

Prop. Regs. Clarify Treating Revocable Trust as Part of Estate

Proposed Regulations have been issued under Section 645, which allows certain revocable trusts to be treated as part of the estate for income tax purposes. This article analyzes the new Prop. Regs., which effectuate the intended benefits of the statute.

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TRA '97 added IRC Section 645, which permits an executor and a trustee to elect that a qualified revocable trust be treated and taxed as part of a decedent's estate for income tax purposes. The IRS has recently issued Proposed Regulations¹ that provide (1) procedures for making the Section 645 election, (2) rules regarding the tax treatment while the election is in effect, (3) rules for terminating the election, and (4) clarification of the reporting rules. When finalized, the

Proposed Regulations will replace the procedures for making the Section 645 election in Rev. Proc. 98-13.²

Benefits of election

The Section 645 election makes available to trusts some of the income tax advantages traditionally available only to estates. Making the election means that only one Form 1041 (fiduciary income tax return) is filed, rather than separate returns for the trust and the estate. Under the Proposed Regulations, an electing trust is no longer required to file an income tax return for the balance of the taxable year after the date of death. During the election period, the trustee has to file only one fiduciary income tax return for the combined trust and estate under the name and taxpayer identification number (TIN) of the estate. All items of income, deduction, and credit are combined. If there is no estate representative, the trustee files the Form 1041. The electing trust is treated as part of the related estate.

Electing trusts may now select a fiscal year rather than a calendar year. Income tax benefits include deducting amounts paid to or permanently set aside for charity,³ deducting up to \$25,000 in real estate passive losses,⁴ and qualifying for the \$600 personal exemption deduction under Section 642(b).

Interim guidance. Until the Proposed Regulations become final, fiduciaries must follow the existing guidance set forth in Rev. Proc. 98-13, which requires separate TINs for the trust and the related estate. Under the Rev. Proc., the trust is required to file a Form 1041 for the short taxable year from the date of death through December 31.

Qualified revocable trust

Only "qualified revocable trusts" (QRTs) are eligible for the Section 645 election. A QRT is intended to include the typical revocable living trust which is generally intended as a substitute for a will. A QRT is any trust that is treated on the date of death as a grantor trust under Sec-

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tion 676, but the definition does not include grantor trusts treated as owned by a decedent (1) by reason of a power exercisable by the decedent only with the approval or consent of another person, or (2) solely by reason of a power held by a nonadverse party. A QRT must be a domestic trust as defined in Section 7701(a)(30)(E).

Distributable net income. For purposes of computing distributable net income (DNI), the electing trust and related estate are treated as separate shares. The Proposed Regulations provide rules for adjusting the DNI of the separate shares with respect to distributions from the estate to the trust.⁵

Example.⁶ (All events relate to the same taxable year.) Estate share (Estate) has \$15,000 of gross income, \$5,000 of deductions, and \$10,000 of taxable income and DNI. The estate distributes \$15,000 to Trust which reduces the Estate's DNI by \$10,000. Trust share (Trust) has \$25,000 of gross income and \$5,000 of deductions. In calculating DNI, the gross income of Trust is increased by \$10,000, which is the same amount of the reduction of Estate's DNI. For purposes of computing DNI, Trust has \$30,000 of DNI. Trust distributes \$35,000 to C, its sole beneficiary. C must include \$30,000 in gross income. The gross income reported on Form 1041 for the electing trust and related estate is \$40,000.

Making the election

Election statement. If there is a personal representative of the related estate, the personal representative and the trustee of the QRT make the Section 645 election to treat the QRT as part of the related estate in a written statement that must be

attached to the Form 1041 filed for the first taxable year of the related estate. The Form 1041 and the attached statement must be filed not later than the time prescribed under Section 6072 (including extensions) for filing the return for such taxable year.⁷ The statement must contain the following:⁸

1. Declaration that the Section 645 election is being made;
2. Name, address, date of death, and TIN of the decedent;
3. Name and address of the QRT, and its TIN, if any;
4. Name, address, and TIN of related estate;
5. Representation that the trust is a QRT;
6. Representation that the personal representative elects to treat the QRT as part of the related estate, and that he/she understands the requirement to make a timely return of income for the combined related estate and QRT, and make timely payment of tax due; and
7. Statement from the QRT trustee, that he/she elects to treat the trust as part of the related estate and will cooperate with the personal representative to file the income tax return for the combined related estate and QRT, and pay the tax due.

If there is no personal representative, the Section 645 election is made by the trustee in a written statement that is attached to Form 1041. This statement contains basically the same information as above plus a representation that there is no personal representative and to the trustee's knowledge and belief, one will not be appointed.⁹

Election period. Once the election is made, it remains in effect for the

entire election period. The election period begins as of the date of the decedent's death and terminates on the day before the "applicable date." If a Form 706 (estate tax return) is not required to be filed for the related estate, the applicable date is the day that is two years after the date of death.¹⁰

If a Form 706 is required to be filed, the applicable date is the day that is six months after the date of final determination of liability for estate tax. This date is the earliest day on which any of the following has occurred:¹¹

1. Issuance of an estate tax closing letter by the IRS, unless a refund claim is filed within six months after issuance of the letter;
2. Final disposition of a refund claim, unless suit is instituted within six months after final disposition of the claim;
3. Execution of a settlement agreement with the IRS;
4. Issuance of a judgment or order resolving the estate tax liability, unless a notice of appeal or petition for certiorari is filed within 90 days after issuance; or
5. The expiration of the period of limitations under Section 6501.

Taxpayer identification numbers

If an election is to be made to treat a revocable trust as part of the estate, and there is an estate per-

¹ REG-106542-98, 65 F.R. 79015-79024 (12/18/00).

² 1998-1 CB 370.

³ Section 642(c).

⁴ Section 469(i)(4).

⁵ Prop. Reg. 1.645-1(e)(2)(iii).

⁶ This example is based on Prop. Reg. 1.645-1(e)(2)(iii), Example.

⁷ Prop. Reg. 1.645-1(c)(1).

⁸ Prop. Reg. 1.645-1(c)(1)(ii).

⁹ Prop. Reg. 1.645-1(c)(2).

¹⁰ Prop. Regs. 1.645-1(f)(1) and 1.645-1(f)(2)(i).

¹¹ Prop. Reg. 1.645-1(f)(2)(ii).

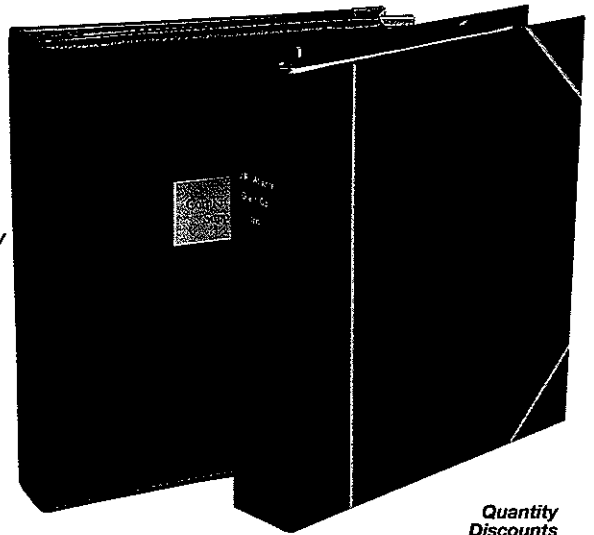
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sonal representative, then the representative is responsible for obtaining the TIN for the estate. If there is no personal representative for the related estate, the trustee of the electing QRT is responsible for obtaining the TIN. There is no need to obtain a separate TIN for the trust.¹²

If a Section 645 election will be made, the trustee of the QRT and the personal representative of the related estate may treat the QRT as an electing trust as of the decedent's date of death. In that event, the QRT is not required to file a fiduciary income tax return for the short taxable year (from the date of death to December 31). If a QRT is treated as an electing trust and a valid Section 645 election is not made, the QRT will be subject to penalties and interest for failing to obtain a TIN and file a Form

1041 and pay the tax due thereon.¹³

If a valid Section 645 election is made after a Form 1041 is filed for the QRT, then the trustee must amend the Form 1041 to indicate that it is a final return, and attach a copy of the election statement to the amended Form 1041, with the following words at the top of the return: "Filed Pursuant to Section 1.645-1." The QRT's items of income, deduction, and credit must be excluded from the amended return and must be included on the Form 1041 filed for the first taxable year of the related estate.¹⁴

The related estate's TIN must be furnished to all payors of the electing trust. If there is a personal representative, the representative is responsible for furnishing the TIN. If there is no personal representative, the trustee of the QRT has the responsibility. A Form W-9 is required to be furnished to all payors with the name of the related estate as the primary name, the name of the electing trust as the secondary name, the TIN of the

related estate, and the address of the QRT trustee.¹⁵

Additional Issues

Income tax burdens. The Proposed Regulations do not provide rules for allocating the tax liability between the electing trust and the related estate. The personal representative and the trustee must allocate the tax liability in a manner that reasonably reflects the tax obligations of each entity. The failure to do so may result in deemed gifts having been made.¹⁶

Effective date. The Proposed Regulations are to be effective when finalized. In the meantime, the guidance provided in Rev. Proc. 98-13 should be followed.

Conclusion

The enactment of Section 645 offers a significant benefit to the trustee and personal representative. The Proposed Regulations carry out the intention of the statute. They are not burdensome and should prove to be effective. ■

¹² Prop. Regs. 1.645-1(d)(1)(i) and 301.6109-1(a)(4).

¹³ Prop. Reg. 1.645-1(d)(1)(iii).

¹⁴ Prop. Reg. 1.645-1(d)(1)(iii)(B)(2).

¹⁵ Prop. Reg. 1.645-1(d)(2).

¹⁶ Preamble to the Proposed Regulations.