

Income Tax Elections for Estates

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Elections

- Choice of Fiscal year
- IRC 645 Election
- 65 Day Election (IRC 663(b))
- IRC 643(e)(3)- Property Distributions
- IRC 691(c) – Estate Tax Deduction
- Deducting Expenses on the 1041 vs 706

Choice of Fiscal Year

Option to use any month for year-end (cannot be more than a 12-month year)

- Election made when Form 1041 is filed, not upon applying for the estate EIN or upon filing the extension
- Deferring Income/Accelerating Deductions
 - Choosing optimal fiscal year – income deferral, acceleration of deductions, avoidance of wasting deductions, timing of income inclusion on the beneficiaries' income tax returns vs the estate's income tax return
 - Fiscal year beginning 2/1/24 ending 1/31/25 defers income reporting (assuming distributions made) by beneficiary to 2025
 - 11/30/24 estate year-end - 12/31/24 Schedule K-1 from a pass-through entity would be included in the 11/30/25 year-end

Choice of Fiscal Year

Example: The Estate of Jane Doe's current fiscal year ends 11/30/24. Jane's estate owns an interest in a partnership, Jane Doe, LLC, that has a calendar year-end. The Schedule K-1 for the partnership's year ending 12/31/24 will be included in the estate's income tax return for the year ending 11/30/25, resulting in an almost full year of deferral in reporting the income.

Choice of Fiscal Year

- Final year considerations
 - Excess deductions on termination not allowed through 12/31/2025
 - Capital losses of the estate pass out to the beneficiaries
 - If the estate has an interest in a passive activity that is being distributed to a beneficiary (other than in satisfaction of a pecuniary bequest), any suspended PALs associated with the activity at the time of distribution increase the basis of the interest to the beneficiary.
 - An NOL of the estate passes out to the beneficiaries to be utilized on their individual income tax returns
 - In tracking the number of years remaining for the NOL carryover, the final year of the estate and the first year in which the beneficiary reports the NOL count as two separate years.

IRC 645 Election

- Inclusion of qualified revocable trust with estate income tax return
 - Qualified revocable trust is a trust that was treated as owned by the decedent under IRC 676 due to a power to revoke that was exercisable by the decedent
- Allows fiscal year-end instead of calendar for trust activity
- Reduces administrative burden of filing two separate income tax returns
- Allows the trust to take advantage of certain income tax provisions that are only allowable for estates

IRC 645 Elections

- Allows the trust to take advantage of certain income tax provisions that are only allowable for estates
 - The allowance to deduct up to \$25,000 of losses from rental real estate activities against non-passive income for the first two years after the deceased owner's death (provided the decedent actively participated in the rental real estate activity)
 - Not having a two-year deadline for qualifying as an eligible S corporation shareholder if the trust owns S corporation stock.
 - Being eligible to deduct losses for funding pecuniary bequests with noncash property distributions.

IRC 645 Election

Making the election

- Check the box on page 1 of Form 1041 and include trust's EIN (new EIN obtained following the death of the decedent)
- Attach Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, to the timely filed (including extensions) tax return for the first tax year of the related estate
 - Irrevocable election once made
 - Election period – begins on the date of the decedent's death and ends on the earlier of:
 - the day on which the electing trust and related estate have distributed all of their assets or
 - the day before the applicable date.

IRC 645 Election

Making the election (cont.)

Applicable date is –

If a Form 706 was required to be filed, the later of

- 2 years after the date of the decedent's death or
- 6 months after the final determination of liability

for estate tax.

If a Form 706 was not required to be filed, then 2 years after the date of the decedent's death.

65 Day Election (IRC 663(b))

- Available to estates and complex trusts.
- Ability to treat any distribution made within first 65 days of subsequent tax year as having been made in the prior year (by March 6, 2025 for 2024)
 - If the amount(s) distributed within the first 65 days of the subsequent year exceed the amount needed for the election, only the portion for which the election is desired needs to be included in the election
- Shift income out of compressed trust/estate income tax brackets to beneficiaries (try to avoid highest tax rates and Medicare surtax)
 - 37% rate once taxable income over \$14,450 for 2024

65 Day Election (IRC 663(b))

- Allows for “hindsight planning” to determine if shifting income out of the estate to the beneficiaries is desirable
 - Communication between the fiduciary return preparer and beneficiaries’ individual income tax return preparer(s) is key
- Maximum amount for which the election can be made is the greater of FAI (fiduciary accounting income) or DNI (distributable net income)
- Check the box in the Other Information section on page 3 of Form 1041 and attach election statement

65 Day Election (IRC 663(b))

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

Trust Name: _____ EIN: _____

Trustee Name(s): _____ Year Ended: _____

Address: _____

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

<u>Amount Distributed</u>	<u>Date of Distribution</u>	<u>Recipient Beneficiary</u>
\$XXXXXX		

IRC 643(e)(3) – Property Distributions

General rule for property distributions – no gain or loss is recognized (unless the distribution is in satisfaction of a pecuniary bequest) and the estate's basis in the asset carries over to the beneficiary.

IRC 643(e)(3) – allows for the recognition of gain (but not loss, due to the related party rules) on the distribution of property to the residual beneficiaries of an estate.

Result of this election is that the asset is treated as “sold” by the estate on the date of distribution.

-If gain is recognized, the beneficiary's basis is the FMV on the date of distribution.

-If loss is realized (not allowed to be recognized by the estate), then the beneficiary needs to keep track of two bases:

1. The estate's basis in the asset will be used to compute a gain on the disposition of the asset by the beneficiary.

2. The FMV of the asset will be used to compute a loss on the disposition of the property by the beneficiary.

If the beneficiary sells the asset at a price that is between the FMV and the estate's basis of the asset on the date of distribution, no gain or loss will be recognized by the beneficiary.

IRC 643(e)(3) – Property Distributions

Holding period – When an IRC 643(e)(3) election is made, the beneficiary’s holding period begins on the date of the distribution.

Making the election – Check the box in the Other Information section on page 3 of the Form 1041 and report the estate’s gain(s) on Schedule D. Including “IRC 643(e)(3)” in the asset description on Schedule D is recommended.

Once made, the election applies to all* distributions of property made during that tax year and is irrevocable.

*Not including specific bequests of property, distributions in satisfaction of pecuniary bequests and distributions of claims to receive IRD.

IRC 643(e)(3) – Property Distributions

Circumstances under which the election should be considered:

- The estate has capital losses or unused deductions to offset the distribution gains.
- The beneficiary plans on selling the asset and there is a built-in unrealized gain at the time of distribution.
- There are multiple beneficiaries and the election will assist in equalizing the tax consequences of property distributions among the beneficiaries.
- There is a desire to shift income to the beneficiaries and using FMV will cause the property distributions to carry out more DNI.

Caution should be taken to avoid creating a disadvantageous tax situation. Taking into account both the estate's tax situation as well as the beneficiary's (such as considering the estate's capital gains rates and net investment income tax threshold vs the beneficiary's, availability of capital losses at the beneficiary level, etc.) is important.

IRC 691(c) Estate Tax Deduction

Code Section 691(c) allows an income tax deduction for estate tax that was paid on items of income in respect of a decedent (IRD). IRD items are subject to both estate tax in the decedent's estate and income tax when the income is received by either the estate or the beneficiary.

Examples of IRD:

- wages of the decedent received after death
- IRA distributions
- 401(k) distributions
- annuities
- accrued interest and dividends as of the decedent's DOD
- installment note income

IRC 691(c) Estate Tax Deduction

If an estate had IRD assets and federal estate tax was paid, a computation must be done to determine the estate tax attributable to the IRD assets. This estate tax is an income tax deduction on the IRD recipient's income tax return.

The deduction is available only in the tax years in which IRD is included in income. The pro-rata deduction amount is based on the amount received currently to total IRD to be received.

For estates, the deduction is taken on page 1, line 19 of Form 1041 and a computation of the deducted amount must be attached to the return.

Deducting Expenses on Form 1041 vs Form 706

- Comparison of estate tax savings vs income tax savings
 - Consider limitations on the 1041 (disallowed 2% floor deductions and allocations to tax-exempt income)
 - Consider timing of payment vs income recognition on the 1041
 - Consider impact on marital deduction (and amount of exemption available for portability) and charitable deductions on the 706
 - Estate transmission expenses
 - Estate management expenses

Deducting Expenses on Form 1041 vs Form 706

Estate transmission expenses

Administration expenses that would not have been incurred if not for the decedent's death. Such as:

- executor commissions
- legal fees
- probate fees
- appraisal fees

If estate transmission expenses are paid from marital or charitable property, then the estate tax marital or charitable deduction must be reduced. If the expenses that cause this reduction are being deducted on the Form 1041, then there is no offsetting deduction for the decrease in the marital or charitable deduction on the estate tax return. As a result, there will be an increase in the taxable estate and consequently, a decrease in the remaining exemption available for the surviving spouse via portability or possible the creation of an estate tax liability.

Deducting Expenses on Form 1041 vs Form 706

Estate management expenses

Expenses incurred for the investment, preservation and maintenance of estate assets. Examples are:

- investment advisory fees
- stock brokerage commissions
- custodial fees
- interest

The estate tax marital or charitable deductions will not be reduced by management expenses attributable to *and* paid from the marital and charitable shares unless the management expenses were deducted as administration expenses on the federal estate tax return.

The estate tax marital or charitable deductions will be reduced for management expenses paid from the marital share or charitable share but *not* attributable to those shares.

If the marital or charitable deductions on the estate tax return are significant, it will most likely make sense to take the management expenses attributable to those shares on the Form 1041 to avoid the reduction of those deductions.

Deducting Expenses on Form 1041 vs Form 706

- Examples of expenses that can be taken on either Form 706 or Form 1041 but not both:
 - Executor commissions; legal and accounting fees; appraisal fees and probate fees
- Examples of expenses that can be taken on both returns (DRD - deductions in respect of decedent. The decedent must have been liable for the expense as of his/her date of death in order for it to be a DRD item.):
 - Expenses related to the decedent's business allowable under IRC 162; interest expense allowable under IRC 163; taxes allowable under IRC 164; investment expenses under IRC 212 and percentage depletion allowable under IRC 611.

Deducting Expenses on Form 1041 vs Form 706

- Election statement outlined in Treas. Reg. 1.642(g)-1 may be handled in either of two ways:
 - Attached to each Form 1041 on which the deductions, which would otherwise have been allowable on the Form 706, are being taken.
 - Filed within the statutory period of limitation for the respective Form 1041 with the appropriate IRS Center for the return.
- Must be filed in duplicate with both statements signed by the executor.
- Consideration should be given to not filing the election statement for the deductions until the earlier of the final estate tax assessment or the statute of limitations for the 1041.



Questions?