WHAT EVERY ATTORNEY NEEDS TO KNOW ABOUT FIDUCIARY INCOME TAX

By

Carol A. Cantrell

Briggs & Veselka Co.
6575 West Loop South #700
Bellaire, Texas 77401
1-800-678-9104
ccantrell@bvccpa.com

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I. FUNDAMENTAL CONCEPTS OF FIDUCIARY INCOME TAX

- Estates, trusts, and their beneficiaries are taxed on the conduit theory, which is similar to partnerships in that income and deductions pass through on the Form K-1 to the beneficial owners.
- But unlike partnerships, estates and trusts can also be a tax paying entity as well as a flow-through.
- The taxable income of a trust or estate is determined in the same manner as an individual with some modifications. IRC Sec. 641(b).
- The amount of DNI determines how much taxable income the estate or trust can distribute to the beneficiaries and on which they will be taxed. IRC Secs. 643, 652, 662.
- Distributable net income (DNI) is the trust's taxable income with certain modifications as enumerated in IRC § 643(a).
- The trust or estate is entitled to a deduction for DNI distributed to beneficiaries. IRC Secs. 651, 661.
- The trust pays tax on any accumulated income of the trust.
- The beneficiaries pay tax on any DNI distributed to them. The income distributed to them retains the same character as it had in the hands of the fiduciary. That is, dividends pass out as dividends, interest passes out as interest, etc. IRC Secs. 652(b), 662(b).
- Except for the year of termination, no losses pass out to the beneficiaries.
- Except for the year of termination, capital gains of the trust are generally classified as corpus rather than income and as such are not included in DNI distributable to the beneficiaries. IRC Sec. 643(a)(3).
- This outline does not cover split-interest charitable trusts described in IRC Sec. 664 or bankruptcy estates under IRC Sec. 1398. Nor does it cover funeral trusts, disability trusts, alimony trusts, exchange funds, or other special types of trusts described in Subpart F of Subchapter J.

II. COMPARING FIDUCIARY AND INDIVIDUAL TAXATION

- Estates and trusts are generally taxed in the same manner as individuals with a few exceptions noted below. IRC Sec. 641(b)
- Some key differences between fiduciary and individual taxation are:
    - Estates and trusts can deduct their administrative expenses without reduction by the 2% floor on miscellaneous itemized deductions under IRC Sec. 67(a) if those costs would not have commonly been incurred by an individual with the same property. IRC Sec. 67(e).
    - Estates and trusts can deduct casualty losses to the extent they exceed 10% of their AGI computed after deducting their administrative expenses. IRC Sec. 165(h)(4)(C).

- Trusts are not allowed a $25,000 deduction for passive losses from rental real estate in which the trustee actively participates. IRC Sec. 469(i).
- Estates and trusts are not entitled to claim a Sec. 179 deduction for depreciable business assets. IRC Sec. 179(d)(4).
- Estates and trusts are entitled to reduced personal exemptions of $600, $300, and $100 compared to the individual exemption of $3,400 (2007) and $3,500 (2008). IRC Secs. 642(b) and 151.
- Estates and trusts are not entitled to a standard deduction. IRC Sec. 63(c).
- Estates and trusts have very compresses tax rate tables compared to individuals. IRC Sec. 1.

- The personal exemption for estates is $600. Simple trusts are entitled to a $300 exemption and complex trusts are entitled to a $100 exemption. IRC Sec. 642(b). Contrast this to individual exemptions allowed of $3,400 (2007) and $3,500 (2008).
- Estates and trusts have completely different rules for charitable contributions than individuals. They can claim an unlimited charitable deduction if made out of their gross income and authorized by the governing instrument. They can also deduct contributions made by the end of the following year. And trusts created before 1969 can "set aside" taxable income earmarked for charity even though not yet paid. IRC Sec. 642(c)
- An estate or trust must allocate net operating losses, depreciation, depletion, and amortization between itself and the beneficiaries on the basis of income allocated to each. IRC Secs. 642(d), (e), and (f).
- An estate or trust may not deduct expenses that were claimed as deductions of the Form 706 estate tax return. IRC Sec. 642(g).
- Distributions of appreciated property to fund a pecuniary bequest are treated as a sale or exchange and will cause the fiduciary to recognize gain or loss. Reg. 1.661(a)-2(f).

III. FILING REQUIREMENTS

- A trust or estate is treated a separate legal entity for federal tax purposes and the fiduciary tax return.
- Form 1041 is used to report the income, deductions, gains, losses, etc. of a domestic decedent's estate, trust or bankruptcy estate.
- A domestic estate or trust must file an income tax return on Form 1041 if it has gross income of $600 or more during a tax year. IRC Sec. 6012(a)(3),(4).
- A trust with less than $600 gross income must file a return of it has any taxable income for the year. IRC Sec. 6012(a)(4).
- If one or more of the beneficiaries of a domestic trust or estate is a nonresident alien individual, the personal representative must file Form 1041, even if the gross income of the estate is less than $600. IRC Sec. 6012(a)(5); Reg. 1.641(a)(2) and 1.61-1(a).

IV. TAX RATES

- Estates and trusts must pay tax on their undistributed income based on special rate tables just for estates and trusts. IRC Sec. 1(e). These rates are indexed for inflation just like other taxpayers.

For Taxable Years Beginning in 2008:

If taxable income is:	The tax is:
Not over $2,200	15% of taxable income
Over $2,200 but not over $5,150	$330.00 plus 25% of the excess over $2,200
Over $5,150 but not over $7,850	$1,067.50 plus 28% of the excess over $5,150
Over $7,850 but not over $10,700	$1,823.50 plus 33% of the excess over $7,850
Over $10,700	$2,764.00 plus 35% of the excess over $10,700.

- The tax rates for estates and trusts are so compressed that the top marginal income tax rate is reached at $10,700 compared to $357,700 for single and married joint individual filers in 2008.

V. SUBCHAPTER J - IRC SECS. 641-685

- The portion of the Internal Revenue Code that is devoted to the income taxation of trusts and estates is Part I of Subchapter J, Sections 641 to 685. Part II contains the rules for income in respect of a decedent and is not discussed in this outline.
- Part I of Subchapter J consists of Subparts A-F as follows:

  Subpart A – General rules for taxation of estate and trusts
  Subpart B – Rules for simple trusts
  Subpart C – Rules of complex trusts
  Subpart D – Accumulation distribution rules
  Subpart E – Rules for grantor trusts
  Subpart F – Misc. (exchange funds, funeral trusts, etc.)

- The rules for taxation operate on the premise that a trust or estate earns or receives income and incurs and pays expenses.

- The trust or estate then makes distributions to beneficiaries that are either required by the instrument, or made through the discretionary powers of the fiduciary.
- The total taxable income is subject to tax and this amount is calculated essentially using the same rules as for individuals.
- The taxable income is then allocated between the entity and the beneficiaries using the rules in Subchapter J.
- If the income is accumulated in the trust or estate, that entity pays the tax.
- If the income is distributed to the beneficiary or beneficiaries, the trust or estate is entitled to a deduction for the amount of the distribution.
- The amount distributed passes DNI out to the beneficiary on the Schedule K-1, which the beneficiary reports on his or her personal tax return.

VI. OVERVIEW OF THE FIDUCIARY INCOME TAX RETURN

- Determine the estate or trust's taxable income before the distribution deduction.
- Determine distributable net income.
- Determine the fiduciary accounting income based on the governing instrument, or state law if the governing instrument is silent.
- Determine the distribution deduction.
- Allocate the DNI distributed among the beneficiaries.
- The trust pays the tax on the balance.

VII. THE SIMPLE TRUST

- The rules for simple trusts are found in IRC Secs. 651 and 652.
- 20% of all fiduciary returns filed are simple trusts according to the IRS Statistics of Income at www.irs.gov. This includes all marital trusts and QSSTs (qualified Subchapter S Trusts).
- In a simple trust all the income is required to be distributed currently, whether or not it is actually distributed. IRC Sec. 651.
- No discretionary distributions are made and no charitable contributions are made.
- In the year of termination, a simple trust becomes complex trust because it makes principal distributions to the beneficiaries.
- Basic approach to the taxation of simple trusts
  - o determine whether trust is simple or complex;
  - o determine the fiduciary accounting income;
  - o compute the trust taxable income before the distribution deduction;
  - o determine the distributable net income (DNI) under IRC Sec. 643;
  - o determine the distribution deduction under IRC 651;
  - o determine the beneficiary's share and the character of the allocation; and
  - o complete the necessary forms.
- If the amount of income required to be distributed currently exceeds the estate or trust's distributable net income (DNI), then the distribution deduction is limited to the DNI. IRC Sec. 651(b).

- DNI only includes income and deductions that are included in the gross income and deductible by the trust for tax purposes.
- A simple trust is entitled to claim a deduction for income that is earned and required to be distributed, even though it has not been distributed. IRC Sec. 651(a).
- The beneficiary must include the income in the year of the trust's deduction, even if the amount was not distributed by the close of the tax year. IRC Sec. 652.
- A trustee can have "sprinkle powers" among a class of beneficiaries and still qualify as a simple trust as long as all the income is required to be distributed currently.
- The characterization of a trust as simple or complex can change from year to year. This is because two of the three requirements of a simple trust depend on trust activity during the year.
- A simple trust is entitled to a $300 personal exemption. IRC Sec. 642(b)(2)(B).
- It is imperative to read the trust documents to determine whether the trust has a mandatory income distribution requirement that could make it a simple trust.

VIII. THE COMPLEX TRUST

- The rules for complex trusts are found in IRC Secs. 661 and 662.
- 45% of all fiduciary returns filed are complex trusts or estates according to the IRS Statistics of Income at www.irs.gov.
- A complex trust does not require that all income be distributed currently. IRC Sec. 661.
- It can provide for and make distributions out of principal and can provide for charitable contributions.
- In the year of termination, a trust is always complex because it makes principal distributions to the beneficiaries.
- Estates are treated as complex trusts because they usually accumulate income during administration
- The distribution deduction in a complex trust is the sum of the amounts required to be distributed, plus all other amounts distributed, limited to deductible distributable net income. IRC Sec. 661(a)(2).
- Distributions from a complex trust are divided into Tier 1 and Tier 2 distributions. IRC Sec. 661(a).
- Tier 1 distributions are distributions of income that is required to be distributed currently. IRC Sec. 661(a)(1).
- Tier 2 distributions are all other amounts properly paid, credited or required to be distributed. IRC Sec. 661(a)(2).
- The underlying rationale of the two-tier system is that Tier 1 distributions are more likely to be from taxable income and should absorb most of the DNI. Therefore, DNI absorbs the first tier of distributions before the second tier. This means if all the DNI is absorbed by the Tier 1 distribution, any Tier 2 distributions in excess of DNI escape tax.
- If DNI is greater than the Tier 1 distribution, the excess DNI is allocated among the Tier 2 beneficiaries.

- DNI is allocated among the beneficiaries in each tier in relation to the amount of fiduciary accounting income (FAI) distributed to each.
- A beneficiary can be both a Tier 1 and Tier 2 beneficiary.

IX. THE GRANTOR TRUST

- The grantor trust rules are found in Subpart E of Subchapter J. IRC Secs. 671-679.
- 35% of all trust returns filed are grantor trusts according to the IRS Statistics of Income at www.irs.gov.
- If a trust meets one or more of the requirements of Subpart E, the grantor or another person is treated as the owner of some or all of the trust. Instead, he or she includes the trust's income, deductions, and credits on his or her personal tax return rather than under the rules for nongrantor trusts in Subparts A through D of Subchapter J. IRC Sec. 671.
- A single trust can be part grantor and part nongrantor. IRC Sec. 671. In that case, the income and deductions attributable to the grantor portion are reported on the grantor or other person's income tax return and the rest of the income and deductions are reported on Form 1041 following the rules for simple or complex trusts, whichever is appropriate.
- A grantor trust reports the income and deductions attributable to the grantor portion of the trust on Form 1041. However, these items are not reflected on page 1 of Form 1041. Rather they are reported on a plain paper schedule attached to the Form 1041.
- A wholly owned grantor trust, all of which is treated as owned by one or more grantors, may elect to waive the Form 1041 filing requirement. If the trust has only one grantor, the trustee should provide the grantor's social security number(s) to the payors on Form W-9 and the payors will issue Forms 1099 directly to the grantor. Reg. 1.671-4(b)(2).
- If the trust has more than one grantor, the trustee may furnish the trust's federal ID number to the payors, who will issue Form 1099 directly to the trust. The trustee must them issue Forms 1099 to the grantors according to the portion of the trust treated as owned by each grantor. Reg. 1.671-4(b)(3).
- Because it is easier to file Form 1041, most wholly owned grantor trusts that are eligible to waive the Form 1041 in favor of Forms 1099 choose not to do so.

X. WHAT IS DISTRIBUTABLE NET INCOME (DNI)?

- DNI is strictly a tax concept, a fiction that is one of many that tax practitioners must deal with. It is different from taxable income and from fiduciary accounting income. It is a blend of both. IRC Sec. 643(a).
- Distributable Net Income (DNI) creates a tax presumption that any distribution is made from trust income first.
- It determines how much of the taxable income of a trust or estate is taxed to the fiduciary and how much is taxed to the beneficiaries.

- It also determines the character of the income taxed to each. IRC Secs. 652(b), 662(b).
- An estate or trust is allowed a deduction for the amount of DNI that is passed out to the beneficiary on Schedule K-1. IRC Secs. 651, 661.
- The amount of this distribution deduction is equal to the lesser of the taxable portion of DNI, or the amount actually distributed or required to be distributed. IRC Sec. 651(b), 661(c).
- The distribution deduction is calculated on Schedule B of the Form 1041.
- This calculation determines the distribution deduction and the amount of taxable income allocated to a particular beneficiary.
- Therefore, the sum of the Schedule K-1 allocations should equal the total distribution deduction.

XI. CALCULATING DISTRIBUTABLE NET INCOME (DNI)

- DNI is a hybrid of taxable income and fiduciary accounting income. IRC Sec. 643.
- The starting place for its calculation is trust taxable income followed by a series of adjustments as described below. IRC Sec. 643.
- Begin with trust taxable income, and

    + add back the personal exemption
    + add back capital losses (if added to corpus)
    + add back net tax-exempt income
    - subtract taxable stock dividends and extraordinary cash dividends allocated to corpus
    - subtract capital gains allocated to corpus
    = DNI

XII. DETERMINING THE DEDUCTIBLE PORTION OF DNI

- Once DNI is calculated, "deductible DNI" must be calculated.
- Because tax exempt interest is included in DNI, but not in the trust's taxable income, the trust is not entitled to a deduction for the portion of DNI consisting of tax exempt income. IRC Secs. 651(b), 661(c).
- Once DNI is determined, it must be separated into the taxable component and the tax-exempt component. Sometimes this is as simple as subtracting out all the tax-exempt income. But if the trust incurred expenses to produce the tax exempt income, the trust's distribution deduction must be reduced by tax-exempt income, net of any expenses incurred to produce it.

XIII. COMPUTING THE DISTRIBUTION DEDUCTION

- To compute the distribution deduction, Schedule B compares the IRC Sec. 651 or 661 DNI (the taxable portion of Sec. 643 DNI) with the taxable portion of the actual distribution.

- In a simple trust, the actual distribution is determined once fiduciary accounting income is calculated.
- It becomes more difficult with a complex trust, especially one that accumulates the income.
- Generally, the deduction for distributions to beneficiaries is the lesser of the total amount of distributions made or required to be made to the beneficiaries, or the DNI of the trust or estate.

XIV. ELECTION TO TREAT REVOCABLE TRUST AS PART OF ESTATE

- A qualified revocable trust (QRT) can elect under Sec. 645 to be treated as an estate for income tax purposes.
- When a Sec. 645 election is made, all of the rules relating to the income taxation of estates also apply to the QRT.
- A Sec. 645 election can be made where there is both an estate and a revocable trust or where there is just a revocable trust that becomes irrevocable upon the grantor's death.
- The election is made on Form 8855.
- The treatment of trusts and estates is generally the same for income tax purposes, except that estates have certain advantages listed below:
    - Estates can use a fiscal year whereas trusts must use a calendar year. IRC Secs. 441 (estates) and 644(a) (trusts).
    - Estates are entitled to a $600 personal exemption compared to only $100 or $300 for trusts. IRC Sec. 642(b).
    - Estates are not required to make estimated payments until the estate has been in existence for two years. IRC Sec. 6654(l).
    - Estates are entitled to a $25,000 passive activity loss deduction for rental real estate for two years after the date of death if the decedent actively participated before death. IRC Sec. 469(i)(4) .
    - Estates are eligible to hold S corporation stock during the period of estate administration. IRC Sec. 1361(b)(1)(B).
    - Estates are allowed a charitable contribution deduction for income set aside as well as actually paid. IRC Sec. 642(c)(2).
    - Estates may claim a loss for a pecuniary bequest satisfied with depreciated property even though the parties are "related." IRC Sec. 267(b)(13).

XV. DISTRIBUTIONS IN-KIND

- If noncash property is distributed, the beneficiary is taxed on the lesser of its tax basis or fair market value to the extent of DNI. IRC Sec. 643(e)(2).
- The estate or trust is likewise entitled to a deduction for the lesser of the property's tax basis or its fair market value to the extent of DNI. IRC Sec. 643(e)(2).

- If the estate or trust elects, it can treat the property distribution as a sale to the beneficiary at fair market value and recognize any gain. In that case, the beneficiary has an adjusted basis in the property equal to its fair market value on the date of distribution rather than a carryover basis from the estate or trust. IRC Sec. 643(e)(3).
- An estate realizes gain or loss if it distributes property in kind to a beneficiary in satisfaction of the beneficiary's right to receive a distribution in a specific dollar amount or in specific property other than that distributed. Reg. 1.661(a)-2(f).

XVI. THE 65-DAY ELECTION

- Distributions made within 65 days of the trust's subsequent tax year end may be deemed to have been made as of the last day of the tax year. Thus the trust will be afforded a distribution deduction, shifting the tax liability to the beneficiaries. IRC Sec. 663(b).
- This election is made by the trustee on an annual basis and must be made on a timely filed return (including extensions).
- This election is available to both trusts and estates.
- Note that the trustee of a simple trust is not concerned with this election because all the income is required to be distributed is treated as though distributed to the beneficiaries whether or not it is actually distributed. IRC Secs. 651 & 652.
- Distributions eligible for the election, however, cannot exceed the greater of the trust income or the DNI for the election year.

XVII. MULTIPLE TRUSTS TREATED AS SINGLE TRUSTS

- Multiple trusts are treated as a single trust for tax purposes if they have substantially the same grantor or grantors, the same primary beneficiary or beneficiaries, substantially no independent purpose, and tax avoidance as their principal purpose. IRC Sec. 643(f).
- For purposes of this rule, a husband and wife are treated as one.
- This rule does not apply to multiple trusts that were created before March 2, 1984.

XVIII. THE SEPARATE SHARE RULE

- Separate shares occur when the will or trust document states that separate accounts or shares are to be maintained for each beneficiary. IRC Sec. 663(c).
- The separate share rule also applies to estates.
- Separate shares are not the same as separate trusts. A single trust with separate shares files a single Form 1041.
- The existence of separate shares requires a separate accounting for each share's portion of DNI. IRC Sec. 663(c).
- Each beneficiary is taxed on only his or her share of DNI to the extent distributions are made to that beneficiary. This prevents one beneficiary from being required to report DNI properly reportable by another.

- Separate shares achieves a multiple-trust result but in one trust.
- In order to have separate shares, the single trust must have more than one beneficiary, and the beneficiaries must have substantially separate and independent shares.
- A single trust with separate shares is entitled to only one deduction for the personal exemption and must use a single tax table for all trust income rather than separate tables for each separate share.
- The separate share rule is not elective. If the rule applies, it must be used.
- Separate share treatment will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created.

EXHIBIT A

SHORT VERSION
ESTATE AND TRUST INCOME TAX RETURN CHECKLIST
2007 - FORM 1041

Client Name and Number: ______________________________

Prepared by: ____________ Date: ________ Reviewed by: ____________ Date: ________

Note: Consider disclosure requirements for written tax advice. (See Checklist for Written Tax Advice under Circular 230.)

	DONE	N/A	COMMENTS OR EXPLANATION
100) GENERAL INFORMATION			
101) Consider:			
.1) Signed engagement letter.	____	____	____
.2) Separate engagement letter for tax advise under the CPA-client privilege provisions of § 7525.	____	____	____
102) Review and update fiduciary's beneficiaries' name, address, and taxpayer identification numbers, etc., and IRS tax processing center.	____	____	____
103) Review permanent file, prior returns, workpapers, etc.	____	____	____
104) Obtain information concerning IRS and state tax audits, and/or correspondence.	____	____	____
105) Check for carryover items and update carryforward schedules including effect of prior tax audits.	____	____	____
106) Verify that copies of will or trust document and Form 706 or 709 and the date created (for GST purposes) are in the file.	____	____	____
107) Determine proper classification of trust (grantor, simple, complex, qualified disability trust, ESBT, pooled income fund, bankruptcy estate).	____	____	____
108) Determine proper basis of property passing from a decedent.	____	____	____
109) Determine situs of trust.	____	____	____
110) Determine residencies of fiduciary and beneficiaries.	____	____	____
111) Review proforma/organizer for accuracy.	____	____	____
112) Determine state filing requirements.	____	____	____
113) Determine if accounting methods used are comparable to the preceding year unless changes are approved or required.	____	____	____
114) Determine if there have been any changes in income interests or rights over corpus of beneficiaries during the year.	____	____	____
115) Determine if gift tax returns are required by grantor.	____	____	____

SHORT VERSION
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		DONE	N/A	COMMENTS OR EXPLANATION
116)	Obtain copies of court filings for accounting or tax information.	______	____	____________
117)	Consider obtaining copies of marriage, birth and death certificates.	______	____	____________
118)	Consider obtaining documentation affirming grantor's and beneficiaries' status as U.S. citizens.	______	____	____________
119)	If first return for an estate, determine proper allocation of income and deductions between trust, estate, and/or final 1040.	______	____	____________
120)	Review trust document for termination date.	______	____	____________
121)	Determine accounting income (Reg. § 1.643(b)-1).	______	____	____________
122)	Consider filing Form 56 (not required).	______	____	____________
123)	Determine that all current adjustments from changes in accounting method and period are reported.	______	____	____________
124)	Inquire if foreign financial accounts exist.	______	____	____________
125)	Determine that adequate support is in the file to verify GST inclusion ratio.	______	____	____________
126)	Consider filing power of attorney.	______	____	____________
127)	Determine if a foreign trust.	______	____	____________
128)	Determine if a U.S. person created or transferred property to a foreign trust.	______	____	____________
129)	Determine proper reporting if foreign trust has a U.S. grantor or the trust made distributions to a U.S. person.	______	____	____________
130)	Consider if an "abusive trust arrangement" exists.	______	____	____________
131)	Determine proper filing if return pertains to a bankruptcy estate of an individual and gross income exceeds exemption.	______	____	____________
132)	If an estate has been open more than 2 years, consider estimates.	______	____	____________
133)	Determine if Form 1040 Schedule H is required for household employees.	______	____	____________
134)	Consider if disaster relief provisions apply.	______	____	____________
135)	If business purchased life insurance on certain employees after 8/17/06, consider if business has satisfied the notification and annual information reporting requirements (PPA 2006, §§ 101(j) and 6039I).	______	____	____________

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SHORT VERSION
ESTATE AND TRUST INCOME TAX RETURN CHECKLIST
2007 - FORM 1041

	DONE	N/A	COMMENTS OR EXPLANATION
200) INCOME			
201) Compare sources of income with prior year.	____	____	____
202) Sale or dispositions of property:			
.1) Check for recapture items. (Note unrecaptured § 1250 gain.)	____	____	____
.2) Review interest rates on debt instruments.	____	____	____
.3) Determine if installment sales rules apply. (See Installment Sale Checklist.)	____	____	____
.4) Report proper amount from pledging installment receivables.	____	____	____
.5) Determine the holding period and federal, state, and AMT tax bases of disposed property.	____	____	____
.6) Determine the effect of dividends (stock and reinvested) and OID on tax bases of sold assets.	____	____	____
.7) Consider rules for related party and like-kind exchanges. (Form 8824)	____	____	____
.8) Utilize suspended losses.	____	____	____
.9) Consider deferring gain from involuntary conversions.	____	____	____
203) Report gains on constructive sales of appreciated financial positions.	____	____	____
204) Determine proper reporting of all annuities, qualified retirement plans, IRAs, etc.	____	____	____
205) Consider the need for separate passive activity reporting.	____	____	____
206) Consider regular and AMT passive activity loss limitations, carryovers and elections. (See Passive Activity Checklist.)	____	____	____
207) Review Schedules K-1 to determine that all are present and that all items have been consistently reported.	____	____	____
208) Inquire about other possible sources of income such as salaries, dividends, interest, rents, taxable fringe benefits, etc.	____	____	____
209) Determine that gain is reported if appreciated property is used to satisfy pecuniary bequest.	____	____	____
210) Consider the election to recognize gain or loss when property is distributed. (§ 643(e)(3))	____	____	____

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<u>**SHORT VERSION**</u>
<u>**ESTATE AND TRUST INCOME TAX RETURN CHECKLIST**</u>
<u>**2007 - FORM 1041**</u>

	DONE	N/A	COMMENTS OR EXPLANATION
211) Consider ordinary income treatment from gain on sale of market discount bonds.	______	____	____________
212) Consider the mark-to-market rules for dealers in securities. (§ 475)	______	____	____________
213) Determine if there is income from discharge of indebtedness. (Note exclusion and elections under § 108 and Form 982.)	______	____	____________
214) If trust is an electing small business trust (§1361(c)(2)(A)(v)) consider special taxation rules under § 641(c).	______	____	____________
300) DEDUCTIONS			
301) Determine the proper allocation of, and limitations on, deductions for interest and other expenses relating to:			
.1) Investment expenditures.	______	____	____________
.2) Qualified residence interest.	______	____	____________
.3) Trade or business expenditures.	______	____	____________
.4) Passive activity expenditures.	______	____	____________
.5) Tax-exempt investments.	______	____	____________
.6) Capitalization of interest during construction.	______	____	____________
.7) Inventory and cost of goods sold.	______	____	____________
.8) Meals and entertainment expenses (allowable percentage).	______	____	____________
.9) Club dues.	______	____	____________
302) Consider all depreciation requirements and options including:			
.1) Note that § 179 deduction is not allowed.	______	____	____________
.2) Limitations relating to listed property. (Note exceptions for clean fuel, electric, and vehicles with GVW of more than 6,000 lbs. and qualified non-personal use trucks and vans.) (Reg. § 1.280f-6(c)(3)(iii)) (Rev. Proc. 2007-30)	______	____	____________
.3) For business vehicles, consider the limitations for trucks and vans rated at 14,000 lbs. gross vehicle weight or less.	______	____	____________

		DONE	N/A	COMMENTS OR EXPLANATION
.4)	Consider § 179D election to expense energy efficient commercial building property placed in service after 12/31/05 and before 1/1/09. (TRHCA 2006)			
.5)	Consider additional first-year depreciation expanded rules for property placed in service in the GOZone area. (TRHCA 2006 and SBWOTA 2007)			
.6)	Depreciation of property received in a like-kind exchange or involuntary conversion. (T.D. 9314)			
.7)	Determine if leasehold improvement property or restaurant property qualifies for 15-year recovery period (for property placed in service before 2008).			
.8)	Determine if leased property should be capitalized.			
.9)	Determine bases for federal and state purposes.			
.10)	Compute state depreciation, if different.			
303)	Determine that amortizable items, including goodwill, are written off over the correct periods. (Note recapture rules for § 197 intangibles for property disposed of after August 8, 2005.)			
304)	Inquire about other allowable deductions such as worthless securities, casualty losses, vacation homes, attorney, accountant, and fiduciary fees, etc.			
305)	Determine amount of income distribution deduction.			
306)	If there is a property distribution, determine that the amount claimed is equal to the lesser of adjusted basis or fair market value.			
307)	Determine if loans made after Sept. 19, 1995 by a foreign trust to a U.S. grantor or beneficiary should be treated as distributions.			
308)	Consider 65-day distribution election for complex trust or estate.			
309)	Determine the amount of deduction for estate tax attributable to income in respect of decedent, including generation-skipping transfer tax.			
310)	Attach proper election for items deducted on Form 1041 that could have been claimed on Form 706.			
311)	Determine passive activity reporting for activities distributed to beneficiaries.			

	DONE	N/A	COMMENTS OR EXPLANATION
312) Determine limitation on losses from related party transactions.			
313) Determine if basis and loss limitation rules apply. (§§ 267, 469, 704(d), 1366(d))			
314) Determine that there is no § 6166 interest deduction for decedents dying after 1997.			
315) Determine if executor elected prior to 1999 to make remaining estate tax payments under TRA 1997 procedures with a reduced interest rate.			
316) Consider capitalization of carrying charges on non-productive property.			
400) TAX COMPUTATION AND CREDITS			
401) Compute tax, including alternative minimum tax.			
402) Compute all applicable credits, including carryovers.			
403) Claim prior year overpayment applied, estimate payments, and extension payment.			
404) Compute credit recapture.			
405) Compute tax underpayment penalties.			
406) If multistate filing, claim credit for taxes paid to nonresident states.			
407) Determine if EFTPS is required for federal and/or state purposes.			
500) OTHER REQUIREMENTS			
501) Compare taxable income and tax to projections.			
502) If estimate is based on prior year, determine if 100% or 110% rule applies.			
503) Evaluate estimated tax payment/withholding.			
504) Determine that proper classifications of income have been made on Schedule(s) K-1.			
505) If estimated tax payments should be allocated to beneficiaries, file Form 1041-T within 65 days after year-end.			
506) Consider that most domestic trusts are not subject to accumulation distributions.			

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	DONE	N/A	COMMENTS OR EXPLANATION
507) If Form 8271 is required for tax shelters, attach it to Schedule K-1s.			
508) Consider election to forgo net operating loss carryback.			
509) Consider inconsistent treatment notice for income not consistently reported. (§ 6034A)			
510) Consider risk of accuracy-related penalty. (§ 6662)			
511) Prepare state and local tax returns.			
512) Determine if excess deductions or losses are available to beneficiaries in final year.			
513) If there has been a generation-skipping distribution, prepare Form 706-GS(D), 706-GS(D-1) or 706-GS(T).			
514) Attach extension requests.			
515) Inquire if information returns (Forms 1098, 1099, etc.) have been filed.			
516) Inquire if employment taxes were timely deposited.			
517) Note the higher deposit limits for employment taxes.			
518) Consider preparing distribution of income reconciliation for beneficiaries.			
519) Consider new requirements for avoiding preparer penalties (for returns due on or after 1/1/08) (SBWOTA 2007 and Notice 2007-54) and note that:			
.1) Undisclosed positions must meet the "more likely than not" standard.			
.2) Disclosed positions must meet the "reasonable basis" standard.			
520) Note planning/additional service suggestions.			
521) Consider tax shelter disclosure statement under Reg. § 1.6011-4.			
522) Consider third-party service provider notification.			
523) Consider Circular 230 requirements.			

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COMMENTS OR EXPLANATIONS

EXHIBIT B
Where to Deduct Income and Estate Tax Deductions

Section 642(g) provides that amounts allowable on Form 706 under IRC §§ 2053 or 2054 are not also allowed as an income tax deduction on Form 1041, unless the estate irrevocably elects to waive the right to deduct them for income tax purposes. This does not apply to deductions in respect of a decedent under IRC § 691. There are also many other exceptions to this rule summarized in the chart below.

Description	IRC Section	706 and 1041[1]	706, 1041, or Split[2]	706 or 1040	706 Only	1040 Only[3]
Unrecovered basis of an annuity	72					X
Trade or business expenses accrued pre-death	162	X				
Interest accrued pre-death	163	X				
Taxes accrued pre-death	164	X				
Net operating loss of decedent	165(c)(1)					X
Unreimbursed casualty or theft losses of the estate	165(c)(3)		X			
Capital losses of the decedent	165(f)					X
Expenses accrued pre-death for the production or collection of income, the management of income producing property, or the determination, collection or refund of any tax.	212	X				
Medical expenses of the decedent paid within a year of death	213(c)(1)			X		
Passive activity losses of the decedent	469(g)(2)					X

[1] These items are income in respect of a decedent under IRC § 691.
[2] See Reg. § 1.642(g)-2 for authority to claim these deductions either on Form 706, 1041 or split them.
[3] These items are properly reported on the decedent's income tax return under his method of accounting either a) in a prior tax year or b) in the year of death, but prior to the date of death.

Post death estate administration expenses such as legal, accounting, court costs, investment management, and executor commissions	642(g)	X	
Funeral expenses	2053(a)(1)		X
Selling expenses, if necessary to pay debts, expenses, or taxes, preserve property, or effect a distribution	Reg. § 20.2053-3(d)(2)		X
State death taxes	2058		X