Death Is No Excuse: Use Postmortem Planning—Part 2

A decedent's final income tax return presents opportunities to claim deductions, make an election, and fulfill executor duties.

AMY K. KANYUK

A client's death brings with it a host of planning and tax considerations. The practitioner should be mindful of these matters, and the various tax planning opportunities and elections that may be available to minimize income and estate taxes for the decedent's estate.

Part 1 of this article[1] covered matters related to federal estate taxes. Part 2 of this article will cover matters related to income taxes after death, including the decedent's final income tax return, discharging the executor from liability for the decedent's and the estate's taxes, the estate's income tax return, income in respect of a decedent, taxation and timing of distributions, electing to treat the decedent's revocable trust as part of the estate, and issues related to S corporations.

Decedent's final tax returns. The executor must file the decedent's final income tax return (Form 1040) for the period ending with the date of death.[2] The executor should be sure to check Reg. 31.6091-1 to confirm the appropriate IRS office in which to file the final return.

Only the taxpayer who sustains a loss is entitled to take a deduction for it.[3] Accordingly, business losses and capital losses sustained by a decedent for the period ending with the date of death (i.e., in the decedent's final tax year) are deductible only on the decedent's final income tax return (Form 1040). No part of such a net operating loss or capital loss is deductible by the decedent's estate, and those losses cannot be carried over to subsequent years,[4] although it may be possible to carry back a net operating loss on the decedent's final return to prior years.[5]

Carryovers for net operating losses and capital losses from a year prior to death are deductible for the last time of the decedent's final Form 1040. Carryforwards attributable to the surviving spouse can be carried forward by the surviving spouse, so the executor must allocate any carryforward items between the decedent and the surviving spouse.

The decedent's final income tax return is due on the normal date that it would have been due if the decedent had not died (i.e., April 15 of the year following the date of death).[6] The final return cannot be filed before January 1 of the year after the year of the decedent's death, so if a decedent dies early in the calendar year, it may be many months before the final Form 1040 can be filed and the estate settled.

The decedent and his or her surviving spouse can file a joint tax return for the year of death, as long as the surviving spouse does not remarry before the end of the tax

AMY K. KANYUK is a partner at McDonald & Kanyuk, PLLC in Concord, New Hampshire. She concentrates her practice on estate, gift, and generation-skipping planning for individuals and families of high net worth, and is a Fellow of the American College of Trust and Estate Counsel.

year.[7] The final joint return includes the decedent's income through the date of death, and the surviving spouse's income for the entire year.[8] The decedent's estate and the surviving spouse are jointly and severally liable for the entire tax due.[9] The executor must allocate the joint tax liability or joint refund between the estate and the surviving spouse, in order to determine what must be included (or can be deducted) on the decedent's estate tax return.

The executor can apply for release from personal liability for the decedent's income and gift taxes by filing Form 5495.

In addition to filing the decedent's final Form 1040, the executor should confirm that all of the decedent's prior tax returns (income and gift) were filed before the date of death. If the executor cannot locate copies of all of prior returns, he or she can request copies of them from the IRS by filing Form 4506 (Request for Copy of Tax Return), or of transcripts of prior returns by filing Form 4506-T (Request for Transcript of Tax Return). There is a $50 fee for each return requested, but no fee for a transcript.

The executor should delay distributing estate assets until he or she is sure that all of the estate's tax obligations have been satisfied. If the executor does make a distribution, refunding agreements with the beneficiaries, and state law provisions allowing the executor to reclaim prior distributions to pay estate debts and taxes, can be used to reacquire the distributed assets if necessary, but require that the beneficiary still have the funds to repay the estate.

Prompt assessment and discharge from personal liability for taxes. The executor is personally liable for the decedent's income and gift tax liabilities, to the extent that the decedent's assets come within the reach of the executor.[10] With respect to a return that has been filed, the executor can request a prompt assessment of any tax deficiency for that return, and also can request to be released from personal liability for it.

The IRS generally must assess a federal income or gift tax deficiency within three years after the return is filed.[11] However, by filing Form 4810, the executor can request that the assessment of any income or gift tax deficiency be made within 18 months after the request is made.[12] Accordingly, if the request is made when the return is filed, the statute of limitations is reduced by half. The right to request a prompt assessment does not shorten the statutory period for assessment of a deficiency if no return was filed or if there was a substantial omission of income. If no return has been filed, Section 6501(c)(3) provides that the tax may be assessed, or a proceeding in court for the collection of the tax may be begun without assessment, at any time.

The executor also can apply for release from personal liability for the decedent's income and gift taxes by filing Form 5495 (Request for Discharge from Personal Liability). Upon receipt of the form, the IRS has nine months to notify the executor of the taxes due. Upon payment of the amount of which the executor is notified, or, if no notice is given, nine months after the IRS's receipt of the Form 5495, the executor will be discharged from personal liability for any deficiency in the tax that is later found to be due.[13]

Planning tips for the estate's income tax return

The decedent's estate is a separate taxpayer. Accordingly, the executor should obtain a taxpayer identification number for the estate and file a Form 56 (Notice of Fiduciary Relationship) with the IRS notifying the IRS of the fiduciary relationship. This will cause the fiduciary to receive tax notices that

1 Kanyuk, "Death Is No Excuse: Use Postmortem Planning—Part 1," 43 ETPL 30 (January 2016).

2 Section 6091(b)(1); Reg. 1.451-1(b)(1) (decedent's final tax year ends with the date of death).

3 See Calvin, 354 F.2d 202, 16 AFTR2d 6025 (CA-10, 1965) ("[I]n the absence of express statutory language, only the taxpayer who sustained the loss is entitled to take the deduction. To extend the net operating loss to a taxpayer who did not participate in the risk when the loss occurred is to ignore completely the Congressional purpose of allowing such a deduction.").

4 Rev. Rul. 74-175, 1974-1 CB 52. Note that Section 642(h)(2) allows carryovers to the beneficiaries of an estate or trust upon termination of the estate or trust.

5 See Section 172(b)(1)(A)(i).

6 Reg. 1.6072-1(b).

7 Reg. 1.6013-1(d)(2).

8 Reg. 1.6013-1(d).

9 Section 6013(d)(3).

10 The federal statute creating personal liability for the failure of a fiduciary to pay taxes is found in 31 U.S.C. section 3713(b), which is not in the Internal Revenue Code. Claims by the U.S. government (i.e., taxes) have priority when "the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor." 31 U.S.C. section 3713(a)(1)(b). If the executor pays a debt of the estate before paying the taxes, the executor is liable to the extent of the payment. 31 U.S.C. section 3713(b). A distribution to an estate beneficiary is a "debt" for purposes of 31 U.S.C. section 3713(b). See Reg. 20.2002-1. Payments to an unsecured creditor of the decedent's estate also are debts for this purpose.

11 Section 6501(a).

12 Section 6501(d).

13 Reg. 301.6905-1(a). For the discharge of the executor of personal liability for the federal estate tax, see Section 2204.

14 Regs. 1.652(c)-2 and 1.662(c)-2.

15 Section 691(a)(1).

16 Section 691(a)(2).

17 Reg. 1.691(a)-4(b)(2).

18 Section 691(c).

19 Section 643(a).

20 See Section 642(h) and Reg. 1.643(a)-3(e), Example 7.

otherwise would have been sent to the decedent.

The executor can choose a calendar or fiscal tax year for the estate. If the executor chooses a fiscal year, the initial fiscal year must end no later than the last day of the calendar month before the month of the decedent's death. For example, if the decedent dies on April 20, the fiscal year must end no later than March 31.

Choosing a fiscal year can significantly defer the date of the first payment of income tax by the estate. For example, if the decedent dies on 7/15/2016 and the executor uses a calendar year, the estate's first tax year will end on 12/31/2016, and the estate must file a tax return by 4/15/2017. Using a fiscal year, the estate's first tax year must end no later than 6/30/2017, in which case the estate's income tax return would be due on 10/15/2017.

When a distribution is made from an estate, the recipient beneficiary generally includes in his or her gross income the beneficiary's share of the estate's income for its tax year that ends with, or within, the beneficiary's tax year. For example, all distributions made between 4/1/2015 and 3/31/2016 from an estate having a March 31 fiscal year end are taxable to the beneficiary on his or her 2016 income tax return (which is due on 4/15/*2017*), as if all of the distributions were made on 3/31/2016. Accordingly, choosing a fiscal year for an estate may allow the deferral of the payment of tax on distributions to the beneficiaries.

Suppose, however, the taxpayer is a beneficiary of an estate or trust in the year of the taxpayer's death. In that situation, the taxpayer's final Form 1040 must include any distributions of income actually received from the estate or trust before the date of death.[14]

Income in respect of a decedent

Income in respect of a decedent (IRD) is income that the decedent earned, but did not receive, before death. A common example of IRD is income attributable to distributions from a decedent's IRA or 401(k) plan. IRD received by the decedent's estate or a beneficiary is taxable to the estate or beneficiary when the estate or beneficiary receives it.[15]

The distribution of an IRD receivable to a beneficiary who inherited it from the decedent through a specific or residuary bequest is not a transfer that requires the recognition of income.[16] The beneficiary must include the IRD income in his or her gross income when he or she actually receives it.[17]

IRD also is an asset of the decedent's estate for estate tax purposes. If the decedent's estate was subject to federal estate tax, the estate or beneficiary can take an income tax deduction against the IRD for the estate tax attributable to the inclusion of the IRD in the decedent's gross estate.[18] This deduction is intended to avoid double estate and income taxation of the same amount, but it does not provide a complete offset. Instead, the deduction provides rough justice to produce a total income and estate tax that is about the same as the amount the decedent would have paid if he or she had lived and included the IRD in his or her income. The IRD deduction is allowed for the federal estate tax, but not for any state estate tax attributable to the inclusion of the IRD in the gross estate for state estate tax purposes.

Taxation of distributions

For an understanding of the tax treatment of distributions, key terms need to be mastered.

Distributable net income. Distributable net income (DNI) is, in general, the estate's or trust's taxable income, and excludes capital gains.[19] In the year of termination of the estate or trust, however, all capital gains are included in DNI and all capital losses are taken into account in computing DNI. These gains and losses pass to the beneficiaries.[20]

DNI is important for three reasons:

1. It provides a ceiling on the amount an estate or trust can deduct for distributions to beneficiaries.
2. It provides a ceiling on the amount a beneficiary must

account for on his or her income tax return with respect to distributions from an estate or trust.

3. It identifies the character of the income distributed to the beneficiary (e.g., taxable interest, nontaxable interest, dividends, etc.).

DNI and fiduciary accounting income (FAI) usually are not the same in a given year because the rules for determining DNI and FAI are different.[21] DNI deals with determining the appropriate amount of tax to be borne by the trust or estate and its beneficiaries. FAI deals with equitable concepts of allocating the income and principal between income beneficiaries and remaindermen. Accordingly, an item that may be subject to federal income tax is not necessarily "income" for FAI purposes (e.g., capital gains), and an expense that may be deductible for income tax purposes may not be charged in full against "income" for FAI purposes (e.g., fiduciary fees, which, under most states' laws, are charged one-half to principal and one-half to income).

Capital gains and losses are usually not included in DNI. Although capital gains are taxable as income for income tax purposes, they usually are considered to be principal for fiduciary accounting purposes. Reg. 1.643(a)-3(b), however, now allows capital gains to be included in DNI, if, pursuant to either: (1) the terms of the governing instrument and applicable local law; or (2) a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law, or by the governing instrument if not prohibited by applicable local law), the capital gains are either:

- Allocated to income.
- Allocated to corpus but consistently treated as part of a distribution to a beneficiary.
- Allocated to corpus but actually distributed to the beneficiary.[22]

Distributions from an estate or trust to a beneficiary are taxable to the beneficiary, and deductible by the estate or trust, only to the extent of the estate's or trust's DNI.[23] If an estate or trust has more than one beneficiary, substantially separate and independent shares of different beneficiaries are treated as separate estates or trusts, and the DNI that is carried out to a beneficiary, and deductible by the estate or trust, is limited to the DNI that is allocable to the beneficiary's separate share. A separate share is a separate economic interest in one beneficiary or a class of beneficiaries, such that their separate economic interests do not affect one another.[24]

Taxable income is not allocated to beneficiaries who do not actually receive distributions from the estate or trust. Also, as explained below, some distributions do not carry out DNI, and are not taxable to the beneficiaries who receive them.

Specific bequests. The payment of a specific bequest (money or specific property) is not taxable to the beneficiary, as long as the bequest is: (1) paid all at once, or in no more than three installments; and (2) ascertainable under the governing instrument as of the date of the decedent's death.[25] Because the distribution is not taxable, the estate or trust receives no distribution deduction, and the beneficiary is not deemed to receive DNI.

Whenever property (other than cash) is distributed to a beneficiary, the estate or trust may elect to recognize gain (but not loss) on the distribution, as if the distributed property had been sold to the beneficiary at its fair market value. If the election is made, it applies to all distributions made by the estate or trust during the tax year.[26]

Interest paid on pecuniary bequests is interest income to the beneficiary. The interest is not deductible by the estate or included in DNI, because it is not necessary for the estate to incur the interest charges, and the interest is not "investment interest" that is tied to a debt incurred for investment.[27] An estate tax deduction for interest paid on specific bequests (as an administrative expense under Section 2053) may be allowed in some instances.[28]

If the executor or trustee distributes appreciated property to a beneficiary to satisfy a pecuniary bequest (i.e., a bequest that has a fixed-dollar amount), the distribution is treated as a taxable sale

21 DNI is a federal tax concept. Fiduciary accounting income is determined by the governing instrument and local law, not by the Internal Revenue Code. Almost all of the states have adopted the 1997 Uniform Principal and Income Act, which, in general, governs what is income and what is principal with respect to receipts and disbursements of a trust or estate (i.e., determining the rights of a beneficiary with respect to income).

22 See also Reg. 1.643(a)-3(e) (Examples 2, 12, 13, and 14).

23 Section 661 (deduction to estate) and Section 662 (income to beneficiary).

24 See Reg. 1.663(c)-4(a).

25 Section 663(a)(1); Reg. 1.663(a)-1.

26 See Section 643(e).

27 See Sections 212 and 163.

28 See Turner, 306 F. Supp. 2d 668, 93 AFTR2d 2004-686 (DC Tex., 2004).

29 Reg. 1.661(a)-2(f).

30 See Estate of Noel, 50 TC 702 (1968).

31 See Section 691(a)(2) and Reg. 1.691(a)-4(b)(2).

32 Reg. 1.1014-4(a)(3).

33 Rev. Rul. 69-486, 1969-2 CB 159.

34 Section 1014.

35 The 65-day election cannot be made for a "simple" trust, because those trusts are required to distribute all of their income.

36 Reg. 1.663(b)-1(a).

37 See Reg. 1.663(b)-2(a)(2).

38 Regs. 1.663(b)-2(a)(1) and (2). It may be possible to make a late 65-day election, or revoke the election, under Reg. 301.9100-1.

39 See Reg. 1.643(b)-1 ("Definition of 'Income'").

40 Reg. 1.663(b)-1(a)(2).

or exchange, and any gains or losses must be recognized by the estate or trust.[29] Because assets (other than IRD) receive a step-up in basis at death, the gain recognized is limited to the gain that accrued between the date of death and the distribution date.

If an executor distributes the right to receive IRD to satisfy a pecuniary bequest, the tax on the IRD is accelerated, and the estate recognizes income.[30] Conversely, the tax on the IRD is not accelerated, and the estate does not recognize income, if the IRD is distributed to satisfy a specific bequest, a percentage bequest, or a portion of a residuary bequest.[31]

Distribution of property in-kind. Distributions in kind generally do not result in the recognition of gain or loss (unless the distribution is made in satisfaction of a pecuniary gift).[32] However, if the will or trust leaves bequests to multiple beneficiaries, and the beneficiaries agree to take specific assets of equal value, rather than receive a fractional interest in every asset, there is a taxable exchange. The non-pro rata distribution is treated as a pro rata distribution of each asset to the beneficiaries, followed by an exchange among the beneficiaries of their undivided interests in the assets.[33] However, if the executor or trustee is authorized (under state law or the governing instrument) to make non-pro rata distributions, the distributions are not treated as sales or exchanges. For this reason, drafting attorneys should ensure that their wills and trust agreements authorize the fiduciary to make non-pro rata distributions.

Basis adjustments at death. The basis of property acquired from a decedent generally is the property's fair market value on the date of death.[34] This rule can either "step up" or "step down" the basis of property. If the executor elects alternate valuation for federal estate tax purposes under Section 2032, the basis of each asset of the estate becomes the asset's value on the alternate valuation date. Items of IRD (e.g., IRA assets, deferred compensation, and installment notes receivable), however, do not receive a step-up in basis. Rather, the basis of an item of IRD equals the decedent's basis at the time of death.

The 65-day rule. Generally, for an estate or complex trust[35] to take a distribution deduction for a particular tax year, the entity actually must make the distribution to the beneficiary during that tax year. However, if the fiduciary wants to maximize the distribution deduction by distributing all of the entity's DNI in a particular year, it may be difficult to determine this amount before the tax year actually ends.

Section 663(b) allows fiduciaries to elect to treat all or any portion of a distribution made to a beneficiary within the first 65 days of the estate or trust's subsequent tax year as if the entity had made the distribution on the last day of the preceding tax year.[36] The 65-day election is:

- Made no later than the due date (including extensions) of the entity's income tax return.
- Made on an annual basis, by checking the appropriate box on page 2 of Form 1041 (or, if no return is due, by filing a timely statement with the IRS[37]).
- Irrevocable after the last day on which it can be made.[38]

The amount subject to the election is limited to the greater of DNI or fiduciary accounting income[39] not otherwise distributed in the given year, reduced by payments made in the prior year.[40] Distributions made within the 65-day window cannot be treated as having been made in the prior year if doing so would result in a tax-free distribution of principal because of the DNI limitation. For example, X Trust, a calendar-year trust, has $1,000 of income and $800 of DNI in 2016. The trust pays $550 to A, a beneficiary, on 1/15/2016, which the trustee elects to treat as paid on 12/31/2015. The trust also pays to A $600 on 7/19/2016, and $450 on 1/17/2017. For 2016, the maximum amount that the trustee may elect to treat as properly paid or credited on the last day of 2016 is $400 ($1,000 - $600). The $550 paid on 1/15/2016 does not reduce the maximum amount to which the election may apply, because that amount is treated as having been paid on 12/31/2015.[41]

The 65-day rule provides flexibility to fiduciaries with respect to timing distributions for tax purposes, and allows the fiduciary to base those distributions on the entity's actual income for a given year. The rule can be used to have the estate or trust income taxed to the beneficiaries, rather than subject to the compressed income tax brackets that apply to trusts and estates. It also may avoid subjecting the net investment income earned by an estate or trust to the 3.8% investment income surtax.

Section 1411(a)(2) imposes on estates and trusts a tax of 3.8% on the lesser of their undistributed net investment income or the excess of their adjusted gross income (as defined in Section 67(e)) over the dollar amount at which the highest tax bracket in Section 1(e) begins for such tax year. The tax does not apply to a trust's income or gain from a trade or business activity in which the estate or trust materially participates. The issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS, and may be addressed in a separate guidance project issued under Section 469.[42] Because an individual beneficiary needs to have a relatively high modified adjusted gross income in order to be subject to the 3.8% tax, an estate or trust that distributes its net investment income to an individual may be able to eliminate the 3.8% tax at the entity level (through a DNI deduction) without creating a liability for the tax at the beneficiary level.[43]

The Section 645 election.
The Code contains an election that affects the tax treatment of revocable trusts.

Taxation of a revocable trust. During the grantor's life, the IRS ignores a revocable trust's existence for federal income tax purposes, and the grantor reports the trust's income, deductions, and credits on his or her individual income tax return (Form 1040). The revocable trust itself generally is not required to file its own tax return.[44]

After the grantor's death, the trustee must wind up the trust's affairs before distributing its assets to the beneficiaries. During this winding-up period, the decedent's revocable trust (often called an "administrative" trust during this period) is a separate taxpayer for income tax purposes. The trustee must obtain a taxpayer identification number (TIN) for the trust and file income tax returns for it.[45] Various factors—including the complexity of the decedent's estate plan, the size of his estate, certain post-mortem elections made by the executor and trustee, and whether the IRS audits the estate tax return—may prolong the existence of the administrative trust for several years after the grantor's death.

The trustee cannot, however, unduly postpone the winding up of a trust. If the trustee unreasonably delays the distribution of the trust corpus, the IRS will consider the trust terminated for federal income tax purposes after a reasonable period for the trustee to complete the administration of the trust. The IRS also will consider a trust terminated when all of its assets have been distributed except for a reasonable amount that is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[46]

The Code treats the decedent grantor's revocable trust and estate differently for federal income tax purposes. In some cases, the Code affords more favorable tax treatment to the estate than to the trust. Section 645 levels the playing field between trusts and estates by allowing the trustee to elect to treat the trust as part of the grantor's estate (rather than as a separate entity) for income tax purposes.

Treating the revocable trust as part of the estate. If the trustee makes the election under Section 645 (the "645 election"), the trust and estate file a single combined income tax return each year,[47] rather than each filing a separate return. The election makes available to the revocable trust those tax advantages that otherwise would be available only to the estate. These advantages include:

- Availability of a fiscal year as the tax year. If there is a probate estate, the revocable trust will use the same tax year as the estate (which can be a fiscal year). If there is no probate estate, the trustee has the same

[41] *Id.*

[42] TD 9644, 12/02/2013.

[43] See Sections 1411(a)(1) and 1411(b), and Reg. 1.1411-3(e).

[44] Reg. 1.671-4(b)(2)(ii).

[45] Reg. 301.6109-1(a)(3)(i)(A).

[46] Reg. 1.641(b)-3(b).

[47] The combined estate and trust must file an income tax return if the total gross income of the combined entity is $600 or more. Reg. 1.6012-3(a)(1)(iv).

flexibility as the executor in selecting the tax year.[48]

- Deferral of payment of income tax on income earned by the trust after the date of death until the due date of the estate's income tax return.
- Availability of a deduction for amounts of income permanently set aside for charitable purposes.[49]
- No estimated tax obligation for the estate or trust two years after the decedent's death.[50]
- Waiver of the material participation requirement for the passive loss rules (i.e., participation is treated as active for both the estate and the trust).[51]
- Eligibility to hold S corporation stock without meeting special trust rules (i.e., the revocable trust can hold S stock for an unlimited time during the period of administration, rather than the two-year after-death period otherwise required by the Code).[52]
- Availability of a $600 personal exemption, instead of the $300 or $100 exemption that usually applies to simple and complex trusts, respectively.[53]

Factors to consider. The trustee should consider whether these advantages warrant making a 645 election for the trust. In particular, the trustee, taking into account the expected duration of the estate and revocable trust, should determine whether the election will reduce the trust's income taxes, reduce the trust's administrative costs, conform with applicable state law, require complicated separate share calculations, or be practical in light of various nontax factors (e.g., the relationship between the beneficiaries or the fiduciaries). Because a 645 election may affect the various beneficiaries differently, drafters should authorize both the executor and the trustee to make the election.

Reporting requirements. If the 645 election is made, all items of income, deduction, and credit are combined and reported on one income tax return (Form 1041) filed under the name and taxpayer ID number of the estate.[54] The electing trust does not file a return if there is an executor of the estate. If there is no executor, the trustee must file a Form 1041 each year during the election period, using the trust's taxpayer ID number, and treat the trust as an estate.[55]

Although only one Form 1041 will be filed for both the estate and trust, the trustee and the executor each continue to be responsible for paying the tax due for their respective entities. The tax burden of the combined estate and trust must be allocated between the entities in a manner that reasonably reflects the tax obligations of each. However, the separate share rules of Section 663(c) still apply with respect to distributions.

The separate share rule of Section 663(c) requires that the separate and independent shares of different beneficiaries in the same estate or trust be treated as separate shares or trusts in determining the DNI allocable to the respective beneficiaries. No separate share rule exists for purposes of Section 645. This means the entire trust (and not simply one or more separate shares of the trust) will be subject to the election.

These rules treat the revocable trust and the estate as separate shares for purposes of computing DNI and applying the distribution provisions of Sections 661 and 662.[56] Reg. 1.645-1(e)(2) provides examples of how the separate share rules apply in the context of a 645 election.

Making the election. Only "qualified revocable trusts" (QRTs) may make a 645 election. A QRT is a trust (or a portion of a trust) that the grantor had the power to revoke on the date of his death.[57] If the grantor was incapacitated at the time of his death, the trust will qualify as a QRT if the grantor's agent or legal representative could revoke the trust under state law during the grantor's incapacity.[58]

To make a 645 election, the executor (or, if none, the trustee) must file Form 8855 ("Election to Treat a Qualified Revocable Trust as Part of an Estate") by the due date (including extensions) of the estate's first federal income tax return (Form 1041). The executor (or trustee) must file the form regardless of whether there is sufficient income to require the filing of that return.[59] The election is effective as of the date of the decedent's death and, once made, cannot be revoked.[60]

The 645 election begins on the date of the decedent's death and ends on the earlier of:

48 Reg. 1.645-1(e)(3)(i).

49 Regs. 1.645-1(e)(2)(i) and 1.645-1(e)(3)(i).

50 Reg. 1.645-1(e)(4) and Section 6654(l)(2)(A).

51 Section 469(i)(4) allows an estate (but not a trust) to deduct up to $25,000 of real estate passive activity losses for two years after death. This deduction is available to revocable trusts making the Section 645 election. Regs. 1.645-1(e)(2)(i) and (3)(i).

52 Section 1361(c)(2)(A)(ii)); Regs. 1.645-1(e)(2) and (3).

53 Reg. 1.645-1(e)(2)(ii)(A). If the estate and trust filed separate returns, the estate could take a $600 exemption and the trust (assuming it was a complex trust) could take a $100 exemption, for a total deduction of $700. Under Section 645, the total personal exemption for both the estate and trust is $600. Section 642(b).

54 Reg. 1.645-1(e)(2)(ii)(A).

55 Reg. 1.645-1(e)(3)(ii). The trust is required to obtain a taxpayer ID number upon the decedent's death, regardless of whether there is an executor. Reg. 1.645-1(d)(1). In addition, the trust may need to obtain a new taxpayer ID number at the end of the Section 645 election period. See Reg. 301.6109-1(a)(4).

56 Regs. 1.645-1(e)(2)(iii) and 1.663(c)-4(a).

57 Reg. 1.645-1(b)(1) and Section 676.

58 67 FR 78,371 (12/24/2002), TD 9032, Preamble.

59 Regs. 1.645-1(c)(1)(i) and 1.645-1(c)(2)(i). See also Sections 6012(a)(3) and (4) (filing requirements for estates and trusts).

60 Reg. 1.645-1(e)(1).

- The day on which both the trust and estate have distributed all of their assets.
- The day before the "applicable date."

If the decedent's estate is not required to file a federal estate tax return (Form 706), the applicable date is two years after the decedent's date of death. If the estate files a 706, the applicable date is the date that is the later of two years after the decedent's date of death, and six months after the decedent's estate tax liability has been "finally determined." The date on which the estate tax liability is "finally determined" is the day on which the first of a series of events occurs. In general, for purposes of the 645 election, the decedent's estate tax liability has been "finally determined" as of the earliest of:[61]

- Six months after the IRS issues a closing letter. (For federal estate tax returns filed on or after 6/1/2015, the IRS will issue a closing letter only if the taxpayer requests it. The IRS has asked that such requests not be submitted until four months after the return is filed.)
- The date of a final disposition of a claim for refund that resolves the liability for the estate tax.
- The date on which the IRS and executor execute a settlement agreement that determines the liability for the estate tax.
- The date of a court order resolving the estate tax liability.
- The expiration of the limitations period for assessment of the estate tax.

When the 645 election terminates, the combined estate and trust are deemed to distribute the separate share comprising the electing trust to a new trust. The combined estate and trust (or just the trust, if there is no executor) is entitled to a distribution deduction under Section 661 for the items of income—including net capital gains—deemed distributed to the new trust. The new trust must include that income in its gross income under Section 662.[62]

Planning for Subchapter S corporation

Each shareholder of an S corporation is treated as receiving a direct pro rata share of S corporation income, losses, deductions, and credits each year, and is taxed on S corporation income each year, regardless of whether the corporation distributes any of its earnings to the shareholder.[63] The character of any item passed through from the corporation to the shareholder is the same as it would be if the shareholder had received the item directly from the source (instead of from the corporation).[64]

When a shareholder of an S corporation dies, his or her executor must consider a variety of issues regarding the continued ownership of the stock and taxation of the S corporation income, including income tax reporting in the year of death, the income tax basis of the stock passing to the decedent's heirs, and maintaining the company's status as a qualified S corporation during the period of administration.

Tax reporting in year of death. S corporation income is pro rated on a per-share-per-day basis among shareholders.[65] When a shareholder dies, income allocable to the decedent's stock is pro-rated between his individual income tax return and his estate. However, if all of the shareholders agree, the corporation can close its books as of the date of death, and allocate the actual pre- and post-death income between the decedent and the decedent's estate.[66] The shareholders must analyze the impact of this election before any affected tax returns are due, and they may need to adjust their estimated income tax payments as a result of the election.

Tax basis of inherited stock. The decedent's S corporation stock receives a step-up in basis under Section 1014. However, the stepped-up basis is reduced by the portion of the stock's fair market value that is attributable to IRD. For example, if a cash-method S corporation has uncollected receivables at the date of death, and those receivables would have been treated as IRD if

61 See Reg. 1.645-1(f).
62 Reg. 1.645-1(h).
63 Reg. 1.1368-1(b).
64 Section 1366(b).
65 Section 1377(a)(1).
66 Sections 1366(a)(1) and 1377(a)(2).
67 See Section 1367(b)(4)(B).
68 Reg. 1.1366-2(a).
69 Section 1361(b)(1)(B).
70 See Old Va. Brick Co., 367 F.2d 276, 18 AFTR 2d 5750 (CA-4, 1966) (estate in existence beyond reasonable period will be considered terminated for Subchapter S purposes). Where the sole purpose for retaining stock of an S corporation in the estate is to facilitate the installment payment of the estate tax under Section 6166, the administration of the estate is not considered to extend beyond a reasonable period, and the estate will be an eligible shareholder for the period during which the estate complies with the provisions of Section 6166. Rev. Rul. 76-23, 1976-1 CB 264.
71 Section 1361(c)(2)(A)(i); Reg. 1.1361-1(k)(1), Example 2.
72 Section 1361(c)(2)(A)(ii). During this time, the *estate* (not the trust) is treated as the shareholder of the corporation for purposes of the S corporation qualification requirements. Section 1361(c)(2)(B)(ii). However, the trust will continue to be the shareholder for all reporting and tax liability purposes. Regs. 1.1361-1(h)(3)(ii)(A) and 1.1361-1(k)(1), Example 2.
73 Reg. 1.1361-1(h)(1)(iv)(B).
74 Section 1361(c)(2)(A)(iii).
75 *Id.*
76 Reg. 1.1361-1(j)(1).
77 See Reg. 1.1361-1(j)(1)(i). See also Reg. 1.1361-1(k)(1), Example 4 (trust qualifies as QSST if trustee has discretion to accumulate or distribute trust income and currently distributes all income to sole income beneficiary).
78 Section 1361(d)(1)(B); Reg. 1.1361-1(j)(7)(i).
79 Reg. 1.1361-1(j)(8).
80 Section 1361(d)(2)(B).
81 Reg. 1.1361-1(j)(6)(iii).

the decedent had held them directly, then the basis of the inherited stock is reduced by the IRD. [67] Suspended losses on the S stock are personal to the deceased shareholder, and therefore are not passed on to the beneficiaries.[68]

Maintaining S status. The Code limits the permitted shareholders of an S corporation to domestic individuals, estates, certain trusts, and certain exempt organizations.[69] Estates are permitted S corporation shareholders during the period of administration (regardless of the length of the administration period, as long as it is reasonable).[70] Only certain types of trusts may hold S stock.

Grantor trusts are eligible S corporation shareholders. Accordingly, a decedent's revocable trust is an eligible S shareholder during the decedent's life.[71] When the decedent dies, the revocable trust becomes an irrevocable, nongrantor trust, and new rules apply with respect to the eligibility of the trust to hold the S stock. In particular, the trust can continue to hold the S stock for a period of two years after the date of death.[72] If the trustee makes a Section 645 election (to treat the trust as part of the estate for income tax purposes), then the trust will be an eligible S shareholder for the period in which the Section 645 election is in effect, and then for an additional two years after the S stock is transferred from the qualified revocable trust to a new trust (during the Section 645 election period), or when the stock is deemed to be distributed to a new trust at the end of the election period.[73]

A trust that receives stock transferred to it pursuant to the terms of a will is an eligible S corporation shareholder for the two-year period beginning on the date on which the stock is transferred to the trust.[74] Thus, the estate can hold the S stock for the entire period of administration, and then the receiving trust (whether a testamentary trust or the decedent's inter vivos revocable trust) can hold the stock for an additional two years.[75]

Any other trust that continues in existence beyond these time periods, and that will continue to hold S stock, must elect to be treated either as a "qualified Subchapter S trust" (QSST), or an "electing small business trust" (ESBT). QSSTs and ESBTs differ with respect to how income and principal may be distributed, and how the income from the S corporation is taxed. Although ESBTs provide more flexibility with respect to the dispositive provisions of the trust, QSSTs may be more efficient for income tax purposes.

QSSTs. In order to qualify as a QSST, the trust must satisfy the following criteria:[76]

1. It can have only one beneficiary.
2. It must distribute (or be required to distribute) all of its income each year to its beneficiary, who must be a citizen or resident of the U.S. If the trust is silent on this matter, the trust must in fact distribute all of its income to the current income beneficiary.[77]
3. It cannot distribute principal to anyone other than its sole beneficiary.
4. The current income beneficiary's income interest must terminate on the earlier of the beneficiary's death and the termination of the QSST. Upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to that beneficiary.

The income beneficiary of a QSST is treated as the S corporation shareholder for purposes of the pass-through of income, gain, loss, deduction, and credit.[78] The beneficiary therefore reports on his or her personal tax return the QSST's share of the corporation's items of income, gain, loss, and deduction. However, the income beneficiary is not treated as the owner of the S corporation stock for purposes of determining and attributing the federal income tax consequences of a disposition (e.g., a liquidating distribution) of the S stock by the QSST. Thus, when a QSST sells its S corporation stock, the QSST election terminates with respect to the stock sold, and any gain or loss recognized on the sale belongs to the trust, not its income beneficiary.[79]

A QSST election must be made by the trust's sole beneficiary with respect to each S corporation whose stock is owned by the trust.[80] Generally, the beneficiary must make a QSST election within two months and 16 days after the S corporation stock is transferred to the trust.[81]

The election's effective date can be up to two months and 15 days *before* the date on which the election is made (i.e., the election can be retroactive).[82] Once made, a QSST election is irrevocable and treated as being made for successive beneficiaries.[83]

ESBTs. Unlike QSSTs, ESBTs can have multiple beneficiaries, accumulate income, sprinkle income and principal among the beneficiaries, and serve as a generation-skipping vehicle.[84] In order to qualify as an ESBT, the trust must satisfy the following criteria:

1. All of the beneficiaries must be individuals, estates and, in certain circumstances, nonprofit organizations. For this purpose, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust. [85]
2. No interest in the trust has been acquired by purchase (i.e., the beneficiaries must have acquired their interests in the trust by gift, bequest, etc.).[86]

Once a trust makes an ESBT election, each "potential current beneficiary"[87] of the trust is treated as a shareholder for purposes of determining whether the trust meets the shareholder requirements of the Code.[88] The corporation cannot have: (1) more than 100 shareholders; (2) a shareholder who is not a person (other than an estate, certain trusts, and certain charitable organizations); (3) a nonresident alien shareholder; or (4) more than one class of stock.[89]

A potential current beneficiary generally is a person who is entitled to, or in the discretion of any person may receive, a distribution of principal or income from the trust. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts. For example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation.

The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[90] For federal income tax purposes, however, an ESBT is treated as two separate trusts—one trust holds the S stock (the "S portion"), and the other trust holds the remaining assets (the "non-S portion").[91] The items of income, deduction, and credit attributable to the non-S portion are taxed under the normal nongrantor trust tax rules. The S portion is treated as a separate trust for purposes of determining the taxable income attributable to the S stock held by the ESBT.

The income of the S portion (and all gains and losses from the sale of S corporation stock) is taxed at the highest marginal income tax rate for trusts (currently 39.6% for ordinary income and 20% for capital gains).[92] None of the S portion items may be attributed to any beneficiary. Consequently, the S corporation income is not treated as DNI for trust accounting purposes, and a distribution of that income to the beneficiaries does not reduce the EBST's taxable income or produce taxable income for any beneficiary.[93] If the trustee does not materially participate in the operation of the S corporation, special rules apply to calculate the ESBT's net investment income and the amount of the 3.8% surtax.[94]

The trustee of the trust (not the beneficiary) makes the ESBT election.[95] The trustee must do so within the time period prescribed for filing a QSST election, which, in general, is within two months and 16 days for the date on which the stock is transferred to the ESBT.[96]

If a QSST or ESBT election is not made within the required time period, the IRS may permit the beneficiary or trustee to make a late election. Rev. Proc. 2013-30[97] provides the exclusive simplified methods for taxpayers to request relief for late QSST and ESBT elections, if the taxpayer satisfies certain requirements. In general, the taxpayer must seek relief for the late election within three years and 75 days of the "effective date," which is the date on which the QSST or ESBT is intended to be effective. If an entity does not satisfy the Rev. Proc. 2013-30 requirements, the entity may seek relief in a private letter ruling request.

Conclusion

A client's death does not end the tax planning process. Regardless of the size or complexity of an estate, post-mortem planning can be used to minimize the total tax obligation and maximize the net value passing to the beneficiaries. ■

82 Section 1361(d)(2)(D).
83 Section 1361(d)(2)(C).
84 A charitable remainder trust cannot be an ESBT. Section 1361(e)(1)(B).
85 Reg. 1.1361-1(m)(1)(ii)(A).
86 Reg. 1.1361-1(m)(1). See also Section 1361(e)(1)(C) (definition of "purchase").
87 The identity of the trust's beneficiaries affect whether the trust can be an ESBT, while the identity and number of potential current beneficiaries affects whether the corporation can be an S corporation.
88 Reg. 1.1361-1(m)(4).
89 Section 1361(b)(1).
90 Reg. 1.641(c)-1(a).
91 Regs. 1.641(c)-1(b)(2) and (3).
92 Section 641(c)(2).
93 Section 641(c)(3).
94 Reg. 1.1411-3(c). See also TD 9644, Para. 4.B (12/2/2013) (application of Section 1411 to ESBTs).
95 Section 1361(e)(1)(A); Reg. 1.1361-1(m)(1)(i).
96 Reg. 1.1361-1(m)(2)(iii). See also Reg. 1.1361-1(j)(6)(iii).
97 2013-36 IRB 173.