joint interest was created.

    a. i. and v.
    b. ii. and iii.
    c. i., ii., and v.
    d. i., iv., and v.

12. If an executor elects to use the alternate valuation date, the estate's assets will be valued as of what date?

    a. The decedent's date of death.
    b. One month after the decedent's date of death.
    c. Six months after the decedent's date of date.
    d. One year after the decedent's date of death.

13. When does the holding period begin for real property received by a remainder beneficiary after the death of a life tenant?

    a. On the original owner's date of death.
    b. When the life tenancy and remainder interest are created.
    c. When the remainder beneficiary takes possession of the property.
    d. When the remainder beneficiary disposes of the property.

14. The Pfleugerman Estate owns mutual fund shares. It receives a distribution that is considered a return on the decedent's original investment. How would this distribution be treated?

    a. The distribution is taxed, unless it is reinvested in additional fund shares.
    b. Gain from the distribution will be considered an alternative minimum tax (AMT) preference item.
    c. The fund will realize long-term capital gain and pay fund-level income tax.
    d. The distribution would not be taxed, but would reduce the estate's basis in the shares.

15. When might the average basis method be used to calculate the basis of mutual fund shares?

    a. The shares are in an account that is handled by an agent or custodian who redeems or acquires shares.
    b. The taxpayer elects not to use the first-in, first-out (FIFO) or specific identification method.
    c. The fiduciary wants to sell specific mutual funds shares that were purchased in a particular transaction.
    d. The mutual fund shares are subject to the wash sale rules of IRC Sec. 1091.

16. Which of the following may occur when related parties participate in the sale or exchange of property?

    a. Gains from the sale of multiple assets are aggregated.

    b. Losses are disallowed to prevent taxpayer manipulation.

    c. Gains from the sale can be deferred using the installment method.

    d. The IRS will treat such transactions as occurring at arm's length.

17. Joyce's personal residence is owned by her estate after her death. The estate sells the residence for a gain of $600,000. Joyce met all ownership and holding period conditions prior to her death. How much of the personal residence gain can be excluded by the estate?

    a. $0.

    b. $250,000.

    c. $500,000.

    d. $600,000.

18. When would an estate be able to include the expenses of selling the decedent's personal residence in its administration expenses?

    a. The executor elects the modified carryover basis rules.

    b. There is a loss on the sale of the personal residence.

    c. The sale is needed to pay off the decedent's debts.

    d. The beneficiaries request that the estate make the sale.

19. What condition is the most critical for a beneficiary to get a Section 303 redemption rather than the estate?

    a. That the interest of the beneficiary has been directly reduced by qualified expenses.

    b. That the treatment is limited to taxes and administration expenses.

    c. That the value of corporate stock exceeds 35% of the adjusted gross estate.

    d. That the tax basis of the stock is not stepped-up for the beneficiary.

20. Which of the following generally occurs when unexercised incentive stock options (ISOs) are received from a decedent?

    a. Part of the gain on the options is taxed as compensation instead of gain.

    b. They are ineligible for a step-up in basis under IRC Sec. 1014(a).

    c. Income in respect to a decedent (IRD) is triggered when the ISOs are exercised.

    d. Basis will be the FMV of the ISOs at the decedent's death minus the option price.

21. Which of the following could occur when an estate sells property that results in a Section 1231 gain?

    a. It will be treated as ordinary gain, regardless of holding period.

    b. It cannot be reported using the installment method.

    c. If held longer than a year, it qualifies for long-term capital gains treatment.

    d. It is exempt from the 3.8% net investment income tax (NIIT).

22. How long must noncorporate taxpayers hold qualified small business stock (QSBS) to be able to exclude a portion of gain on the sale?

    a. More than one year.

    b. At least three years.

    c. More than five years.

    d. At least ten years.

23. When is installment reporting required on a property sale with a gain?

    a. The taxpayer has nonrecaptured Section 1231 loss carryovers.

    b. The sale involved QSBS.

    c. The property is sold at a loss.

    d. One or more payments are received after the end of the tax year.

24. A capital account reconciliation will be the most useful if a partnership maintains its books on what basis?

    a. The cash basis.

    b. The tax basis.

    c. GAAP.

    d. The Section 704(b) safe harbor rules.

25. If a partnership passes a loss through to a fiduciary partner, who has the responsibility for determining any limitations on the amount of loss the fiduciary partner can claim?

    a. The partnership.

    b. The fiduciary partner.

    c. Beneficiaries of the fiduciary partner.

    d. The IRS.

26. The amount a trust or estate has at risk in a particular activity includes which of the following?

    a. Amounts borrowed from a person who has a capital or profit interest.

    b. Amounts borrowed for the activity that the fiduciary must repay.

    c. Nonrecourse loans unsecured by the fiduciary's own property.

    d. Amounts used in the activity that are protected by a guarantee.

27. When a partner dies, how much partnership income will be included as income on the decedent's final Form 1040?

    a. Partnership income through the date of death.

    b. Partnership income through the end of the calendar year.

    c. Partnership income through the end of the partnership's tax year.

    d. Partnership income through the beginning of the year in which the decedent dies.

28. When distributions are used to liquidate a deceased partner's partnership interest, under what circumstances would the distributions be considered IRD?

    i. They are a distributive share of the income of the partnership.
    ii. They are paid in exchange for the deceased partner's interest in partnership property.
    iii. They are payments guaranteed to another partner.

    a. ii.

    b. i. and ii.

    c. i. and iii.

    d. i., ii., and iii.

29. What is one of the key requirements of a Section 754 election?

    a. It is made by the decedent's estate.

    b. The transferee has 60 days from the date of death to notify the partnership.

    c. Basis adjustments must be reflected in the partnership's return.

    d. The election cannot be made after the extended due date for the partnership's return.

30. Can an estate be considered a shareholder of an S corporation?

    a. No, if the shares go to an estate, the corporation's S election will terminate.

    b. Yes, but only if the shares are held for a sufficiently long administration period.

    c. Yes, but only if the estate is not considered part of another shareholder's family.

    d. Yes, the estate can be a shareholder under the eligibility rules and the 100 shareholder limitation.

31. Conrad wants to set up a trust fund that will provide income to his wife, Colleen, for the rest of her life, but give the principal to their daughter Cleo upon Colleen's death. What type of trust would likely meet Conrad's needs?

    a. An electing small business trust (ESBT).

    b. A qualified Subchapter S trust (QSST).

    c. A qualified subpart E trust.

    d. A testamentary trust.

32. Jason, the deemed owner of a grantor trust, dies on June 1, 2017. By what date must a QSST election be made?

    a. June 16, 2018.

    b. August 16, 2018.

    c. June 16, 2019.

    d. August 16, 2019.

33. Which of the following is a condition that must be met for an ESBT to serve as an S corporation shareholder?

    a. All the beneficiaries are individuals, charities, or C corporations.

    b. Interests in the trust cannot be acquired by purchase.

    c. Each beneficiary makes the appropriate ESBT election.

    d. The trust was first a QSST.

34. Under most circumstances, a stockholder's original basis in S corporation stock is determined as what?

    a. The adjusted basis of assets the shareholder contributed plus gain recognized on the transfer.

    b. The basis of the shareholder who transferred the stock to the new shareholder.

    c. The FMV of the shares at the date of the previous shareholder's death.

    d. The original cost the stockholder paid to acquire the S corporation shares.

35. If pass-through losses are nondeductible due to insufficient basis, how long can they be carried forward?

    a. One year.

    b. Three years.

    c. Five years.

    d. Indefinitely.

36. The March Testamentary Trust holds S corporation stock. Where does it report items it receives on a Schedule K-1 from the S corporation?

    a. Directly on Form 1041.

    b. On a statement attached to Form 1041.

    c. Directly on Form 1040.

    d. Directly on Form 1120S.

37. Can a QSST election be revoked?

    a. Yes, the QSST election can be revoked at any time by the trust.

    b. Yes, but only with the consent of the IRS.

    c. Yes, but only if the QSST is converting to an ESBT.

    d. No, once a QSST election is made, it is irrevocable.

38. Can trusts deduct Section 179 expenses?

    a. Yes, trusts are always eligible to deduct this type of expense.

    b. Yes, if the deemed owner of certain trusts is considered the S corporation shareholder.

    c. No, unless a trust is an ESBT, it cannot deduct this type of expense.

    d. No, trusts cannot deduct this type of expense under the Code.

39. Where does an estate or trust usually report trade or business income and expense amounts from its Schedule K-1 received from other fiduciaries?

    a. On Schedule E of Form 1040.

    b. On Schedule F for Form 1040.

    c. On Form 1041.

    d. On Form 1120S.

40. Which of the following occurs if rental or royalty payments are received after a decedent's death?

    a. The income may be considered IRD.

    b. It will be exempt from the passive activity rules.

    c. The fiduciary will claim all depletion and depreciation deductions.

    d. Losses from prior years can be used reduce the NIIT.

GLOSSARY

50% inclusion rule: In regards to taxpayers' basis in estate property, this rule says that, for legally married tenants of joint tenancy property, half of the fair market value of spousal joint interest property that meets the requirements of a *qualified joint interest* is included in the gross estate of the first spouse to die, regardless of how much each spouse contributed towards the purchase price of the property.

Adjusted net capital gain: *Net capital gain* plus qualified dividend income. It is adjusted by reducing net capital gain (not below zero) by (1) capital gain attributable to unrecaptured depreciation on Section 1250 property and (2) 28% rate capital gains, and then qualified dividend income is added.

At-risk rules: These rules, in IRC Sec. 465, limit the losses generated by various business and investment activities to the amount that the taxpayer is "at risk economically." Therefore, if an activity is profitable in a taxable year, there is no at-risk limitation.

Capital asset: Any asset held by an estate or trust, except depreciable real property used in the taxpayer's trade or business (if conditions in IRC Sec. 1231 are met), inventory, specified literary or artistic property, business accounts or notes receivable, or certain U.S. publications.

Covered securities: Mutual fund shares acquired or transferred after December 31, 2011.

Electing small business trust (ESBT): If all criteria under the Code are met, this type of trust (which has multiple beneficiaries and allows the accumulation of income) can be an *S corporation* shareholder.

Modified carryover basis rules: The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) repealed the fair market value basis rules of IRC Sec. 1014 for decedents who died in 2010. However, the 2010 Tax Relief Act reinstated the estate and GST taxes retroactively to January 1, 2010, along with the traditional step-up (or step-down) rules of IRC Sec. 1014. A special election was made available, allowing an executor of an estate created in 2010 to opt out of federal income taxes. If the election was made, for income tax purposes, the property acquired from a decedent in 2010 is treated as if received by a gift, and the basis to the estate (or other person) acquiring the property is the lesser of (1) the decedent's adjusted basis (with certain modifications) or (2) FMV of the property at the date of the decedent's death.

Net capital gain: The excess of net long-term gains over net short-term losses.

Noncovered securities: Mutual fund shares acquired before 2012.

Passive activities: Business activities in which the taxpayer does not materially participate.

Potential current beneficiary: Any person or charity that is entitled to, or at the discretion of the trustee may receive, a distribution from the principal or income of the trust.

Qualified joint interest: Any interest in property owned by the decedent and his or her spouse as tenants by the entirety or as joint tenants with the right of survivorship if the decedent and his or her spouse are the only join tenants.

Qualified nonrecourse financing: Any financing that is (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 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 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 the regulations, no one is personal liable for repayment; and (4) not convertible to equity.

Qualified small business: A C corporation other than a (1) DISC or regulated investment company, (2) real estate investment trust or REMIC, or (3) cooperative or corporation that has a Section 936 (Puerto Rico and possessions tax credit) election in effect.

Qualified subchapter S trust (QSST): If the criteria specified in the Code are met, this type of trust is allowed to hold *S corporation* stock. Unlike an *ESBT*, this type of trust only has one income beneficiary.

S corporation: A form of corporation that allows the company to enjoy the benefits of incorporation while it is taxed as if it were a partnership. Typically, they have 75 or fewer shareholders.

Section 1231 property: Property used in a trade or business and involuntary conversions.

Section 1245 recapture: Depreciation recapture upon disposition of certain depreciable property.

Section 1250 recapture: Deprecation recapture upon disposition of certain depreciable real property.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 1—Distributable Net Income, the Distribution Deduction, and Property Distributions (T41TG171)

CTEC Course No. 3039-CE-2151

Name: ______________________

Firm Name: ______________________

Firm Address: ______________________

City: ______________________ State /ZIP: ______________________

Firm Phone: ______________________ Firm Fax No.: ______________________

Firm Email: ______________________

CTEC No.: ______________________ PTIN: ______________________

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________________

Birth Month: ______________________ Licensing State: ______________________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⦸ ⊗ ☑ .

You must complete the entire course to be eligible for credit.

	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.	○	○	○	○

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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1041 Deskbook—Course 1—Distributable Net Income, the Distribution Deduction, and Property Distributions

Course Acronym: T41TG171

Your Name (optional): ______

Date: ______

CTEC Number: 3039-CE-2151

Email: ______

IRS Program Number(s): 0YC0C-T-01007-17-S

CE Provider: Checkpoint Learning

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?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______

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** ○ ○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1041 Deskbook—Course 2—Capital Asset Transactions, Rents, Royalties, and Pass-through Income (T41TG172)

CTEC Course No. 3039-CE-2147

Name: ______________________

Firm Name: ______________________

Firm Address: ______________________

City: ______________________ State /ZIP: ______________________

Firm Phone: ______________________ Firm Fax No.: ______________________

Firm Email: ______________________

CTEC No.: ______________________ PTIN: ______________________

Signature: ______________________

Credit Card Number: ______________________ Expiration Date: ______________________

Birth Month: ______________________ Licensing State: ______________________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓ .

You must complete the entire course to be eligible for credit.

	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.	○	○	○	○

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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1041 Deskbook—Course 2—Capital Asset Transactions, Rents, Royalties, and Pass-through Income

Course Acronym: T41TG172

Your Name (optional): ____________

Date: ____________

CTEC Number: 3039-CE-2147

Email: ____________

IRS Program Number(s): 0YC0C-T-00864-17-S

CE Provider: Checkpoint Learning

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?	○	○	○	○	○	○	○	○	○	○

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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** ○ ○

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