Navigating the River Styx | Come Sail Away with these Post-Death Elections

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Young Lawyers Forum
Post-Death Elections | Contents

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QSST and ESBT | S Corporation Basics

• S Corporation requirements (IRC § 1361)
  • Must be a domestic corporation
  • No more than 100 shareholders
  • Can only have one class of stock
  • No non-resident alien shareholders
    • Shareholders can only be individuals, estates, certain types of trusts and certain exempt organizations

• Types of Trusts that are eligible S corporation shareholders (IRC § 1361(c)(2)(A)):
  • Grantor Trusts (both during the Grantor’s life and for two years after Grantor’s death)
  • Trusts to which stock has been transferred by Will (but only for two years following such transfer)
  • Trusts formed primarily for exercising voting stock transferred to the trust

• What if S corporation stock is transferred to a trust that does not fall into the above categories? Is the S corporation status lost?
• Taxation, among other reasons, is a major advantage of the S corporation structure as it allows pass-through taxation to shareholders rather than requiring corporate level taxation.

• **Example:** A holds S corporation stock during her life. When she passes away, stock passes to a trust for A’s daughter, B, that otherwise does not qualify as an S corporation shareholder pursuant to terms of A’s Will. After two years, if nothing is done, the S corporation status will be lost. What can be done?
QSST and ESBT to the rescue
• Qualified Subchapter S Trusts ("QSSTs")
• Electing Small Business Trusts ("ESBTs")

*If the shareholder Trust can qualify as a QSST or an ESBT, the Trust can be an acceptable S corporation shareholder*
What is a QSST?

A QSST (Qualified Subchapter S Trust) is a trust that meets the requirements of IRC § 1361(d)(3):

1. During the lifetime of the current income beneficiary, there is only one income beneficiary (who must be a US citizen or permanent resident),
2. Distributions of principal during the lifetime of the current income beneficiary can only be made to such beneficiary,
3. The current income beneficiary’s income interest must terminate upon the earlier of the income beneficiary’s death or the termination of the trust, and
4. If the trust terminates during the current income beneficiary’s lifetime, all trust assets must be distributed to the current income beneficiary.

In addition, all of the trust’s accounting income must either be required to be distributed, or actually distributed, to the trust beneficiary at least annually. (IRC § 1361(d)(3)(B)).
QSST and ESBT | Example

C is the current income beneficiary of a trust. The Trust terms give the Trustee discretion to distribute trust corpus to C and D, a contingent trust beneficiary. The Trustee only distributes trust corpus to C during C’s lifetime.

Can the trust qualify as a QSST? (Treasury Reg. § 1.1361-1(j)(1)(iii))

NO
QSST and ESBT | How is a QSST Election Made?

• The current income beneficiary must file a statement providing:
  • (A) Name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;
  • (B) Identifies the election as a QSST election under IRC § 1361(d)(2);
  • (C) Specifies effective date for election;
  • (D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and
  • (E) Provides all information and representations necessary to show that:
    • (1) the trust meets the requirements under IRC § 1361(d)(3)
    • (2) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.
    • (3) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary. (Treas. Reg. § 1.1361-1(j)(6)(ii))

• If the S corporation transfers its stock to the QSST on or before the date the corporation makes its S election, the QSST election may be made on Part III of Form 2553, Election by a Small Business Corporation.
QSST and ESBT | What is an ESBT?

An ESBT (“Electing Small Business Trust”) is a trust that meets the requirements of IRC § 1361(e), which are:

(1) the trust is a domestic trust and all beneficiaries are individuals, estate or certain types of charitable organizations,

(2) no beneficiary has acquired an interest in the Trust (as opposed to trust assets) by purchase and

(3) the trustee has made a timely ESBT election.
In determining whether the corporation meets the S corporation shareholder requirements of IRC § 1361(b)(1), each potential current beneficiary of an ESBT is treated as a shareholder of the corporation. (Treas. Reg. § 1.1361-1(m)(4)(i))

Example: Trust C is a domestic trust with a nonresident alien as a potential current beneficiary. Will this alone disqualify the trust as an ESBT?

No, a nonresident alien shareholder is counted for purposes of the 100 shareholder limit, but does not disqualify the trust as a permissible S corporation shareholder (Treas. Reg. § 1.1361-1(m)(2)(ii)(E)(2)).

Generally, ESBTs are not as restrictive as QSSTs since ESBTs can have multiple beneficiaries and the ESBTs are not required to distribute all income. On the other hand, the ESBT portion of the trust will be taxed at the highest individual rate on all ordinary income. (Treas. Reg. §1.641(c)-1(e)(1)).
The trustee of the trust must make the ESBT election

The election statement must include—

• (A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock.

• (B) Identification as an ESBT election

• (C) The first date on which the trust owned stock in each S corporation;

• (D) Effective date of election;

• (E) Representations signed by the trustee stating that—

  • (1) The trust meets the definitional requirements of an ESBT

  • (2) All potential current beneficiaries of the trust are otherwise eligible shareholders of an S corporation (except that a non-resident alien can be a potential beneficiary) (Treas. Reg. § 1.1361-1(m)(2)(ii))
QSST and ESBT | When to make election

• Generally the beneficiary must make the QSST election and the Trustee must make the ESBT election within the two-month-and-16-day period beginning on the date of the trust's receipt of the S corporation stock (see Treas. Reg. § 1.1361-1(j)(6)(iii), (m)(2)(iii)).
QSST and ESBT | How to remedy a missed election

• Request relief under IRC § 1362(f)
  • Gives the Secretary the authority to grant relief if the requirements were not met to qualify as a QSST or ESBT
• Under Revenue Procedure 2013-30:
  • A corporation is eligible for relief under this provision if (1) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent, (2) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (i) so that the S corporation is a small business corporation, or (ii) to acquire the required shareholder consents, and (3) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to IRC § 1362(f) agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to the period.
The corporation has the burden to establish that, given the facts, the Service should find that the termination was inadvertent (Treas. Reg. § 1.1362-4(b)).

The corporation submits a ruling request for “inadvertent termination relief” (Treas. Reg. § 1.1362-4(c)).

If a corporation is eligible for relief pursuant to this provision then, notwithstanding the circumstances causing the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary.
754 Election | Adjustment to Basis of Partnership Property

- When is the election an option? When the estate holds interest in partnerships and/or LLCs.
- Why make the election? Get a step-up in basis for assets in the partnership.
- Who makes the election? The partnership. If there are lower-tier partnerships, they need to make their own elections too. No need for an election if the partnership has already made the election.
754 Election | Adjustment to Basis of Partnership Property

- Timing and manner? On the partnership tax return for the tax year in which the death has occurred.
- Revocation available? Yes, send request for revocation to the appropriate district director.
- What happens if it is late? Ask for IRC § 9100 relief via a Private Letter Ruling.
Portability | What is Portability?

• Involves the use by a surviving spouse of the unused Federal Estate and Gift Tax Exemption of a predeceasing spouse (IRC § 2010(c)(5)(A))
Portability | How and When to Elect Portability

• Portability is dealt with on the Form 706 (generally due within 9 months of a decedent’s death, unless an extension is filed)

• If a Form 706 is timely filed, portability is automatically elected. The executor can elect to opt out of portability, but otherwise the election is made.
Portability | Examples: To Port or Not to Port

• Example #1: Portability

Tony and Carmela are married and their total net worth is $22 Million. Tony has made no taxable gifts during his life. When Tony passes away in 2019, his estate is worth $8.4 Million. Since Tony will only utilize $8.4 Million of his Federal Estate Tax Exemption, an election is made on the Form 706 for Tony’s estate to preserve the $3 Million of Exemption not used by Tony for Carmela’s use. When Carmela passes away, she has $13.6 Million of assets in her name. This exceeds her $11.4 Million exemption, but luckily she has $3 Million that she ported from Tony’s estate, so her estate will pay no Federal Estate Tax

Result: No Federal Estate Tax

• Example #2: No Portability

Tony and Carmela are married and their total net worth is $22 Million. Tony has made no taxable gifts during his life. When Tony passes away in 2019, his estate is worth $8.4 Million. Carmela elects to opt out of the portability election to port Tony’s unused Federal Estate Tax Exemption. When Carmela passes away, she has $13.6 Million in her name. This exceeds her $11.4 Million exemption, so her estate will pay Federal Estate Tax on any amounts over $11.4 Million

• Result: Federal Estate Tax
Portability | Doh! I forgot to file a 706 to elect portability

- Homer dies after Mr. Burns releases the hounds on him. In her grief, Marge, the Executrix of Homer’s estate, forgets to file a Form 706. Assuming the deadline to file the Form 706 has passed, can she still elect portability?

- It depends:
  - If a Form 706 was otherwise required to be filed for Homer’s estate, then she cannot File a Form 706 to elect portability
  - If a Form 706 was not otherwise required to be filed for Homer’s estate, then there are remedies for relief for a failure to file a Form 706 to elect portability
    - Relief is available pursuant to Revenue Procedure 2017-3, Revenue Procedure 2019-3 (in place of a private letter ruling request)
As a **general rule**, property passing from the estate of a US decedent to a surviving spouse qualifies for the marital deduction (IRC § 2056(a)).

**Exception to the rule:** However, on the lapse of time or occurrence or nonoccurrence of an event or contingency, if an interest passing to a surviving spouse terminates or fails and passes to someone other than the spouse for less than full consideration, such property passing to a surviving spouse will not be entitled to a deduction (IRC § 2056(b)(1)(B)).

**Exception to the Exception:** However, if property passing to the surviving spouse and then to a person other than the spouse meets the requirements to be classified as Qualified Terminal Interest Property (“QTIP”) and a QTIP election is made, this property will qualify for the marital deduction.
QTIP Election | What is QTIP Property?

• QTIP Property is property:
  • Passing from the decedent spouse
  • In which the surviving spouse has a qualifying lifetime income interest
  • The QTIP election is made with respect to the property (IRC § 2056(b)(7)(B)(i))

• If a spouse’s terminal interest meets the QTIP requirements and a QTIP election is made, the property passing to the spouse qualifies for the marital deduction. The property is treated as passing to the surviving spouse, and no part of the property is treated as passing to any person other than the surviving spouse. (IRC § 2056(b)(7)(A))
QTIP Election | How QTIP Election is Made

• The election is made by the Executor of the Decedent’s estate on a Form 706 (IRC § 2056(b)(7)(B)(v))

• The election is made on Schedule M of Form 706. On this schedule, list any property for which the QTIP election is being made
QTIP Election | Tax Effects of a QTIP Election/Marital Deduction

• To the extent property in the predeceasing spouse’s estate exceeds the estate tax exemption, the remaining property can transfer to the surviving spouse, qualifying for the marital deduction.

• Result to predeceasing spouse: no estate tax due at the first spouse’s death.

• To the extent property passing to the surviving spouse qualified for the marital deduction at the first spouse’s death, this property is includable in the estate of the surviving spouse for estate tax purposes.

• Result to surviving spouse: additional assets included in his or her estate.
QDOT | Qualified Domestic Trust – the Noncitizen Spouse

• Generally, the estate tax marital deduction is not allowed if the receiving spouse is not a US citizen (IRC § 2056(d)(1)(A))

• Exception to this rule: property passing to the noncitizen spouse in a Qualified Domestic Trust (“QDOT”) (IRC § 2056(d)(2)(B))
A qualified domestic trust (QDOT) is a trust that meets the following requirements (IRC § 2056A(a)):

1. The trust document must require that at least one trustee of the trust is an individual US citizen or a domestic corporation (hereinafter “US Trustee”).
   - This requirement can be waived by the IRS (IRC § 2056A(a)(1)(A))
2. The trust instrument must state that unless the US trustee can withhold from any distributed trust corpus the estate tax on such distribution, no distribution (other than an income distribution) may be made from the trust.
3. If there are any regulations regarding the collection of the estate tax imposed on the trust, the trust must meet these requirements.
4. The executor must elect that the trust be treated as a QDOT.
QDOT | How to make a QDOT Election

- Election made on Form 706, Schedule M
  - The election is made by listing the QDOT or the entire value of the trust property on Schedule M of Form 706 and deducting the value of the trust. If the property is listed and the executor deducts the value of the trust, the election is assumed to have been made (Treas. Reg. § 20.2056A-3(d)), Form 706 Instructions)
QDOT | How to make a QDOT Election

- Additionally, attached to Schedule M, the following information should be provided for each QDOT:
  - Name and addresses of trustees
  - EINs of the QDOTs
  - Description of transfers from predeceasing spouse that are the source of property to be placed in the QDOT
GST Tax | Background

• The generation-skipping transfer ("GST") tax is imposed upon (1) a direct skip, (2) a taxable termination, and (3) a taxable distribution. IRC § 2611.
  • “Direct skip” = transfer subject to gift or estate tax to a “skip person”. IRC § 2612(c).
  • “Taxable termination” = the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless— (A) immediately after such termination, a non-skip person has an interest in such property, or (B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. IRC § 2612(a)(1).
  • “Taxable distribution” = trust distribution to a skip person. IRC § 2612(b).
GST Tax | Definitions

• “Skip person” = an individual two or more generations below the transferor; or a trust all the beneficiaries of which are skip persons. IRC § 2613(a).

• “Non-skip person” = any person not a skip person. IRC § 2613(b).

• “Transferor” = the decedent, if the transfer is subject to estate tax, or the donor, if the transfer is subject to gift tax. IRC § 2652(a)(1).
  
  • Note: in the case of a QTIP trust, assets are included in the gross estate of the surviving spouse beneficiary under IRC § 2044, and hence, the surviving spouse is considered the “transferor” with respect to the trust. Treas. Reg. § 26.2652-1(a)(3).
GST Tax | “Applicable Rate” and “Inclusion Ratio”

• “Applicable rate” = the maximum transfer tax rate then in effect [currently 40%] multiplied by the inclusion ratio. IRC § 2641(a).

• The “inclusion ratio” is a number between 0 and 1, inclusive. See IRC § 2642.
  • Transferor fully allocates GST tax exemption to transfer to a trust => inclusion ratio of 0.
  • Transferor allocates no GST tax exemption to transfer to a trust => inclusion ratio of 1.
  • Transferor allocates some GST tax exemption to transfer to a trust, but less than the value of assets transferred => the trust will have an inclusion ratio between 0 and 1.
GST Tax | GST tax exemption

• $11.4 million for decedents dying in 2019. IRC §§ 2631(c); 2010(c)(3)(C); Rev. Proc. 2018-57.

• May be allocated to transfers outright or transfers in trust.

• May be allocated to transfers during life or at death.
Reverse QTIP Election | Background

• For federal estate tax purposes, a [regular] QTIP election causes the QTIP trust to be included in the surviving spouse’s estate upon his or her death. IRC § 2044(b)(1)(A).

• For GST tax purposes, a QTIP election causes the surviving spouse to be considered the “transferor” of the QTIP trust for GST tax purposes. IRC § 2652(a)(1)(A).

• The election under IRC § 2652(a)(3) is called a ”reverse QTIP election” because it reverses the GST tax effect (but not the estate tax effect) of a QTIP election.
Reverse QTIP Election | Effect

• In the case of a QTIP trust, the decedent’s executor may elect to treat all of the property in such trust for purposes of the GST tax as if the election to be treated as qualified terminable interest property had not been made. IRC § 2652(a)(3); see Treas. Reg. § 26.2652-2.


• Result: the deceased spouse’s executor may allocate the deceased spouse’s unused GST tax exemption to the QTIP trust.
Reverse QTIP Election | Treas. Reg. § 26.2652-1(a)(5), Ex. 6

- T establishes a testamentary trust having a principal of $500,000. Under the terms of the trust, all trust income is payable to T's surviving spouse, S, during S's lifetime. T's executor makes an election to treat the trust property as qualified terminable interest property and also makes the reverse QTIP election. For purposes of chapter 13, T is the transferor with respect to the trust. On S's death, the then full fair market value of the trust is includible in S's gross estate under section 2044. However, because of the reverse QTIP election, S does not become the transferor with respect to the trust; T continues to be the transferor.
Reverse QTIP Election | How to make it

• The election is made on the decedent’s federal estate tax return. Treas. Reg. § 26.2652-2(b).
  • List the QTIP trust with respect to which the election is made on Schedule R, Part 1, Line 9.
  • Consider attaching a statement (1) showing the property to be transferred to the trust and, and (2) making a formula allocation.

• Once made, the election is irrevocable. Treas. Reg. § 26.2652-2(a).
Reverse QTIP Election

Form 706 Schedule R

SCHEDULE R—Generation-Skipping Transfer Tax

Note: To avoid application of the deemed allocation rules, Form 706 and Schedule R should be filed to allocate the GST exemption to trusts that may later have taxable terminations or distributions under section 2612 even if the form is not required to be filed to report estate or GST tax.

The GST tax is imposed on taxable transfers of interests in property located outside the United States as well as property located inside the United States. See instructions.

Part 1. GST Exemption Reconciliation (Section 2631) and Special QTIP Election (Section 2652(a)(3))

You no longer need to check a box to make a section 2652(a)(3) (special QTIP) election. If you list qualifying property in Part 1, line 9, below, you will be considered to have made this election. See instructions for details.

<p>| | |</p>
<table>
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<tbody>
<tr>
<td>1</td>
<td>Maximum allowable GST exemption</td>
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<tr>
<td>2</td>
<td>Total GST exemption allocated by the decedent against decedent’s lifetime transfers</td>
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<tr>
<td>3</td>
<td>Total GST exemption allocated by the executor, using Form 709, against decedent’s lifetime transfers</td>
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<tr>
<td>4</td>
<td>GST exemption allocated on line 6 of Schedule R, Part 2</td>
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<tr>
<td>5</td>
<td>GST exemption allocated on line 6 of Schedule R, Part 3</td>
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<tr>
<td>6</td>
<td>Total GST exemption allocated on line 4 of Schedule(s) R-1</td>
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<tr>
<td>7</td>
<td>Total GST exemption allocated to inter vivos transfers and direct skips (add lines 2-6)</td>
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<tr>
<td>8</td>
<td>GST exemption available to allocate to trusts and section 2032A interests (subtract line 7 from line 1)</td>
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</table>
| 9 | Allocation of GST exemption to trusts (as defined for GST tax purposes):  

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>Name of trust</td>
<td>B</td>
<td>Trust’s EIN (if any)</td>
<td>C</td>
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Reverse QTIP Election | Severing a partially exempt trust

• What if the deceased spouse’s estate planning documents provide for a marital trust but do not provide for a GST exempt marital trust?
  • Treas. Reg. § 26.2654-1(b)(1) permits a severance of the trust followed by a reverse QTIP election with respect to one of the two severed trusts.
  • Some states allow a trustee to sever a trust without a judicial proceeding. See e.g. Texas Property Code § 112.057.
  • Note: A partial reverse QTIP election is not allowed. IRC § 2652(a)(3).

• What if you can’t sever the marital trust?
  • Consider making a reverse QTIP election with respect to the entire trust.
The 65-Day Rule | IRC § 633(b)

• Income Tax Time Travel.

IRC § 633. Special rules applicable to sections 661 and 662

(b) DISTRIBUTIONS IN FIRST SIXTY-FIVE DAYS OF TAXABLE YEAR.

(1) GENERAL RULE. If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) LIMITATION. Paragraph (1) shall apply with respect to any taxable year of an estate or a trust only if the executor of such estate or the fiduciary of such trust (as the case may be) elects, in such manner and at such time as the Secretary prescribes by regulations, to have paragraph (1) apply for such taxable year.

• so:
  • why?
  • how?
  • when?
  • any limitations?
The 65-Day Rule | why

- compressed fiduciary income tax brackets.

<table>
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<tr>
<th>2019 Estates &amp; Trusts</th>
<th>2019 Single Taxpayer</th>
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<tbody>
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<td>$0 - $2,600</td>
<td>$0 - $9,700</td>
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<tr>
<td>10%</td>
<td>10%</td>
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<td>$2,600 – $9,300</td>
<td>$9,700 - $39,475</td>
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<td>24%</td>
<td>12%</td>
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<td>$9,300 - $12,750</td>
<td>$39,475 - $84,200</td>
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<td>$12,750 +</td>
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<td>24%</td>
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<tr>
<td></td>
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<td>32%</td>
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<td>$510,300 +</td>
</tr>
<tr>
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</table>

- shift income downstream to lower net tax paid.
- what about TCJA (the 2017 Tax Act)?
The 65-Day Rule | how

- **check-the box election** | Form 1041, Other Information Line 6

**IRS Form 1041**

<table>
<thead>
<tr>
<th>Question 6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>To make the section 663(b) election to treat any amount paid or credited to a beneficiary within 65 days following the close of the tax year as being paid or credited on the last day of that tax year, check the box. This election can be made by the fiduciary of a complex trust or the executor of a decedent’s estate. For the election to be valid, you must file Form 1041 by the due date (including extensions). Once made, the election is irrevocable.</strong></td>
</tr>
</tbody>
</table>

- no: (1) grantor trusts or (2) simple trusts
- election is irrevocable (*but only made for that year*)
The 65-Day Rule | when

- make the election on a **timely filed return**

Treas. Reg. § 1.663(b)-2

(a) Manner and time of election; irrevocability -

(1) When return is required to be filed. If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

- what if no return is required?

**Instructions**

**Question 6**
To make the section 663(b) election to treat any amount paid or credited to a beneficiary within 65 days following the close of the tax year as being paid or credited on the last day of that tax year, check the box. This election can be made by the fiduciary of a complex trust or the executor of a decedent's estate. For the election to be valid, you must file Form 1041 by the due date (including extensions). Once made, the election is irrevocable.
The 65-Day Rule | limitations

• the election is limited by income in the tax year in which the election is made

Treas. Reg. § 1.663(b)-1

(2) Effect of election.

(i) An election is effective only with respect to the taxable year for which the election is made. In the case of distributions made after May 8, 1972, the amount to which the election applies shall not exceed:

(a) The amount of income of the trust (as defined in § 1.643(b)-1) for the taxable year for which the election is made, or

(b) The amount of distributable net income of the trust (as defined in §§ 1.643(a)-1 through 1.643(a)-7) for such taxable year, if greater, reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year by reason of section 663(b) and this section.

• An election is effective only to the extent of the greater of:
  • fiduciary accounting income; or
  • distributable net income (DNI) reduced by distributions
The 65-Day Rule | limitations

• **Example.** A Trust has $1,000 of FAI and $800 of DNI in 2020. The Trust pays $550 to its sole beneficiary, Benedict, on January 15, 2020. Trustee makes a 65-day rule election on a return filed on April 1, 2020 to treat the $550 as being paid on December 31, 2019. The Trust makes additional distributions to Benedict of $600 on July 19, 2020 and $450 on January 17, 2021.

• so, what’s the limitation?

• *Ignore $550 paid in 2020 because,* for purposes of the calculation, the entire amount is treated as paid in 2019 (even if it is limited by this provision).
645 Election | IRC § 645

- **Income Tax PB&J.** Combine tax returns of estates and revocable trusts.

**IRC § 645. Certain revocable trusts treated as part of estate.**

(a) **General rule.** For purposes of this subtitle, if both the executor (if any) of an estate and the trustee of a qualified revocable trust elect the treatment provided in this section, such trust shall be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent’s death and before the applicable date.

• **so:**
  - why?
  - how?
  - when?
  - any limitations?
645 Election | why

• **Year-End Flexibility.** Elect a calendar year end or a fiscal year end. This permits *income-shifting* and *deferral*.

• **Charitable Bequests.** Actually paid vs. permanently set aside.

  IRC § 642 Special rules for credits and deductions.
  (c) Deduction for amounts paid or permanently set aside for a charitable purpose.
  (2) Amounts permanently set aside. In the case of an estate [...] there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c) [...].
645 Election | why

• **Year-End Flexibility.** Elect a calendar year end or a fiscal year end. This permits **income-shifting** and **deferral**.

• **Charitable Bequests.** Actually paid vs. permanently set aside.

• **S-Corp. Holding Period.** 2-years vs. period of administration.

**Treas. Reg. § 1.641(b)-3 Termination of estates and trusts.**

(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates.
645 Election

- separate filing election | Form 8855
- check-the-box | Form 1041, Item G
File the Form 8855 by the Estates 1041 filing for year 1

Treas. Reg. § 1.645-1(c)(1)

(i) Time and manner for filing the election. For the election to be valid, the election form must be filed not later than the time prescribed under section 6072 for filing the Form 1041 for the first taxable year of the related estate (regardless of whether there is sufficient income to require the filing of that return). If an extension is granted for the filing of the Form 1041 for the first taxable year of the related estate, the election form will be timely filed if it is filed by the time prescribed for filing the Form 1041 including the extension granted with respect to the Form 1041.
645 Election | limitations

• The Trust must be a “qualified revocable trust.” IRC § 645(b)(1).

• It only lasts for up to 2 years from date of death. IRC § 645(b)(2).
  • unless a 706 is due, in which case it is the later of 2-years after date of death and 6-months after final determination of tax liability.
Accounting Methods| accrual & cash methods

• Fiduciary Flexibility.

• Instructions:

  Accounting Methods
  Figure taxable income using the method of accounting regularly used in keeping the estate's or trust's books and records. Generally, permissible methods include the cash method, the accrual method, or any other method authorized by the Internal Revenue Code. In all cases, the method used must clearly reflect income.

• so:
  • why?
  • how?
  • when?
  • any limitations?
Accounting Methods | why & how

• **Generally, Cash.** Virtually all estate/trusts use the cash basis method.

• **Fiduciary Flexibility.** Select the appropriate accounting method for the estate/trust, notwithstanding the method used by the decedent.

• **Look For:** a small business (even a sole proprietorship) that involves the purchase of merchandise (e.g. a manufacturing company). That implicates accrual method.
Accounting Methods | when & limitations

• the executor must select an accounting method for the first fiduciary income tax return
• an accounting method generally remains consistent and can only be changed with consent by filing a Form 3115.
• Consider: what are the fiduciary considerations for reporting on an accrual basis?
IRC § 2032 Election | alternate valuation

IRC § 2032:

- When is the election an option? Whenever the estate tax/GST tax will be lower than if you used the date of death.
- Why make the election? Lower estate/GST taxes (good), but watch out for lower step-up in basis (possibly bad) and potential ill effects on elections that rely on adjusted gross estate (§6166, §2302A) and dispositions that rely on formulas.
IRC § 2032 Election | alternate valuation

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IRC § 2032 Election | alternate valuation

IRC § 2032

- Who makes the election? The Executor.
- Timing and manner? On a timely filed Form 706, Part 3, and then again on Schedules A through I. Protective elections are allowed.
- Revocation? Generally no, unless you are amended a timely filed Form 706 before the due date.
- What happens if it is late? Once one year from the due date for the Form 706 has past (plus extensions), you cannot make the election.
IRC § 2032A Election | alternate valuation

IRC § 2032A

- When is the election an option? When you have an active farm/business that makes up a certain portion of the estate and is passing to certain family members.
- Why make the election? The election is best made traditional valuation is higher. and it is very unlikely that the farm/business will be sold in the next 10 years. The limitation on decrease in valuation must be worth the potential for additional estate tax if the farm/business is sold within 10 years.
IRC § 2032A Election | alternate valuation

IRC § 2032A (cont.)

- Who makes the election? The Executor, with signed statements from all of the persons with beneficial interests in the property.
- Timing and manner? On a timely filed Form 706, Part 3, and then again on Schedules A-1. Protective elections are allowed.
- Revocation? Generally no, unless you are amended a timely filed Form 706 before the due date.
- What happens if it is late? Once the due date for the Form 706 has past (plus extension), you cannot make the election.
Disclaimers | Requirements under IRC § 2518

• Irrevocable and unqualified refusal to accept property.
• In a writing that identifies property being disclaimed and is signed by disclaimant or his legal representative.
• Delivered to transferor of the interest, his legal representative, or the holder of the property to which the interest relates within 9 months after the later of (1) the transfer creating the interest in such person, or (2) the day or which such person attains age 21.
• Disclaimant may not accept property or any of its benefits.
• Disclaimed property passes without direction by disclaimant.
• Disclaimed property passes either to the spouse of the decedent or to a person other than the person making the disclaimer.
Disclaimers | Disclaimer by surviving spouse

• If a surviving spouse retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard. Treas. Reg. § 25.2518-2(e)(2).

• => a “disclaimer trust” that is designed to hold assets disclaimed by the surviving spouse should not give the surviving spouse a power of appointment over trust property (unless such power is limited by an ascertainable standard).
Disclaimers | Effect

• Effect of a Disclaimer:
  • Treas. Reg. § 25.2518-1(b): “. . . for purposes of the federal estate, gift, and generation-skipping transfer tax provisions, the disclaimed interest in property is treated as if it had never been transferred to the person making the qualified disclaimer. Instead, it is considered as passing directly from the transferor of the property to the person entitled to receive the property as a result of the disclaimer. Accordingly, a person making a qualified disclaimer is not treated as making a gift. Similarly, the value of a decedent's gross estate for purposes of the federal estate tax does not include the value of property with respect to which the decedent, or the decedent's executor or administrator on behalf of the decedent, has made a qualified disclaimer.
  • A disclaimer by a child could cause the child’s parent to make a direct skip for GST tax purposes if the property passes to a grandchild.
Disclaimers | Why? (non-tax)

- The disclaimant does not need or want the property.
- The disclaimant prefers that the property pass to others.
- The disclaimant has creditor problems. Does this work?
Disclaimers | Why? (tax)

• The disclaimant wants to exclude the property from his or her estate for federal estate tax purposes.

• A surviving spouse wants to utilize the deceased spouse’s unused estate tax exclusion.

• To fix a trust so that it qualifies for the marital deduction.
  • Ex: the will of the deceased spouse provided for a marital trust that would qualify under IRC § 2056(b)(7) except that the surviving spouse has a lifetime power of appointment in favor of others.
  • If the surviving spouse disclaims that power, the trust can qualify as a QTIP trust.

• To utilize a decedent’s unused GST tax exemption.
  • Ex 1: Deceased spouse’s will leaves everything outright to spouse, or if spouse fails to survive, to lifetime trusts for children, remainder to grandchildren.
  • Ex 2: Single decedent’s will leaves everything outright to children, or if children fail to survive, to grandchildren.
• **Disclaimer of a separate interest.**
  - Each interest in property that is separately created by the transferor is treated as a separate interest that may be disclaimed. Treas. Reg. § 25.2518-3(a)(1)(i). As a result, a disclaimer may be made with respect to one interest but not the other, even if both interests relate to the same property.

• **Disclaimer of a specific asset of a trust.**
  - If specific trust asset is disclaimed, it must “leave” the trust i.e. be segregated. Treas. Reg. § 25.2518-3(a)(2).

• **Disclaimer of an undivided portion.** Treas. Reg. § 25.2518-3(b).
  - must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property.
  - must extend over the entire term of the disclaimant's interest in such property and in other property into which such property is converted.

• **Disclaimer of a pecuniary amount.** Treas. Reg. § 25.2518-3(c).
  - no income or other benefit of the disclaimed amount inures to the benefit of the disclaimant either prior to or subsequent to the disclaimer.
  - the amount disclaimed and any income attributable to such amount must be segregated from the portion of the gift or bequest that was not disclaimed.
Disclaimers | Powers of appointment

• Is it possible to disclaimer a power of appointment? Yes. Treas. Reg. § 25.2518-3(a)(1)(iii).

• Note: if the disclaimant retains any other right to direct the beneficial enjoyment of the property (e.g. as a trustee), such right must be limited by an ascertainable standard.
Disclaimers | Disclaimant serving as trustee

• Can a person who disclaims an interest in a trust later serve as trustee of that trust?
  • Maybe. A person who is also a fiduciary can disclaim with the fiduciary retaining the fiduciary power to designate beneficiaries as long as the power is subject to an ascertainable standard. Treas. Reg. § 25.2518-2(e)(1)(i).
Community Property | CP states

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin
Community Property | Income tax basis adjustment

• For federal income tax purposes, upon the death of one spouse, the basis in all community property is adjusted to date of death fair market values. IRC § 1014(b)(6).
  • Consider converting separate property to community in order to get the basis adjustment upon the death of either spouse.
  • A couple who moves from a common law to a community property state should consider making an agreement to convert separate property to community property.
Community Property (Texas) | Basics

• Property owned by a spouse at the time of marriage is that spouse’s separate property (SP).

• Property received by a spouse during marriage gift or inheritance is that spouse’s SP.

• The “community property presumption”: all property owned by either spouse at the time of divorce or death is community property (CP).
  • => all earned income is CP.
  • => all unearned income (interest, dividends, etc.), whether earned on CP or SP, is CP.
Community Property (Texas) | Intestate succession: married with children

- Community property:
  - All to the surviving spouse if all the decedent’s children are also children of the surviving spouse.
  - To the decedent’s descendants if one or more of the decedent’s children are not children of the surviving spouse.

- Separate property real property:
  - 1/3 life estate to the surviving spouse, remaining life estate and all remainder to descendants.

- Separate property personal property:
  - 1/3 to surviving spouse, 2/3 to children.
Community Property (Texas) | Intestate succession: married without children

- Community property:
  - All to the surviving spouse.

- Separate property real property:
  - ½ to surviving spouse, ½ to heirs-at-law (parents).

- Separate property personal property:
  - All to surviving spouse.
Community Property (Texas) | Right of Reimbursement

• Right of Reimbursement (Texas Family Code 3.402(a)):
  • (1) payment by one marital estate of the unsecured liabilities of another marital estate;
  • (2) inadequate compensation for the time, toil, talent, and effort of a spouse by a business entity under the control and direction of that spouse ("community efforts doctrine");
  • (3) the reduction of the principal amount of a debt secured by a lien on property owned before marriage, to the extent the debt existed at the time of marriage;
  • (4) the reduction of the principal amount of a debt secured by a lien on property received by a spouse by gift, devise, or descent during a marriage, to the extent the debt existed at the time the property was received;
  • (5) the reduction of the principal amount of that part of a debt, including a home equity loan:
    • (A) incurred during a marriage;
    • (B) secured by a lien on property;
    • (C) incurred for the acquisition of, or for capital improvements to, property;
  • (6) the reduction of the principal amount of that part of a debt:
    • (A) incurred during a marriage;
    • (B) secured by a lien on property owned by a spouse;
    • (C) for which the creditor agreed to look for repayment solely to the separate marital estate of the spouse on whose property the lien attached; and
    • (D) incurred for the acquisition of, or for capital improvements to, property;
  • (7) the refinancing of the principal amount described by Subdivisions (3)-(6), to the extent the refinancing reduces that principal amount in a manner described by the applicable subdivision;
  • (8) capital improvements to property other than by incurring debt; and
  • (9) the reduction by the community property estate of an unsecured debt incurred by the separate estate of one of the spouses.
Community Property (California) | Basics

• Separate property is all property owned before the marriage; all property acquired after married by gift/bequest; and income/rents from separate property assets. Cal. Family Code § 770.

• Community property is everything else acquired while domiciled in California. Cal. Family Code § 760.

• Quasi-community property is property that was acquired by a spouse while domiciled elsewhere, but would have been community property had the spouse been domiciled in California. Cal. Family Code § 125.
Community Property (California) | Joint Tenancy & Community Property with Right of Survivorship

• Joint tenancy provides a non-probate transfer of interest from one tenant to the other upon a tenant’s death.
  • On the death of the joint tenant, the portion of the joint tenancy included in the decedent’s estate for estate tax purposes is received a step-up/step-down in basis. The other portion does not.

• Community Property with Right of Survivorship provides a non-probate transfer of community property assets designated as “community property with right of survivorship” to the surviving spouse. Cal. Probate Code § 682.1.
  • This is a blend of community property and joint tenancy. Arguably, it would fall under IRC § 1014(b)(6), but there has been no formal guidance from the IRS.