CHECK YOUR TAX BLIND SPOTS: WHAT TRUSTS & ESTATES ATTORNEYS – AND OTHER PROFESSIONALS – SHOULD KNOW ABOUT INCOME TAX

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CHECK YOUR TAX BLIND SPOTS: WHAT TRUSTS & ESTATES ATTORNEYS – AND OTHER PROFESSIONALS – SHOULD KNOW ABOUT INCOME TAX

Attorneys whose practices focus on estate and trust administration generally have a strong understanding of the federal transfer tax system, being the laws applying to the federal gift and estate tax; and they regularly prepare gift and estate tax returns. While there are certainly exceptions, trusts and estates attorneys are not often accountants whose practices include the preparation of income tax returns; so it would follow that a trusts and estates attorney would not have the same understanding of the federal income tax system that he or she has of the federal transfer tax system. While a qualified accountant should prepare the income tax returns for a decedent, a decedent's estate, or a trust and should be relied upon for most income tax advice, attorneys should be aware of some basic rules related to the income taxation of trusts and estates so they can give their clients general guidance regarding their obligations and identify issues needing attention by an accountant. Other professionals who work in connection with trusts and estates will also benefit from a general understanding of this topic, including trust officers with corporate fiduciaries that serve as trustee or executor and investment advisors assisting a trustee or executor with the management and investment of trust or estate assets.

This article will address ethical considerations for attorneys as they engage and communicate with clients regarding income tax matters; it will outline, in general terms, some of the most basic rules related to the income taxation of trusts and estates; and it will provide attorneys and other professionals in the field of trusts and estates with strategies for deciphering income tax documents and spotting income tax issues in the course of their representations.

I. ETHICAL CONSIDERATIONS

a. Engagement Letters & Client Memorandums

The Texas Disciplinary Rules of Professional Conduct ("TDRP") provide that "[t]he scope of representation provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client." TDRP Rule 1.02, Comment 4. Most attorneys (and malpractice carriers) would agree it is imperative to have an engagement letter in place for each client representation so matters including what the attorney is being hired to do and how much she will charge to do it can be agreed upon at the start of the representation and not be left open to interpretation.

A good engagement letter will have a clear description of the scope of representation – in other words, what exactly the attorney will be doing for the client. Just as it is important to tell the client what the attorney will be doing on the client's behalf, it can be equally important to tell the client what the attorney will *not* be doing on the client's behalf. The engagement letter between an attorney and an executor or trustee offers the perfect opportunity to explain that the attorney does not prepare income tax returns (assuming that is the case), and that the fiduciary will need to retain an accountant for this purpose. An attorney representing an executor might consider using language such as the following in his engagement letter:

> We do not give financial advice or prepare income tax returns of any kind, and you will need to rely upon a qualified accountant for the preparation of the income tax returns that must be filed for [decedent] for this year (and any prior years, to the extent those returns have not yet been filed) on Form 1040. The Estate will also be a separate taxpayer, and you may need to file income tax returns for it on Form 1041, which should also be prepared by a qualified accountant.

When representing a client who is serving as a fiduciary, it is a great practice to provide that client with a customized memorandum or other written instructions outlining the fiduciary's duties and responsibilities in light of the relevant law and the terms of the governing instrument. For the executor[1] of an estate, such correspondence could also incorporate the important probate and estate tax deadlines. For the trustee of a trust, such a memo might also provide specific guidance regarding the trust's distribution standard. In either case, it is recommended that income taxation be specifically addressed; and the client should be informed that the estate or trust (assuming it is a non-grantor trust) will be its own taxpayer, and the estate or trust's income will be reported annually on a *Form 1041, U.S. Income Tax Return for Estates and Trusts*.

In the case of a decedent's estate or a revocable trust being administered after the settlor's death, the client should be reminded of the responsibility to file the final income tax return of the decedent on *Form 1040,*

[1] The word "executor" is used throughout this paper for the sake of simplicity, but the word "administrator" could be interchanged therewith to signify the personal representative of an estate for which no executor was appointed under the terms of a will.

U.S. Individual Income Tax Return. Section III, below, provides additional information regarding income tax responsibilities of a fiduciary, which can be incorporated into client correspondence. Client memorandums and other correspondence provide another excellent opportunity to inform the client that the attorney does not prepare income tax returns, and she will need to engage an accountant for the preparation of any required income tax returns.

b. Know What's in Your Wheelhouse (and What Isn't)

In the course of client representation, questions inevitably arise that are outside an attorney's scope of knowledge, and this can happen particularly often with regard to income tax issues. When a client has already retained an attorney to advise her, she might be reluctant to establish yet another professional relationship to handle income tax questions. An attorney with a natural tendency to want to solve all of the client's problems might try to address the question himself. However, if the question does not fall within the scope of legal advice the attorney is qualified to provide, then the attorney would be wise to immediately point this out and recommend consultation with a qualified accountant. The TDRP agree, stating the following:

> Matters that go beyond strictly legal questions may also be in the domain of another profession. Family matters can involve problems within the professional competence of psychiatry, clinical psychology or social work; business matters can involve problems within the competence of the accounting profession or of financial specialists. Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. TDRP Rule 2.01, Comment 4.

If an attorney is having difficulty explaining to the client why an income tax issue is outside the attorney's area of knowledge, it might be helpful to remind her that even if the attorney felt comfortable performing the research and analysis, doing so would be cost-ineffective as compared to simply engaging a qualified accountant who likely would not take as long to find the correct answer.

c. Have the Understanding Necessary for Diligent Representation

Federal income taxation is the domain of accounting professionals. Nevertheless, attorneys will often be the client's "first stop" in the course of undertaking duties as a fiduciary; and in light of this, the attorney should have some general understanding of the rules related to income taxation of trusts and estates in order to best represent her client and point the client in the right direction. One might argue this is consistent with the following ethical rule regarding a competent and diligent representation:

> Having accepted employment, a lawyer should act with competence, commitment and dedication to the interest of the client and with zeal in advocacy upon the client's behalf. A lawyer should feel a moral or professional obligation to pursue a matter on behalf of a client with reasonable diligence and promptness despite opposition, obstruction or personal inconvenience to the lawyer." TDRP Rule 1.01.

While this should not be interpreted as requiring the attorney to learn the rules of professional accounting (TDRP Rule 1.01 addresses competent and diligent representation in *legal matters*), one could argue that a good trusts and estates attorney, who wants to best help his client carryout the client's legal duties as a fiduciary, will know enough of the rules that relate to income taxation of trusts and estates so that the attorney can (i) provide general guidance on the appropriate deadlines and filing requirements and (ii) spot income tax issues that will require further attention (often with the assistance of an accounting professional); and such rules are the focus of the remainder of this paper.

d. Clarify the Division of Responsibilities

Ideally, the client will provide the attorney with contact information for her accountant (and the client will provide the accountant with her attorney's contact information); otherwise, the attorney should ask for this information. While the accountant should be relied upon for advice on income tax matters, the probate attorney can be helpful in bringing certain issues to the accountant's attention. By "issue spotting" at the beginning of an engagement and bringing information to the accountant's attention, the advisors can help the client develop an income tax strategy for the administration, rather than leaving everything to tax season when accountants are extremely busy and it may be too late to take some of the actions that could impact the income tax. Ideally, the attorney will seek to establish consensus (in writing) regarding those matters the attorney will help with, those matters the accountant will help with, and what the client's own obligations will be. Open communication will keep both advisors and the client on the same page and develop a sense of community in the process. In many cases, the client will

look to the attorney for a recommendation of an accountant; and it is helpful if the attorney has a list of local accountants who regularly prepare Form 1041 to suggest in this instance.

II. INCOME TAXATION OF TRUSTS AND ESTATES

a. An Estate or Trust as a Taxable Entity

An estate or trust (other than a grantor trust) is its own taxpayer, and the executor or trustee will be responsible for reporting its income and paying any tax due to the extent the income met the relevant filing threshold. Income to a trust or estate is just like income to an individual and can consist of interest, dividends, rents, royalties, income from business interests, and gains from the sale of estate and trust assets (among other things). Estate income may also consist of "income in respect of a decedent," which is basically income that would have been income reported by the decedent had she not died, with common examples including retirement benefits and wages or commissions not paid before death. The property on which tax is imposed under Section 641 of the Internal Revenue Code (the "Code") does not extend to non-probate property that is not part of the estate. In other words, "estate income" does <u>not</u> include income attributable to non-probate assets as such property is not subject to the executor's possession or control. *See* IRC § 641. Rather, the individual inheriting the nonprobate asset, not the executor, will be responsible for the post-death income related thereto.

b. Exception: Grantor Trusts

A grantor trust is a trust that has one or more characteristics that cause the grantor of the trust to be treated as the owner of the trust (or a portion thereof) for income tax purposes. This means the trust's income (or a portion thereof) will be taxable as income to the grantor of the trust and not to the trust itself, and the trust is disregarded as a separate tax entity.

Sections 671 – 678 of the Code describe the specific features of a trust that will trigger grantor trust status, with the most common example being the ability of the grantor to revoke the trust. Revocable trusts are by their nature grantor trusts. Another very common example of a grantor trust is the "intentionally defective grantor trust" (IDGT). Unlike a revocable trust, which is included in the grantor's estate under IRC § 2038 *and* is treated as being owned by the grantor for income tax purposes under IRC § 676 (and often other provisions as well), the IDGT is drafted to be a grantor trust for income tax purposes but escapes taxation in the grantor's estate, most commonly through the use of a power of substitution under IRC § 675(4)(C), which triggers grantor trust status but not gross estate inclusion. The beauty of this type of trust is that the grantor removes the assets (and their growth) from her estate for estate tax purposes but pays the trust's income taxes without that payment being considered a gift, which lets her indirectly further benefit her beneficiaries (gift tax-free) since the trust assets will not be reduced by tax payments.

Normally trust income is reported on Form 1041. If the trust is a grantor trust however, the trustee may still file a Form 1041 identifying the trust, but the trust income will not be reported on the return (or more specifically, only that income related to the portion of the trust not taxable to the grantor will be reported). Reporting income for a grantor trust may be done in different ways. The trustee may file a Form 1041, the trustee will include with it an attachment that identifies the individual to whom the trust income will be taxed, and the trustee will provide the attachment to such individual. The individual will in turn report the trust income taxable to him or her on his or her own Form 1040. Alternatively, and as is done with most revocable trusts, the payors of income can be given the grantor's social security number to associate with the income source so that despite the asset being titled in the name of the trust, the income will be attributed to the grantor's tax identification number. It is strongly advised that grantors and trustees seek the assistance of qualified accountants for purposes of reporting income related to grantor trusts with the grantor trust character of a trust being communicated to the accountant so she knows how income is to be treated and reported; and when a drafting attorney prepares a grantor trust for a client, the attorney should clearly communicate this to the client.

c. Simple Versus Complex Trusts

A simple trust is a trust having terms that require all trust income be distributed to the beneficiary (or beneficiaries) annually, that do not provide that trust property can be used for charity, and that do not permit distributions other than that of current income. Treas. Reg. § 1.651(a)-1. A complex trust is any trust that is not a "simple trust." The distinction between a simple and complex trust is relevant to the discussion of exemptions and deductions, below.

d. Relevant Exemptions & Rates

The gross income threshold triggering the requirement to file a Form 1041 is extremely low, meaning that all trusts and estates, but for those with virtually no income, will be required to file income tax returns. The following are the exemptions in effect as of the writing of this paper:

2023 Exemption Amounts		
Estate	Simple Trust	Complex Trust
$600	$300	$100

Source: IRC § 642(b)

Additionally, trust and estate income is taxed much more aggressively than individuals' income, with the highest income tax rate coming into play at a relatively low threshold. The following provides an indication of ordinary income tax liability for estate and trust income of different amounts:

2023 Income Tax on Trusts and Estates		
If taxable income is between:	Your tax is:	Of amount over:
$0 - $2,900	10%	$0
$2,901 - $10,550	$290 + 24%	$2,900
$10,551 - $14,450	$2,126 + 35%	$10,550
$14,451 and above	$3,491 + 37%	$14,450

Source: theKFordgroup 2023 Tax Pocket Guide

The following provides the current rates for long-term capital gains of trusts and estates:

2023 Long-Term Capital Gains Rates for Trusts and Estates	
Amount of Income	Rate
> $14,650	20%
$3,000 - $14,650	15%
< $3,000	0%

Source: IRS' Instructions for 2023 Form 1041-ES

NIIT. Also be aware that trusts and estates are subject to the additional "Net Investment Income Tax" of 3.8% on the lesser of (a) the undistributed net investment income, or (B) the excess (if any) of adjusted gross income over the dollar amount at which the highest tax bracket begins for an estate or trust for the tax year. IRS Topic No. 559.

e. Deductions on Form 1041

Distributions. Section 661 of the Code (with respect to estates and complex trusts) and Section 651 of the Code (with respect to simple trusts) allow a deduction in computing the taxable income equal to, generally speaking, the total amount of estate or trust distributions made limited to the "distributable net income" ("DNI")[2] of the estate or trust. That DNI is in turn carried out and reported as income to the beneficiaries, as discussed in Paragraph h, below. In this sense, the estate or trust is viewed like a "conduit" for the income, only paying tax on the income to the extent the income is retained in the estate or trust.

The distribution need not be a distribution of cash to qualify for the deduction. In kind distributions can carry out income too. Treas. Reg. § 1.661(a)-2(f)(2). However, distributions satisfying a specific gift of money or property, which can be ascertained at the date of death and which are paid in not more than three installments, will not carry out DNI. IRC § 663(a)(1) and Treas. Reg. § 1.663(a)-1. Note that since formula bequests to a marital or bypass trust typically *cannot* be ascertained at the date of death, those do typically carry out DNI.

Another very important caveat to keep in mind with respect to distributions carrying out DNI: absent the special situations described in Section 1.643(a)-3(b) of the Treasury Regulations, capital gain cannot be distributed as DNI unless it is the final year of the estate or trust administration. Treas. Reg. § 1.663(a)-1.

Administration Expenses. Administration expenses may be deducted on the Form 1041, but only if they were not deducted on the *Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return*. IRC § 642(g). Given today's large estate tax exemption amount and the fact that fewer estate tax returns need to be filed, administration expenses will often be put to use on the Form 1041. However, in the case of a taxable estate, communication between the Form 706 preparer (often the probate attorney) and the accountant preparing the Form 1041 is especially important so it can be mutually agreed where the deduction will be used. Where the administration expenses are deducted will also impact the size of a formula bequest to a marital or bypass trust, so particular attention is warranted. Note that there is also no double deduction allowed for uncompensated losses incurred during an estate settlement from fires, storms, shipwrecks, or other casualties, or from theft. *Id.*

Estate Tax Paid on IRD. Another instance where communication between the Form 706 preparer and Form 1041 preparer is important is with regard to any estate tax paid on "income in respect of a decedent" ("IRD"). Recall that IRD paid to the estate is income to the estate, but it is also includable in the decedent's gross estate under IRC § 2033 and gets reported on the Form 706. Fortunately, if the inclusion of the IRD triggers estate tax, a deduction may be taken for the amount of estate tax attributable to the IRD, calculated as provided in IRC § 691(c). Note that IRD, which commonly includes retirement plans, is often paid

[2] DNI is defined in Section 643 of the Internal Revenue Code, and it is, in the most general of terms, the estate or trust's taxable income without considering the distribution deductions, the § 642(b) exemption, capital gains and losses allocated to principal, and specific types of dividends and interest.

directly to beneficiaries (rather than an estate), in which case the deduction would be available to the beneficiaries under IRC § 691(c); however, this is an income tax deduction that is known to be frequently missed.

Additional Deductions. There are many more deductions that can be taken on a Form 1041, and the foregoing list covers only a few of the most significant ones to be on the lookout for. Consult Subchapter J of the Code, and the related Treasury Regulations, for information about additional deductions, including deductions for net operating losses, depreciation, depletion, and amortization.

f. Timing of Payments and the "65 Day Rule"

Deductions are the critical factor in determining whether or not a trust or estate earning income will pay income tax. Given the income tax rates applicable to trusts and estates (as compared to the rates of many individuals), the distribution deduction serves as a great motivator for executors of estates and trustees of terminating trusts to wind up the administrations as soon as possible. Of course, there will be many instances where distributions simply cannot be made as soon as would be ideal – for example, if the estate or trust is subject to litigation or is subject to a court supervised administration, if the assets take a significant time to collect or are difficult to distribute, or if the estate is subject to debts that need to be addressed before distributions can be made. However, in cases without roadblocks to distributions, the executor or trustee should factor in timing for purposes of minimizing estate income taxes.

The executor or trustee should also be aware of the grace period afforded to her by the "65 Day Rule." Section 663(b) of the Code provides that an amount paid or credited within the first sixty-five days of any taxable year of an estate or trust shall be considered paid or credited on the last day of the preceding tax year.

g. Basis Considerations

Adjustment of Basis at Death. As a general rule, the basis of a decedent's assets gets adjusted to equal the fair market value of the assets as of date of death. There are exceptions to this rule: if the decedent's executor elected to use alternate valuation under IRC § 2032 on the decedent's Form 706, the new basis would be the value as of the alternate valuation date; if the executor special use valuation was made under § 2032A, the new basis will be the value under that section; and if the exclusion under IRC § 2031(c) applies (related to land subject to a qualified conservation easement), the basis will be the basis in the hands of the decedent. This adjusted basis rule does not apply to income in respect of a decedent. IRC §1014.

Tracking Basis. Given that assets will usually be valued at a Decedent's death – be it for the Form 706 or a probate inventory – tracking the basis in assets of an estate or a trust that was recently funded with a decedent's assets will not be too difficult. Things become hairier if a trustee, when reporting a sale of trust property, needs to determine the basis of the asset that has been in trust for many years or decades or which was contributed by a settlor during life who did not properly document the basis of the gifted property on a Form 709. There has been some relief since Congress started requiring financial institutions and brokerage firms to keep records of an owner's basis in securities in 2008. However, there are obviously many trusts in existence that were funded prior to 2008 or which hold assets other than cash and securities, and when it comes time to determine the basis in trust assets, the trustee may need to undertake some historical research.

Common Instances in Which Basis Is Relevant. Basis of estate or trust assets will be important for several reasons, with the following being some of the most common examples:

- *Sale of Estate or Trust Asset*. Most obviously, if an asset is sold, the executor or trustee will need to know the basis in order to determine the relevant capital gain subject to tax (or capital loss).
- *Beneficiary's Basis*. Basis will also be relevant for beneficiaries receiving assets in kind since the basis of property received by a beneficiary in a distribution from an estate or trust will be the adjusted basis of the property in the hands of the estate or trust immediately before distribution, adjusted for any gain or loss that was recognized to the estate or trust on the distribution.[3] IRC § 643(e).
- *Funding Pecuniary Bequests*. Basis will also be important when it comes to funding pecuniary bequests because when appreciated assets are used to fund a *pecuniary bequest*, there will be, in most cases, a taxable gain realized for the estate. Say a will makes a gift of property worth $500,000 to a beneficiary. If the governing instrument requires "date of distribution" values to be used for funding the gift (or if the instrument is silent such that Texas law, specifically Section 124.051 of the Texas Estates Code, applies), and the basis in the assets used to fund the gift is only $450,000, the funding will trigger capital gain of $50,000 for the estate. This rule also applies for pecuniary formula gifts, such as a pecuniary gift of a marital deduction formula amount. Attorneys should remember that

[3] Instances in which an executor or trustee would recognize gain is beyond the scope of this paper.

there are potential income tax consequences when funding pecuniary bequests and encourage their clients to consult with the accountant about how to best minimize such taxes.

h. Distributions Reported to Beneficiary

To the extent a distribution to a beneficiary carries out income, the income is includable in the gross income of the beneficiary who receives it. IRC §§ 652 & 662. The beneficiary's share of the estate's or trust's income is reported on the *Schedule K-1* attached to the Form 1041. The beneficiary must be provided with his Schedule K-1 so that he can report that income on his own Form 1040.

Consider the interesting timing of distributions from an estate and reporting of income. If an estate is on a fiscal year running from February 1, 2022, through January 31, 2023. A distribution carrying out income that happened in February of 2022 would be reported on the Form 1040 of the beneficiary for 2023. The beneficiary would need to report that income in April of 2024 (or October of 2024 with an extension) and pay the tax in April of 2024. That is obviously a significant period of time between a distribution and when it is ultimately reported by the beneficiary, which underscores the importance of beneficiaries being made aware of the tax ramifications of distributions and related reporting.

First, it would be helpful if the executor or trustee would inform beneficiaries as soon as possible that distributions the beneficiaries receive may carry out income; and if they do, the beneficiary should expect to receive a Schedule K-1. If the attorney is communicating directly with an unrepresented beneficiary, or a represented beneficiary's counsel, the attorney could point this out and remind the beneficiary that the attorney does not represent the beneficiary and the beneficiary will need to consult with her own accountant regarding how to report trust income distributed to the beneficiary. The timing of a K-1 issued by an estate or trust could impact whether the beneficiary can timely file her own Form 1040 or will require an extension. Therefore, communication (ideally written communication) is key. It is never too early to warn beneficiaries about the taxability of distributions and reporting requirements so that confusion, surprise, and frustration can be avoided during tax season.

III. IRS HOUSEKEEPING

The following is a list of important forms, elections, and filing requirements that an executor of an estate or a trustee of a trust will need to be aware of.

a. Obtaining an EIN

A decedent's estate will be its own taxpayer and thus requires its own taxpayer identification number ("EIN") to which its income can be reported. Trusts, excluding grantor trusts for which trust income is reported to the grantor, are also unique taxpayers and will require their own EINs. An EIN can be obtained online in a matter of minutes through the IRS' own website.[4] Practice pointer: the individual obtaining the EIN should be certain the number is being obtained directly from the IRS and *not* from a third party purporting to offer this service. If for some reason someone opted not to obtain the EIN online, it can be obtained by filing *Form SS-4, Application for Employer Identification Number* with the IRS.

b. Form 56

The executor of an estate or the trustee of a trust must provide the IRS with specific notice of the creation or termination of a fiduciary relationship through *Form 56, Notice Concerning Fiduciary Relationship*. *See* IRC §6036. Should the fiduciary (or his attorney who has been authorized under a taxpayer power of attorney) need information from the IRS, the IRS typically will not communicate with the fiduciary (or her attorney) until this form has been submitted. Practice pointer: with respect to a decedent's estate, the IRS will likely require one form for the decedent (which lists the decedent's Social Security Number) and one form for the estate (which lists the estate's EIN), so it would be prudent to file both as soon as practicable.

c. Form 2848

If an executor or a trustee would like his accountant or attorney to communicate with the IRS directly on his behalf, the IRS will require a *Form 2848, Power of Attorney and Declaration of Representative* to be on file for the taxpayer, which specifically authorizes the advisor with regard to the subject matter and relevant tax years at issue.

d. Choosing the Estate's Tax Year

A decedent's estate may have either a calendar year or a fiscal year for income tax purposes. A calendar year is a twelve-month period ending on December 31st, and a fiscal year is a twelve-month period ending on the last day of any month other than December. IRC § 441.

[4] https://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online

The following chart illustrates the calendar year period and the fiscal year period for a Decedent dying on June 14th.

Decedent's Date of Death: June 14th		
	Tax Year 1	**Subsequent Tax Years**
Final 1040	January 1 – June 14th	n/a
1041 on Calendar Year	June 15th – December 31st	January 1st – December 31st
1041 on Fiscal Year	June 15th – May 31st	June 1st – May 31st

The election for an estate's tax year – whether calendar or fiscal – is made on the first Form 1041. Treas. Reg. § 1.441-1(c)(1). When obtaining an EIN online, the IRS will ask for the closing month of the tax year. This should not be binding, and filing the Form 1041 should be the definitive statement of the selected tax year; nevertheless, consider selecting the month end that provides the longest tax year possible if you are unsure of which tax year to ultimately use at the time the EIN is obtained.

The selection of a calendar year or a fiscal year is a strategic decision, which should be made based on which option best serves the estate and its beneficiaries. The decision should also factor in the point in the year at which the decedent died, since dying later in the year typically increases the helpfulness of the fiscal year option. The following are among the instances in which a fiscal year may be preferable:

- *Longer reporting period* – Say that there's a significant amount of income to the estate in the period between decedent's death and December 31st, but the deductible expenses won't yet have been incurred by the end of the year. If there will be deductions that could offset that income, then it might make sense to have a longer first income tax year through electing a fiscal year in order to put those deductions to their best use. A longer reporting period may also limit the number of tax returns that need to be filed (for example, if the administration could be completed in one fiscal year, the first Form 1041 could also be the final return), thereby saving administrative costs of return preparation.
- *Deferral of tax payment* – since income tax is due three months and fifteen days after the end of the tax year, a longer first tax year (through the use of the fiscal year) will delay the due date for income taxes owed by the estate, which might be especially helpful for an estate with limited liquidity. A fiscal year also provides tax deferral benefits to the beneficiaries if income has been distributed (as discussed below). Income distributed to a beneficiary gets reported on the beneficiary's Form 1040 for the tax year in which the estate's tax year ended. IRC § 662(c). This could be well after the time the beneficiary received the distribution.

The executor should be encouraged to confer with his accountant to determine the appropriate tax year for the estate after consideration of the relevant facts and anticipated income and deductions. If there are no circumstances that warrant a fiscal year, a calendar year will be preferable from an administrative standpoint. Tax documents, such as 1099s and K-1s, are produced on a calendar year basis, so fiscal year reporting would require apportionment of the income reported on those forms between two different fiscal years, which can be a headache for the executor and his accountant. Since the rest of the world operates on a calendar year, a calendar year should be chosen absent good reason for choosing a fiscal year.

e. Section 645 Election

As a general rule, trusts are not allowed to elect a fiscal year. Unlike estates, trusts must report their income on the calendar year basis. There is a notable exception to this general rule for former revocable trusts that become irrevocable upon the settlor's death (called "qualified revocable trusts"). For such trusts, the executor and trustee may elect to treat the settlor decedent's estate and the qualified revocable trust as one entity for tax reporting purposes. *See* IRC § 645. The election is made on Form 8855, filed by the deadline for the first Form 1041. The election is irrevocable once made. IRC § 645(c). This election is good for the longer of two years after the decedent's death (if no Form 706 is required to be filed) and six months after the "date of final determination of the liability" for the estate tax (if a Form 706 is required to be filed). IRC § 645(b)(2). If a trust eligible for the Section 645 election will last longer than the relevant period described in the preceding sentence, special consideration should be given to the impact of this for the distribution of income to the beneficiaries.

f. Decedent's Final 1040 and Unfiled Prior 1040s; Forms 4506 and 4506-T

Assuming a decedent had the amount of income necessary to require the filing of a Form 1040, a final Form 1040 must be filed for the year in which he died. The Form 1040 for a deceased individual is to be filed by her "executor, administrator, or other person charged with the property of such decedent." IRC § 6012(b)(1). The deceased individual's tax year ends on his date of

death, and the Form 1040 will be due on or about April 15th of the following year (the same due date as applies to living taxpayers), unless an extension is obtained. A decedent's final tax return is generally prepared and filed in the same manner as that of a living individual (for example, the Form 1040 of a decedent who was married can be filed jointly with the spouse).

In many cases, the decedent will have had a relationship with an accountant, who will be helpful in pointing the executor in right direction by providing past tax returns so the executor knows what sources of income to be looking for as she gathers estate assets and compiles the information required for the decedent's final Form 1040. However, there are plenty of cases in which the decedent was a "do-it-yourself-er" and prepared and filed her own returns. In such a case, the executor will need to do a little more digging, hopefully finding copies of past tax returns and good financial records.

The executor of an estate (or other person charged with a decedent's property) also has a duty to file any 1040s that were not filed before the decedent's death. IRS Pub. 559. The most obvious example would be the situation where a decedent dies prior to the due date for the prior year's return (be it April or the extended October deadline).

There are, of course, plenty of messier situations where the decedent failed to file income tax returns for one or more years, or the executor cannot verify whether those returns have been filed. In that case, the executor will need to seek information from the IRS. In order to request a copy of a specific year's return, the executor will file *Form 4506, Request for Copy of Tax Return*. There's a fee for return requests, but alternatively the IRS offers free transcripts of tax returns which include much of the relevant information, which can be requested using *Form 4506-T, Request for Transcript of Tax Return*. Through these documents, the executor can determine whether an income tax return was filed for a given year.

g. Form 1310.

If a decedent is owed a refund from the IRS, the executor will need to file Form 1310 in order to collect the refund.

h. Form 1041

The Form 1041 for an estate or trust will be filed by the fifteenth day of the fourth month after the close of the estate or trust's tax year. An executor or trustee may obtain an automatic extension of time to file the return by five and a half months by filing *Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*. Note, as with other returns: the extension obtained through this form does not extend the due date for paying tax, it only extends the due date for filing the return. IRS Pub. 559.

i. Requests for Prompt Tax Assessment & Discharge; Forms 4810 and 5495

An executor has the opportunity to file *Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)*, which limits the period in which the IRS can assess additional tax due to eighteen months (as compared to the three years the IRS would typically have). Like with the estate and gift tax, an executor can request a discharge from personal liability for income taxes by filing *Form 5495, Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905*. Upon filing of *Form 5495*, the IRS has nine months to inform the executor of additional tax due; and upon payment of such amount (if the IRS issued an amount) or upon the expiration of the nine months (if no amount was issued), the executor will be discharged from liability for deficiencies. IRS Pub. 559.

IV. DECIPHERING TAX FORMS

a. Quickly Identifying Important Information on a Decedent's 1040

One of the primary functions of an executor is to collect a decedent's assets before paying any creditors and expenses and distributing estate property in accordance with the terms of the will. Few decedents leave a comprehensive and current inventory of assets, complete with information such as financial institution, legal description, and account number. An executor will often need to perform some research in order to find out what exactly the decedent owned so that she knows what to collect. While there is no law requiring us to keep records of our assets, there is a law requiring us to file income tax returns each year which document the sources of our income. Therefore, the best place to start is often the decedent's recent Form 1040s.

The problem for the probate attorney is that he is typically not an income tax return preparer, so much of the Form 1040 might be hard to understand. The key is knowing where to look to find the relevant information. If the goal in reviewing a past Form 1040 is to identify assets owned by the decedent, here is where to start:

> *Schedule B*. Schedule B is where the taxpayer reports interest and dividends, so this can help tell the executor the financial institutions where the checking, savings, and brokerage accounts are located.
>
> *Schedule C*. Schedule B is where the taxpayer reports self-employment income, so this can

inform the executor if the decedent owned a business through which she was employed.

Schedule E. Schedule E is where the taxpayer reports income from pass through entities, as well as rents and royalties. If the decedent owned an interest in a partnership, LLC, or S-Corp, the entity names would be found here. If the decedent owned a rental property or mineral interests, information providing clues about those would be found here as well.

A Form 1040 likely will not provide an executor with everything she needs to know to set off on gathering assets. For example, there are many assets that simply do not produce income every year. However, it is a reliable place to start.

b. Schedule K-1

The Schedule K-1, which reports a partner's share of income and deductions, is another tax form that could be important in the course of an estate or trust administration. When a decedent's estate or a trust owns an interest in a business entity, the entity will provide the executor or trustee with a Schedule K-1 reporting its share of income and deductions, so that such information can be reported on the Form 1041 for the estate or trust. Here are some helpful hints for an attorney representing an executor or trustee of an estate or trust that will receive a Schedule K-1:

Beware of "Phantom Income." An executor or trustee who did not receive any distributions from an entity during a tax year should not assume that there will be no income reported to the estate or trust. There can be instances where a Schedule K-1 reports income to a partner, but there was never any distribution made to the partner in the year, and this is often referred to as "phantom income." While a pass-through entity must allocate its income, it might not be obligated to make any distributions.

Proactively Seek Information.
To avoid surprises, an attorney might encourage his executor or trustee client to promptly make contact with the entity's manager to determine whether or not (i) the executor or trustee should expect a Schedule K-1, (ii) there will there be income or deductions allocated to the estate or trust, and (iii) when the Schedule K-1 can be expected. A delay in receiving a K-1 might necessitate the filing of an extension for the Form 1041 for the estate or trust.

The Schedule K-1 is also the tax document that will be provided to beneficiaries of estates and trusts to report to them their share of income and deductions for the year, as discussed above.

V. CONCLUSION & ADDITIONAL RESOURCES

Hopefully this paper provided the reader with a general understanding of some important rules related to the income taxation of trusts and estates, an awareness of some ethical responsibilities related to representing executors and trustees who have income tax reporting obligations, the basic reporting and filing requirements that executors and trustees have, and some strategies for helping executors and trustees carry out their duties.

While this paper is not a thorough examination of the many complicated rules that apply to the income taxation of trusts and estates, there are plenty of excellent resources for finding additional information, including the following:

- *Subchapter J and the related Treasury Regulations.* To go "straight to the source" for matters related to income taxation of estates, trusts, and beneficiaries, see Subchapter J of the Code (Sections 641 – 692) and the related Treasury Regulations.
- *Willms and Davis Publications* – Melissa Willms and Mickey Davis have written extensively on the subject of income taxation of trusts and estates, and their in-depth works include the "Income Taxation of Trusts and Estates" and "Ten Things Every Estate Planner Needs to Know About Subchapter J," found at www.daviswillms.com.
- *Publication 559.* Publication 559 is the IRS' official guide for survivors, executors, and administrators as they prepare tax returns.
- *theKFordgroup's Pocket Guide.* Available at www.thekfordgroup.com, the annual pocket guide provides relevant tax rates and other information helpful to executors and trustees as they anticipate taxes.