STATE BAR OF TEXAS
TAX LAW 101
August 25, 2010
Dallas

CHAPTER 2
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III. WHICH ENTITIES MUST FILE AN ESTATE INCOME TAX RETURN?

A. Income.

A trust (other than a grantor trust) or a decedent’s estate is a separate legal entity for tax purposes. A decedent’s estate comes into being upon the death of a decedent. A trust comes into being when it is created and funded. The creation of a trust can be during the grantor’s lifetime (an intervivos trust) or at the grantor’s death (a testamentary trust). A Form 1041 must be filed for an estate or trust if: (1) the trust has had any taxable income, or has gross income of $600 or more for the tax year; (2) the estate has gross income of $600 or more for the tax year; or (3) any beneficiary is a nonresident alien.

B. Grantor Trust.

A grantor who transfers property to a trust and retains certain powers or interests is treated as the owner of the trust property for income tax purposes. In general, a grantor trust is an ignored entity for tax purposes. A Form 1041 for the trust should be filed if the trust has a tax identification number, and income is received under such tax identification number. All income attributable to the trust is included in the grantor’s income. The IRS instructions for the Form 1041 include instructions for how to file a return for Grantor trust. Check the box for a “Grantor Trust” on page one of Form 1041, and do not report any income amounts on page one of the return. Instead attach a schedule showing all amounts and characterizations and sources of income, and the amounts and sources of all deductions and credits. (This attachment should not be a Schedule K-1.) This paper does not review such instructions beyond this paragraph.

C. Foreign Estate.

A foreign estate is an estate which receives income from non-US sources and is not connected with the United States, and such income is not included in gross income for tax purposes. A foreign estate must file Form 1040NR – United States Nonresident Alien Income Tax Return.

D. Foreign Trust.

A trustee of a foreign trust must file a Form 1040NR, and usually must also file a Form 3520-A – Annual Information Return of Foreign Trust with United States Owner. A foreign trust is a non-domestic trust. A domestic trust is a trust where: (1) a US court exercises primary supervision over the trust; and (2) one or more US persons have the authority to control the substantial decisions of the trust, OR the trust: (1) was in existence on August 20, 1996; (2) was
a domestic trust on that date; and (3) elected to be treated as a domestic trust prospectively.

### IV. WHO HAS THE RESPONSIBILITY TO FILE THE RETURN?

#### A. Fiduciary.

Trustees and executors are “fiduciaries.” A fiduciary is a person with a special obligation toward another person or persons, who holds title for another person with a beneficial interest.

#### B. Co-Trustees/Co-Executors.

When there is more than one fiduciary, the return can be filed by any one of the co-executors or co-trustees, as the case may be. A signed statement by the filing fiduciary that as a co-fiduciary, he or she has sufficient information about the income and deductions of the entity to file the return should be attached.

#### C. Executor.

The executor of an estate has the responsibility for filing the Form 1041 for the estate. A reference to an “executor” also includes an administrator or personal representative or a person in possession of property of a decedent’s estate.

#### D. Trustee.

The trustee of a trust has the responsibility for filing the Form 1041 for such trust.

#### E. Personal Responsibility.

A fiduciary is not personally responsible for the payment of taxes if the assets of the estate or trust decrease in value to less than the amount of the tax due, except to the extent the fiduciary has made distributions from the estate. If debts are paid or distributions are made before the payment of taxes, such fiduciary can become personally responsible for the payment of the taxes, unless the debts are those that have priority over the payment of the tax.

#### F. Paid Preparer.

A paid preparer must also sign the return, and complete the information in the “Paid Preparer” section. This section can also authorize the IRS to speak with the paid preparer about the return. Form 2848 – Power of Attorney and Declaration of Representative can be filed separately to establish a power of attorney.

### V. WHEN SHOULD THE RETURN BE FILED?

#### A. Due date.

The return must be filed on or before the 15th day of the 4th month following the close of the tax year. IRC § 6072(a). If the calculated due date falls on a holiday or weekend, the return must be filed by the next business day. For a calendar year entity, the due date for Form 1041 is generally April 15th.

#### B. Estates.

When filing an estate’s first return, the executor of the estate may chose the same accounting period that the decedent used, or may choose a calendar year, or may chose any fiscal year it wishes. A $600 tax exemption is allowed for a first-year short-period return, without proration.

1. **Fiscal Year.**

   The date of a decedent’s death is the first day of the estate’s tax year. The executor can select a tax year that is no more than 12 months in length and which ends on the last day of any month. If the tax year ends on any day other than December 31, the estate has elected a fiscal tax year. (To make a change in the election, file Form 1128 – Application to Adapt, Change or Retain a Tax Year.)

2. **Beneficiaries.**

   If the tax year of a beneficiary is not the same as the tax year of an estate (or trust making the §645 election), the inclusion of distributed income in the gross estate of the beneficiary should occur in the tax year of the beneficiary in which the end of the fiscal year of the entity falls. IRC §§ 652(c) and 662(c). Thus, coordination between an executor and a beneficiary can result in a significant deferral of income tax.

#### C. Trusts.

With only a few exceptions, trusts must adopt a calendar year.

1. **IRC § 645 Election.**

   IRC § 645 provides that if both the executor of the estate and the trustee of a qualified revocable trust elect the treatment of § 645, the trust shall be treated and taxed as part of the related estate during the election period. This election is made on a Form 8855 – Election to Treat a Qualified Revocable Trust as Part of an Estate, and must be made on or before the the due date for the first income tax return required to be filed, including extensions. This election is irrevocable. This election allows a trust to apply the same fiscal year election rules for the trust as are allowed for the estate. A qualified revocable trust is a trust that, on the decedent’s date of death, was treated as owned by the decedent because of certain retained powers under IRC § 676.

2. **Proper Form Year.**

   Because tax forms change slightly each year, and because they are labeled with a year, you must be
certain to file the appropriate year’s form. The fiduciary should use the tax form for the year in which the fiscal year begins as the appropriate form for the trust. If the estate has a taxable year from April 1, 2009, through March 31, 2010, the Form 1041 for 2009 should be used. If the proper year’s form has not been published by the due date of the return, use the prior year’s form.

D. Extensions.
If additional time is needed to file a Form 1041, use Form 7004 – Application for Automatic 5-Month Extension of Time to File Certain Business Income Tax, Information and Other Returns.

VI. PAYMENT OF TAXES.
A. Payment of Liability.
The entire income tax liability of an estate or trust must be paid on or before the due date for the return. IRC § 6151. All taxes submitted should be paid to the order of the United States Treasury, and the EIN, the form number, and the tax year should be included in the memo line.

B. Estimated Taxes.
Estates that have been in existence for more than two years and all trusts must pay estimated taxes in the same manner as individuals. Thus estates more than two years old and trusts must make quarterly estimated payments. If such estimated payments are required, they must be made by the 15th day of the 4th, 6th, and 9th months of the tax year, and the 15th day of the first month of the following tax year. These estimated payments will be required if the entity expects to owe, after withholding and credits, more than $1,000 in tax, and the withholding will not exceed the lesser of 90% of the tax shown on the current year’s return or 100% of the tax shown on the prior year’s return (110% if the gross income is greater than $150,000.)

C. Interest and Penalties.
The IRS will charge interest on taxes that are not timely paid, even if an extension of time to pay is granted. Penalties are charged for late filing of a return (5% of the tax due charged each month, up to 25% of the tax due as a maximum, if there is no fraud), late payment of income tax (1/2% of the unpaid amount charged each month, with a maximum penalty of 25% of the unpaid amount), and underpayment of estimated taxes. Penalties can also be charged if the fiduciary does not timely provide Schedules K-1 to the beneficiaries of the trust. This is a $50 penalty for each failure, with a maximum penalty of $100,000. Other penalties can be imposed for negligence, substantial understatement of income or tax, or fraud.

All of the penalty maximums are increased if fraud is involved.

D. 65-Day Rule.
The fiduciary of an estate or complex trust may elect to treat any distribution, in whole or in part, made in the first sixty-five days of the tax year as having been distributed in the prior tax year. IRC § 663(b). The election is made on the Form 1041 and is irrevocable, but binding only for the current year.

E. IRC § 643(g) Election.
In a final year of an estate or trust, the fiduciary may elect to have estimated taxes paid allocated to any beneficiary, rather than to the estate or trust. This election is made by filing the Form 1041-T – Allocation of Estimated Tax Payments to Beneficiary, by the sixty-fifth day after the close of the tax year. This amount is reported as income to the beneficiary on Schedule K-1.

F. Throwback Rules.
These rules have been repealed for the most part. They were initially intended to prevent the accumulation of income by a trust with distributions to beneficiaries only in low income years. They are now only applied to distributions made before August 6, 1997, except that they still apply to certain trusts created before March 1, 1984.

VII. AMENDED AND FINAL FORMS 1041.
A. Amended Returns.
If an amendment needs to be made to the Form 1041 after filing, there is a box on the return that should be checked. Prepare the return as filed previously, then make the corrections, check the “amended return” box, and recalculate the totals. File the corrected return, and attach an explanation as to what was done and why. If the return is amended, the Schedules K-1 must also be amended and delivered to the beneficiaries. The Schedules K-1 should be designated as “Amended” as well.

B. Final Returns.
If an estate or trust terminates, there is a box on the return that should be checked for the final year of the return. In the final year of a trust or estate, net operating loss, unused capital losses, capital loss carry forwards, and excess deductions on termination (which are deductions in the final year of the trust or estate which exceed the gross income), will pass through to the beneficiaries through the Schedules K-1. The beneficiaries are able to use these beneficial items on their own income tax returns (subject to their own tax preference limitations.)
1. **Estate Termination.**
   An estate terminates when the period of administration or settlement ends, or all assets have been distributed.

2. **Trust Termination.**
   A trust terminates upon the terms of the instrument creating the trust, or when all of its assets have been distributed.

**VIII. PREPARATION OF THE RETURN.**

**A. Type of Entity.**
   The identification of an entity as a “Decedent’s Estate” is self evident. A simple trust is any trust for which: (1) the trust instrument requires all income to be distributed to the beneficiaries current, (2) the trust has no charitable purpose or beneficiary, and (3) the trust does not distribute any amounts of corpus. A complex trust is any trust that is not a simple trust. An estate is entitled to an exemption of $600, a simple trust is entitled to an exemption of $300, and a complex trust is entitled to an exemption of $100.

1. **Capital Gains.**
   A trust can be a simple trust even if capital gains are not distributed if the capital gains are allocated to corpus by the terms of the instrument creating the trust or by state law.

2. **Final Year.**
   A trust will lose its simple trust designation if trust corpus is distributed. Thus, in a trust’s terminal year, it will necessarily not be a simple trust.

**B. Tax Identification Number.**
   Each trusts or estate (other than a grantor trust) that is required to file a Form 1041 must have a taxpayer identification number. If the number has been applied for but not received (unlikely, since the number can be applied for by phone, fax, or internet), write “Applied For” on the return. (Certain trusts electing § 645 treatment may not need a separate tax identification number.)

**C. Reporting of Income.**

1. **Social Security Number.**
   If income or dividends are reported on a decedent’s social security number in the decedent’s year of death, then such income must be reported on the decedent’s final Form 1040 – U.S. Individual Income Tax Return. These income items should be listed on the appropriate schedule of Form 1040, and the final entry on such schedule should remove, with a negative entry, the appropriate income from the Form 1040 and allocate that amount to the Form 1041 by identifying the estate or trust by name and address.
   These amounts are then included on the Form 1041, and retain the same character on the Form 1041.

2. **Tax Identification Number.**
   All income items reported on the trust’s or estate’s tax identification number for a given year should be included on the Form 1041. In the event the fiscal year of an entity is not a calendar year, the income items reported on the Form 1099 should be allocated based on the actual date of receipt or, if impossible or impractical to determine actual receipt, then allocated based on elapsed time.

3. **Qualified Dividends.**
   Qualified dividend status should be allocated as well. Estates and trusts receive the same lower tax rates for qualified dividends, but for qualified dividends that are allocated from a decedent’s final Form 1040, rather that directly attributed to the estate or trust through a Form 1099, there may be additional restrictions for receiving these benefits. See Publication 550.

4. **Business Income.**
   Income or losses from a business owned by an estate or trust should be reported on Schedule C of Form 1041.

5. **Capital Gains and Losses.**
   Schedule D of Form 1041. Note that the lower tax rates for long-term capital gains available to an individual are also available to a trust or estate in the event the assets have been held for the required periods. Generally, a capital asset must be held for more than twelve months in order for realized gain to be classified as a long term asset, but for property acquired from a decedent, in most situations, the long-term holding period is attributed to such property. IRC § 1223(11). The distributions of capital gains are discussed more completely below.

a. **Basis.**
   IRC § 1014 establishes the income tax basis of property acquired from a decedent as the fair market value of such property at date of death, or at the alternate valuation date, if the alternate valuation date election is made. This can function to create a step-up in the basis, or a step-down in the basis. This change in basis will apply to the full interest of both spouses if the property is community property assets. IRC § 1014(b)(6). These date-of-death values should be represented on the Form 706 – United States Estate (and Generation-Skipping Transfer Tax) Return, if one was filed. If no Form 706 was required for the estate, but if a probate was had, there should be an inventory for such probate, which should reflect these date-of-
death values. If no inventory is available, the executor has the responsibility for determining the appropriate date-of-death value, whether by appraisal for harder to value assets, or by researching values of readily salable assets. The value for those assets that are publicly traded is generally calculated by averaging the high and low values from the date of death. If the date-of-death fell on a weekend or holiday, the reported value is the average of the high and low value for the last trading day prior to date-of-death, and the high and low values from the first trading day after date of death.

b. Income in Respect of a Decedent (IRD).
IRD refers to income earned by a decedent at the time of death, but not reportable on the decedent’s individual income tax return because of a method of accounting. IRD assets are included in a decedent’s gross estate (for estate tax purposes) at full value, but will be subject to income taxation in the hands of the eventual recipient. Thus, IRD items are subject to both estate tax on the full value, and then income tax when the income is recognized, resulting in a double taxation. (Note that the taxpayer recognizing the income, including an estate or trust, will get an itemized deduction, not subject to the 2% limitation, for the portion of the federal estate tax attributable to the income that is recognized under IRC § 691(c). Note that this deduction is available only for the attributable federal estate taxes paid, and not any state inheritance paid.) IRD items include accrued income, deferred salary items, IRAs, 401(k) accounts, and payments on installment contracts. IRD items retain their same character that they had if held in the hands of the decedent.

c. Taxation of Capital Gains.
Capital gains are taxed to the estate or to the trust where the gains must be or are allocated to principal by the instrument creating the estate or trust or by state law. If gains are actually distributed to the beneficiaries or must be in accordance with the instrument creating the estate or trust or by state law, then the capital gains will be part of the DNI, and taxed to the receiving beneficiary. Capital losses are not passed through to a beneficiary, and can only be used to reduce the capital gains of the estate or trust, or reduce the income of the estate or trust. If the estate or trust distributes all income, and has a capital loss, rather than receiving no benefit from the capital loss, the loss will be carried forward to future years. If the loss is never used because there are no gains with which to offset the loss, and income is always distributed, then upon the termination of the estate or trust, the capital loss will pass through to the beneficiaries.

d. Gain or Loss on Distribution.
2. 2004, gain or loss is received by the trust or estate or by the beneficiaries of the trust or estate if an asset is distributed in-kind to satisfy a monetary bequest and the value of the assets has increased or deceased from the date-of-death value.

6. Rents and Royalties.
Income or loss from rents, royalties, partnerships, or other estates or trusts is reported on Schedule E of Form 1041. The instructions for completion of Schedule E of Form 1040 are applicable to Schedule E of the Form 1041.

a. Title.
A will or a trust can make a direct gift of real property, which may, under state law, pass title to the asset to the recipient designated. If the asset is still subject to administration within the estate or trust, then the income is part of the estate or trust as well.

7. Farm Income.
Schedule F of the Form 1041. The instructions for completion of Schedule F of the Form 1040 are applicable to Schedule F of Form 1041.

8. Other Income.
Other income may be reported on the 1041 schedule or form that corresponds to the 1040 schedule or form on which the income would have been reported for an individual or may be reported as “other income” on the Form 1041. These items should be listed and described. This would include any distributions made through a Form 100-R, or any other income that is treated as ordinary income item.

Because of the allocation of certain expenses to tax-exempt income, it is important to report a tax-exempt income on the Form 1041 on the appropriate schedule.

10. Community Property.
Allocation of income and deductions between an estate and a surviving spouse in community property states will depend on the community property laws of the state. Usually, the surviving spouse is taxed on one-half of the income from the community property assets until they are divided. In the first year of an estate, the income received prior to the decedent’s death is included on the couple’s joint Form 1040, and all of the surviving spouse’s community property interest in the income after the date of death. The decedent’s interest in the community property income for items which do not automatically pass to the
surviving spouse would be allocated to the estate’s Form 1041.

D. Household Employees.

If the estate or trust paid a household employee more than $1,500 in wages in a year, or withheld any income tax from payment of any amounts to a household employee, or paid wages of more then $1,000 in any quarter to one or more household employees, the estate should file a Schedule H to report such wages and calculate Household Employment Taxes. The instructions for the Form 1040 Schedule H will apply to the preparation of a Schedule H for Form 1041.

E. Alternate Minimum Tax (AMT).

The AMT can be charged to an estate or trust. It is computed in Part III of Form 1041.

F. Attachments.

The Instructions for the Form 1041 request a specific order for attachments to the Form 1041: Schedule D (Form 1041); Form 4952; Schedule H (Form 1040 is Schedule H is used for the Form 1041); Form 4136; Form 8855; Form 8913; any other schedules or forms; then any other required attachments.

IX. DEDUCTIONS.

A. Allocation to Tax-Exempt Income.

Expenses that are allocable to tax exempt income are not allowed as deductions. (However, state income taxes and business expenses allocable to tax-exempt interest are deductible). Thus, expenses directly allocable to tax-exempt income are fully nondeductible. Expenses directly allocable to taxable income are fully deductible. A reasonable proportion of expenses indirectly allocable to all income must be allocated to tax-exempt income, and thus will be nondeductible.

B. Deduction Elections Between Form 706 and Form 1041.

Certain expenses are deductible directly on the Form 706 for purposes of determining the decedent’s taxable estate, or may be deducted on the Form 1041, but not on both. IRC § 642(g) . Since the estate tax rates applicable to an estate differ from the income tax rates applicable to the estate’s income, these deductions should be considered carefully, in order to determine where they are the most advantageous to minimize the overall tax burden. If the estate is not taxable for federal estate tax purposes, but expenses were incurred in the administration of the estate, these expenses are deductible on the Form 1041.

1. Deduction on 1041.

If the deduction will be taken on the Form 1041, the executor must file an affirmative statement, in duplicate, stating that the items claimed on the Form 1041 have not been allowed as a deduction for estate tax purposes on the Form 706. The statement must irrevocably relinquish the right to claim a deduction for those administration expenses against estate taxes. The language should be in a similar form as follows:

Election to Waive the Right to Claim Administration Expenses on the Form 706.

Pursuant to IRC § 642(g) and Regulation 1.642(G)-1, the taxpayer hereby elects to deduct certain estate expenses on the Form 1041 for the year ended ______________. These expenses have not been claimed or allowed under IRC §§ 2053 or 2054 on the Form 706, and the taxpayer hereby waives the right to deduct such expenses at any time for estate tax purposes.

__________________________, Executor

C. Deductions for Interest.

Interest incurred by the estate or trust on amounts borrowed by the estate or trust or on debts acquired that is not deductible on another schedule is deductible as an administration expense, and reported on Line 10. Personal interest is not deductible on a Form 1041.

1. Qualified Residence Interest.

Qualified residence interest would be deductible as a general expense. This is interest paid on indebtedness secured by a qualified residence of a beneficiary that is owned by the trust, if the residence would be a qualified residence for personal purposes if owned by the beneficiary directly. IRC § 163(h).

D. Deductions for Taxes.

Deductions for taxes are reported on Line 11, but should be individually itemized on an attached schedule.

1. State and local income taxes are deductible.

You may deduct state and local sales taxes or income taxes, but not both. Note than an estate or trust cannot use the Sales Tax Table for individuals, and must keep actual records of sales taxes paid.
2. Real property taxes are deductible.
3. Personal property taxes are deductible.
4. Foreign taxes paid are deductible. In the alternative, a credit for foreign taxes paid can be claimed. Usually the credit is more beneficial.
5. GST Taxes. Generation-skipping transfer taxes paid are deductible.

E. Charitable Deductions.
The portion of the income of a trust or estate that is, under the terms of the governing instrument, required to be paid for a charitable purpose under IRC § 170(c) is allowable as a deduction, and is reported on Line 13 of the Form 1041. This deduction is unlimited. IRC § 645(c). Trusts that claim a charitable deduction must also file a Form 1041-A – United States Information Return Trust Accumulation of Charitable Amounts.

1. The fiduciary may elect to treat income received in the current year, but paid to a charitable entity in the next year as a current charitable deduction. This election is made by filing a statement with the Form 1041 which includes the name and address of the fiduciary, an indication that the election under 642(c)(1) is being made for contributions treated as paid during such tax year, the name and address of the charitable organization to which the funds were paid, and the amount of the contributions and the actual dates of payments. The election must be made by the due date (including extensions) of the Form 1041.
2. If the estate or trust pays any portion of its income to a charitable purpose and takes a charitable deduction, the estate or trust must reduce the deduction by the portion allocable to any tax-exempt income, unless the governing instrument specifically provides the source from which the gift is to be paid.

F. Deductions Not Subject to the 2% Floor.
Generally, miscellaneous deductions of an estate or trust are subject to a 2% floor of the entity’s adjusted gross income, except for expenses that would not have been incurred if the property had not been in a trust or estate. Some deductions are not subject to the 2% floor, and these should be listed on a schedule, described, and then totaled on Line 15a. These deductions would include items like bond premium deductions, casualty and theft losses, net operating loss deductions, and other items of depreciation, amortization and depletion not taken elsewhere.

1. Depreciation, Depletion, and Amortization.
Trusts and estates are allowed deductions for depreciation, depletion and amortization only to the extent such deductions are not apportioned to a beneficiary. The share of such items allocable to the trust or estate should be reported on the appropriate lines of Schedule C, E or F. These items are allocable between the estate, trust, and beneficiary, depending upon the allocation of the income, except that a trust instrument or state law may reapportion or redefine such allocation or establish a reserve. (Note that for an estate, the step-up or –down in cost basis may affect the depreciation of such item in the first year.)

G. Deductions Subject to the 2% Floor.
Generally, miscellaneous deductions of an estate or trust are subject to a 2% floor of the entity’s adjusted gross income, except for expenses that would not have been incurred if the property had not been in a trust or estate. These deductions should be listed on a schedule, and described, and totaled on Line 15b. These deductions include expenses for the production or collection of income under IRC § 212, such as investment advisory services, costs of safe deposit boxes, etc.

1. Adjusted gross income (AGI).
AGI is calculated by computing total income to Line 9 on Page 1 of the return, and then subtracting (1) administration costs of the estate of trust that would not have been incurred if the property were not held in the estate or trust; (2) the income distribution deduction (or the actual distribution, if the distribution is less than the DNI) ; (3) the exemption; (4) the domestic production activities deduction on line 15a if any; (5) the net operating loss deduction on line 15a if any.

H. Income Distribution Deduction.
If the estate or trust was required to distribute income, or if the income was actually paid, credited, or distributed in accordance with the terms of the trust during the tax year, the estate or trust is entitled to an income distribution deduction. This deduction is calculated on Schedule B, on page 2 of the return. In no case may the income distribution deduction exceed the DNI.

1. DNI.
In order to calculate the income distribution deduction, it is necessary to calculate the distributable net income (“DNI”) of the estate or trust. The DNI generally consists of the same income and deduction items that make up taxable income, with a few modifications: (1) no deduction for distributions to beneficiaries; (2) no deduction for the exemption; (3) tax exempt interest on state and local bonds in
included, but reduced by the amount of expense that is disallowed due to allocation to tax exempt income; (4) for a foreign trust, US income and income from outside the US in included (less amounts disallowed due to allocation to tax exempt income); (5) capital gains allocable to corpus that are not paid, credited, or required to be distributed to any beneficiary during the tax year or paid or permanently set aside for a charitable purpose are excluded; (6) capital losses are excluded, except to the extent used to determine the amount of capital gains paid, credited or required to be distribute to any beneficiary during the tax year and (7) for a simple trust, extraordinary dividends or taxable stock dividends that the fiduciary allocates to corpus are excluded.

2. **Income Types.**

Where income is of varying types, the deduction for distribution is allocated in the same proportion as the total of each class of items bears to the total DNI.

3. **Application of Deductions to DNI.**

Deductions entering into the computation of DNI are allocated among the differing types of income that make up the DNI as follows: (1) deductions directly attributable to a type of income are allocated to that income; (2) all other deduction are allocated to the items of gross income included in computed DNI. However, if there is nontaxable income, a portion must be allocated to the nontaxable income as well, and no deductions may reduce an item of income below zero after direct and indirect allocation; (3) if there are excess deductions on any one income type, those deductions may be assigned to another income class.

4. **Schedule K-1.**

A Schedule K-1 must be attached for each beneficiary who received a distribution. The fiduciary is required to deliver a copy of the Schedule K-1 to each of these beneficiaries.

5. **Separate Share Rule.**

The separate share rule limits the income tax liability of one beneficiary receiving corpus distributions, where income is being accumulated for the benefit of another beneficiary. If a single trust or estate has more than one beneficiary, and the different beneficiaries have substantially separate and independent shares, their shares may be treated as separate trusts or estates for determining the DNI allocable to the respective beneficiaries. Thus, if beneficiaries A and B have equal interest in a trust, and the trust has income of $30,000 in a tax year, and A accumulates her share of income - $15,000 – but B takes a distribution of all income and some corpus, B should not be taxed for A’s share of the income. The separate share rule is mandatory and not elective. Also, the rule applies only for purposes of DNI, and no additional exemption is granted.

6. **65-Day Rule.**

The fiduciary of an estate or complex trust may elect to treat any distribution, in whole or in part, made in the first 65 days of the year as having been distributed in the prior year. IRC § 663(b). The election is made on the Form 1041 and is irrevocable, but binding only for the current year.

7. **Specific Gift.**

If the executor or trustee fulfills a specific bequest, the distribution of such amount will not carry through income to that beneficiary, unless the specific gift was to be made from income in accordance with the terms of the instrument creating the gift.

8. **Example.**

A trust has dividend income of $20,000, taxable interest income of $10,000, tax exempt (TE) interest income of $10,000, business income of $10,000, and $20,000 in long term capital gains that are allocated, in accordance with the terms of the trust, to corpus. The trust also pays expenses of $2,000 for the business, $2,000 in expenses allocable to corpus, and $1,000 in expenses allocable to income. The trust makes a distribution to the beneficiary of $20,000.

a. The income for the trust is $50,000. This includes the $20,000 in dividends, $10,000 in taxable interest, $10,000 in TE interest, and $10,000 in business income.

b. The DNI is $45,000, and includes the $20,000 in dividends, $10,000 in taxable interest, $9,400 in TE interest ($10,000 in interest, less the TE portion of the deductions calculated as: $10,000 – ($3,000*($10,000/$50,000)), $10,000 in business income, reduced by the business expense of $2,000, and the trust expenses (other than those allocated to exempt income) of $2,400 (calculated as $3,000 in expenses less the $600 allocated to TE income.)

c. The allocation of different types of income to the beneficiary who received the $20,000 distribution does not have to be proportionate. The $9,400 figure above represents the net TE income after allocation of expenses. The remaining expenses can be allocated to any item, as long as no negative is created. If all of the remaining expenses are allocated to dividends, the remaining
sources of income for allocation to the beneficiary are: dividends of $17,600 (calculated as $20,000 in dividends less the remaining expense of $2,400), $10,000 in taxable interest, $9,400 of TE interest, $8,000 of business income. (As a check, this totals the $45,000 DNI.)

d. Each of these amounts is then multiplied by $20,000/$45,000 (the distributed amount over the DNI) to determine how much of each type of income is includable. The final allocation is:

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$7,822</td>
</tr>
<tr>
<td>Taxable interest</td>
<td>$4,444</td>
</tr>
<tr>
<td>TE interest</td>
<td>$4,178</td>
</tr>
<tr>
<td>Business income</td>
<td>$3,556</td>
</tr>
<tr>
<td>Capital gains</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$20,000</td>
</tr>
</tbody>
</table>

e. These income amounts, and their character, are reported to the beneficiary on a Schedule K-1. The beneficiary then reports the income on their individual return.

I. Estate Tax Deduction.
If the estate contains IRD items, and such amount was included in the decedent’s gross estate for estate tax purposes, and if federal estate taxes were paid, the estate or trust is entitled to a deduction for the federal estate taxes paid on the income which is reported on the Form 1041. IRC § 691(c).

J. Miscellaneous Deduction Rules.
1. 179 Deductions.
   - The 179 election is not available to a trust or estate.
   - Generally, losses from passive activities will be limited to the amount of income derived from all passive activities under IRC § 469. No specific standards have been established for material participation by a trust or estate. Generally, rental activities will be passive. However, for the first 2 years of an estate, up to $25,000 of deductions from rental real estate activities in which the decedent was a material participant are allowed. Additional losses are carried forward. Portfolio income is not passive.
3. Funeral Expenses.
   - Funeral expenses are deductible on Form 706, but are not deductible on Form 1041.
4. Related Parties.
   - For purposes of a trust using the accrual method of accounting, business expenses and interest owed to a related party may only be deducted in the year the income is included in the income of the related party. IRC § 267.
5. Loses from Casualty and Theft.
   - Loses from non-business casualty and theft can be claimed by a trust or estate. The rules under IRC § 165(h)(4) with regard to limitations apply.

X. CREDITS.
   - Generally, tax credits for individuals are also available to an estate or trust.

A. Foreign Tax Credit.
   - An estate or trust is entitled to a foreign tax credit for income or profits taxes paid or accrued to a foreign tax country. Complete Form 1116 to claim this credit.

B. Other Non Business Credits.
   - The trust or estate can claim credits for qualified electric vehicles, alternative motor vehicles, and alternative fuels.

C. General Business Credit.
   - Various business credits are also available to a trust or estate. The trust or estate must file the appropriate form to report and claim such credit.

D. Other Credits.
   - Estates and Trusts can also claim credits for: prior year minimum tax credits (Form 8801), qualified zone academy bond credits (Form 8860), clean renewable energy bond and Gulf tax credit bond credits (Form 8912), recapture of investment property credit (Form 4255), recapture of low-income housing credit (Form 8611), credits for income tax withheld on wages received, and credits for back up withholding, among others.

XI. CONCLUSION.
   - The taxation rules for estates and trusts are clearly similar to those for individuals, but certainly dissimilar enough to cause a large number of errors in reporting by those tax preparers who do not routinely prepare Form 1041. In addition, familiarity with the returns and the applicable rules allows a practitioner to adequately advise the fiduciary of the significant opportunities for tax deferral and minimization. This outline is intended as an outline of the various rules and opportunities.