

## Temporary Bliss: An Entity Election for Trusts

by Michael J. Jones

Michael J. Jones, CPA, a partner in Thompson Jones L.L.P., Monterey, Calif., reviews the provisions of section 645 and the regulations thereunder, which allow a qualified revocable trust to be treated as part of its related estate for all income tax purposes.

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From an income tax perspective, estates of decedents have historically enjoyed advantages over trusts functioning as a means to settle estates of decedents.

An elective remedy arrived in the form of section 1305(a) of the Taxpayer Relief Act of 1997, which added to the Internal Revenue Code section 646,1 applicable to estates of decedents dying after Aug. 5, 1997. Section 646 was redesignated as section 645 the following year by section 6013(a)(1) of the IRS Restructuring and Reform Act of 1998.

Section 645 provides a special, temporary entity election for trusts. By making an election, a qualified revocable trust may be treated as part of its related estate for all income tax purposes. An electing trust is not treated as a separate taxable entity during the period the election is effective. This "entity election" for trusts deserves to be on every postmortem checklist.

The IRS first published guidance in Rev. Proc. 98-13, 1998-1 C.B. 370, Doc 98-1958 (7 pages) or 98 TNT 7-5 . Proposed regulations (REG-106542-98, Doc 2000-33612 (10 original pages) or 2000 TNT 248-9 ) ensued on December 18, 2000. Final regulations under section 645 were promulgated on Dec. 24, 2002 (T.D. 9032, 67 Fed. Reg. 78371, Doc 2002-28080 (13 original pages) [PDF] or 2002 TNT 250-107 ). More recently, the IRS published further guidance in Notice 2003-33, 2003-23 IRB 990, Doc 2003-11626 (3 original pages) [PDF] or 2003 TNT 90-15 .

This article will discuss the income tax differences between estates of decedents and trusts, the provisions of final regulations, and Notice 2003-33. All references are to the code and related regulations, unless otherwise noted.

## **Income Taxation of Trusts vs. Estates**

To evaluate whether to make the section 645 election, the differences between the income taxation of trusts vs. that of estates must be reviewed. A summary of those differences follows.

### ***Annual exemption***

Under section 642(b), an estate is allowed an annual exemption from tax of \$600 of taxable income. A simple trust (one that must distribute all income currently) is allowed an exemption of \$300. All other trusts are allowed an exemption of \$100.

### ***Tax year***

Section 441 and reg. section 1.441-1(c) generally permit taxpayers to elect a tax year ending on the last day of any calendar month. However, section 644 provides that the tax year of all trusts must be the calendar year. There is no such restriction on the tax year of estates.

Reg. section 1.645-1 expressly acknowledges, as an example of the rule that an electing trust is treated as an estate for all income tax purposes, that "[t]he trustee may also adopt a taxable year other than a calendar year."<sup>2</sup>

### ***Estimated taxes***

Section 6654 provides an addition to the income tax if estimated taxes are not paid, as required thereunder.

Section 6654(l) generally subjects estates and trusts to the estimated tax provisions, but also provides a two-year exemption from estimated tax payments for estates, and some trusts following the death of the decedent.

Reg. section 1.645-1(e)(4) provides that the two-year estimated tax exemption applies to all trusts joining in a section 645 election.

Some trusts qualify for the two-year estimated tax exemption without making a section 645 election. Under section 6654(l)(2)(b), trusts are granted the temporary exemption if the trust was a grantor trust under sections 671 through 679 regarding a decedent and also meets one of two other conditions. One is that the decedent's will transfers the residue of the decedent's estate to the trust. The other condition is that no will is admitted for probate, and the trust is primarily responsible for paying debts, taxes, and expenses of administration.

For a trust to elect to be treated as part of a related estate, it must be a qualified revocable trust. At first blush there is a similarity between that definition and the definition of a trust not required to pay estimated taxes for two years. However, there is a difference. The similarity is that a qualified revocable trust is one form of grantor trust under sections 671 through 679. Without further analysis, it would appear that all trusts that are

qualified revocable trusts under section 645 need not pay estimated taxes for two years. But that is not necessarily true. A qualified revocable trust will not always fall within the estimated tax exemption because it might not meet either of the conditions outlined immediately above.

### ***S corporations***

Section 1361 generally provides that some small business corporations may elect to be treated as pass-through entities under subchapter S (so-called S corporations). One requirement for qualification is that all of the corporation's stock must be owned by individuals, but there are several exceptions to this rule. One is that an estate may be an owner of S corporation stock.

Section 1361(c) provides that some trusts may be shareholders. Trusts that were grantor trusts during a shareholder's lifetime may be shareholders only for the two-year period following the death of a decedent. The same two-year trust ownership period is permitted when a will leaves S corporation stock to a trust, but the two-year period runs from the date of the transfer from the estate to the trust.

Reg. section 1.645-1 acknowledges, as an example of the rule that an electing trust is treated as an estate for all income tax purposes, that "an electing trust is treated as an estate for purposes of . . . the subchapter S shareholder requirements of section 1361(b)(1)."<sup>3</sup>

Treatment as an estate might buy valuable time to deal with S corporation stock. A trust treated as an estate should be able to hold S corporation stock as long as the trust is treated as part of its related estate under a valid section 645 election.

### ***Low-income housing credit***

The recapture provisions of section 42(j) permit partnerships with 35 or fewer partners to be treated as the taxpayer to whom the credit is allowed. For purposes of counting partners, spouses and the related estates of either or both are treated as one partner.

### ***Annuities not held by natural persons***

Section 72(u) generally provides that when an annuity is not held by natural persons, the income on the contract for any tax year of the policyholder must be treated as ordinary income received or accrued by the owner during that tax year. Section 72(u)(3)(A) provides that an estate acquiring an annuity through the death of a decedent is not subject to the general rule of section 72(u).

### ***Exclusion of gain on sale of principal residence***

Section 121 provides for exclusion from gross income of gain realized on a sale or exchange of the taxpayer's principal residence, with limits on the amount of gain that may be excluded. Effective for decedents dying after December 31, 2009, section 121(d)(9) extends the exclusion provisions to estates of decedents; any individual that acquires the property from a decedent; and any trust that, immediately before the death of the decedent, was a qualified revocable trust (as defined in section 645(b)(1)) established by the decedent, determined by taking into account the ownership and use by the decedent.<sup>4</sup>

Note that the section 645 election need not be made -- it is sufficient that the trust be a qualified revocable trust under section 645. This special gain exclusion provision expires December 31, 2010.

### ***Charitable contributions***

Section 642(c) allows charitable deductions of trusts and estates in lieu of the deduction allowed by section 170(a). Also, section 642(c)(2) provides a deduction for estates that are required, under the terms of the governing instrument, to permanently set aside a portion of income for charitable purposes. This charitable set-aside deduction generally is not available to trusts after October 9, 1969.

Reg. section 1.645-1 acknowledges, as an example of the rule that an electing trust is treated as an estate for all income tax purposes, that "an electing trust is treated as an estate for purposes of . . . the set-aside deduction under section 642(c)(2)."5

Reg. section 1.645-1(e)(2)(iv) applies the governing instrument requirement of section 642(c) to each entity joining the section 645 election. For example, if an estate and one trust join in a section 645 election, the decedent's will must meet the governing instrument requirement to claim a charitable set-aside deduction relating to the will. Similarly, the trust must meet the governing instrument requirement to claim a charitable set-aside deduction relating to the trust. The making of a section 645 election by the estate and the trust will not permit one entity to "borrow" the governing instrument requirement of the other entity in attempting to qualify for the charitable set-aside deduction claimed in their combined income tax return.

### ***Special offset for passive rental real estate activities***

Section 469 generally limits income tax deductions and credits from some passive activities. Section 469(i) provides that the passive loss limits will not apply to up to \$25,000 for an individual who actively participates in real estate rental activities. The statutory language of section 469(i) refers to this as a special offset.

Section 469(i)(4) extends the special offset to estates, for up to two years after the date of death of a decedent, subject to an adjustment for any part of the \$25,000 limit allowable to the surviving spouse of the decedent.

Reg. section 1.645-1 acknowledges, as an example of the rule that an electing trust is treated as an estate for all income tax purposes, that "an electing trust is treated as an estate for purposes of . . . the special offset for rental real estate activities in section 469(i)(4)."6

### ***Amortization of reforestation expenditures***

Section 194 permits an income tax deduction for some reforestation expenditures. Section 194(b)(3) denies trusts those deductions. However, section 194(b)(4) allows the deduction for an estate. An estate is treated in the same manner as an individual. The deduction is allocated between the income beneficiary and the fiduciary.

### ***Medical expenses of a decedent***

Under section 212(c), medical expenses paid "out of [a decedent's] estate" are treated as though paid when incurred, thus permitting a medical expense deduction on the decedent's income tax return.

### ***Losses between related taxpayers***

Section 267 generally denies a deduction for losses on sales or exchanges between related taxpayers. A loss transaction between a trust and its beneficiaries, such as satisfaction of a pecuniary bequest, will result in denial of the loss deduction. However, section 267(b)(13) provides that an executor of an estate and a beneficiary of the estate are not treated as related parties subject to loss disallowance in a sale or exchange in satisfaction of a pecuniary bequest. See "Preserving Capital Losses of Estates," Tax Notes, Feb. 18, 2002, p. 887.

### ***Allocation of estimated tax to beneficiaries***

Section 643(g) provides that trusts may allocate estimated taxes paid by a trustee to beneficiaries in any tax year. Estates may do so only in the tax year reasonably expected to be the final tax year of the estate.

## **Final Regulations**

The statute is deceptively simple. The goal of creating the income tax fiction that an electing trust will be treated as though it is part of its related estate raises extensive issues, which the regulations deal with admirably.

### ***Effective dates***

Final reg. section 1.645-1 generally applies to trusts and estates of decedents dying on or after December 24, 2002. However, two provisions of the regulation apply to tax years ending on or after December 24, 2002: section 1.645-1(e), relating to tax treatment and general filing requirements of electing trusts and related estates during the election period, and section 1.645-1(h), relating to treatment of electing trusts and related estates following termination of the election.

T.D. 9032 amends several other regulations. The amendments and effective dates are:

Reg. section 1.671-4(d)(2) and (h), relating to method of reporting for grantor trusts under sections 671 through 679, applicable to tax years ending on or after December 24, 2002;

Reg. section 1.6012-3(a)(1)(iv), relating to the income threshold for triggering income tax filing requirements for participants in a section 645 election, not specifying an effective date;

Reg. section 1.6072-1, relating to time for filing returns of individuals, estates, and trusts, applicable to tax years ending on or after December 24, 2002; and

Reg. section 301.6109-1, relating to tax identification numbers applicable to trusts and estates of decedents dying on or after December 24, 2002.

After the final regulation was promulgated, the IRS augmented the effective date provisions in Notice 2003-33, permitting early application of the final regulation's definition of when final determination of the estate tax has been made. This is discussed in more detail below.

### ***Electing trust is part of estate for income tax purposes***

The first phrase encountered in section 645 is "[f]or purposes of this subtitle," which means subtitle A of the code, encompassing all income tax provisions. This should mean that no matter what part of subtitle A might apply to an electing trust, the tax fiction that the trust is not really a trust, but rather is a part of its related estate, will control. That notion is reflected throughout the final regulation. Some examples are given in the above discussion comparing income taxation of trusts vs. estates.

Once the election is made, there is only one entity for purposes of filing income tax returns of the combined group of election participants.<sup>7</sup> All tax attributes and limitations will apply to the combined group as if there is but one taxpaying entity: an estate. For example, and not through limitation: One personal exemption in the amount of \$600 is permitted under section 642(b).<sup>8</sup> One set of income tax brackets under section 1(h) will apply to the combined group.<sup>9</sup> One alternative minimum tax exemption will apply to the combined group. One application of the limitation on specified deductions not exceeding 2 percent of adjusted gross income will apply to the combined group.

### ***Duration of the election***

Under section 645(a), the election is effective for all tax years of the estate ending after the date of the decedent's death and before the applicable date. This period is referred to as the election period.<sup>10</sup>

Section 645(b)(2) provides that the applicable date depends on whether an estate tax return must be filed. If not, the applicable date is two years after the date of the decedent's death. If an estate tax return must be filed, the applicable date is the later of (1) two years after the date of the decedent's death; or (2) the date that occurs six months after the date when the final determination of the estate tax is made.

Even relatively uninitiated students of tax law will recognize the difficulties presented by the problem of determining when a final determination of tax is made. The statute offers no further guidance, yet fails to provide an express delegation of this determination to the Treasury secretary. The regulations fill this void.

The rules for determining when the election period ends, including rules relating to fixing the time when the final determination of the estate tax is made, are covered in detail below.

### ***What is a QRT?***

Only a qualified revocable trust (QRT) may make the election. Section 645(b)(1) provides that a qualified revocable trust is any trust that was a grantor trust for income tax purposes under section 676 "by reason of a power in the grantor (determined without regard to section 672(e))." The typical revocable trust that functions as a will substitute while retaining full lifetime access to trust income and corpus, along with a power to

alter, amend or revoke the trust, will meet the definition of a QRT and so will be a candidate for the election.

Once a QRT has made the election, it is referred to in the regulation as an electing trust and is so treated for the duration of the election.<sup>11</sup>

The statute does not expressly require that the decedent's power exist on the date of the decedent's death. However, reg. section 1.645-1(b)(1) interprets the statute to include this requirement.

Generally, a grantor trust is a trust or a portion of a trust the ownership of which is attributed to the grantor of the trust for income tax purposes under sections 671 through 678. Accordingly, income, deductions, and credits of the property so treated are attributed to the grantor.

Section 676 provides that a trust is a grantor trust if a power to revest title to property in trust may be exercised at any time. That power exercisable by the grantor, a nonadverse party, or both will create a grantor trust. Under section 672(e), a grantor is attributed any power over a trust or interest in a trust held by the spouse of the grantor. However, a grantor trust will qualify for the section 645 election only if the grantor held the power to revest. If the power to revest is not in the grantor, the trust will not be a QRT, even if the power is held by a nonadverse party or the grantor's spouse.

Reg. section 1.645-1(b)(1) says a trust is a QRT even if the grantor's power to revest was predicated upon approval or consent by either a nonadverse party or the decedent's spouse.

May a testamentary trust formed under a decedent's will make a section 645 election? A testamentary trust fails the definition of a QRT because it was not a grantor trust during the lifetime of the decedent. That trust cannot make a section 645 election.

Likewise, successor trusts -- for example, trusts that are distributees of a trust making a section 645 election -- will not be QRTs, nor may they come within the election of the QRT from whence distributions originated. This important point is made in (relative) obscurity, in reg. section 1.645-1(f), relating to duration of the election period. For example, many trusts used as will substitutes function as administrative trusts for what would otherwise be an estate administered under a will. Those trusts frequently distribute assets after death under bequests to a marital trust qualifying for an estate tax marital deduction and a trust that incurs estate tax in an amount that is less than, or equal to, the applicable exclusion amount available under section 2010. The trusts are typically testamentary trusts provided for under the terms of the trust instrument and are often referred to as subtrusts or successor trusts. The section 645 election made by the administrative trust does not apply to them.

### ***Identifying the decedent***

Reg. section 1.645-1(b)(3) defines the decedent as the person who was the grantor of the trust under the definition of a QRT, as of the date of the decedent's death.

## ***Identifying the related estate***

Reg. section 1.645-1(b)(5) defines the related estate as the estate of the decedent who was treated as the owner of the QRT on the date of the decedent's death.

## ***Will there be an executor?***

Throughout the regulation, various provisions depend on whether there is an executor. If there is no executor and one is appointed later, other provisions apply. All of reg. section 1.645-1 must be read with this in mind.

"Executor" is given its own definition for purposes of this regulation.<sup>12</sup> The term includes a personal representative or an administrator. The office may be assumed through formal or informal proceedings. However, unlike the definition used elsewhere in the code, "an executor does not include a person that has actual or constructive possession of property of the decedent unless that person is also appointed or qualified as an executor, administrator, or personal representative of the decedent's estate."

When several jurisdictions act to appoint more than one executor, the executor of the decedent's domicile or the executor appointed in the primary proceeding will be considered the executor under reg. section 1.645-1. Thus, only one executor is needed to execute an effective election or file income tax returns.

## ***Who must make the election?***

The election must be made by the executor of the estate (if there is one) and the trustee of each electing QRT.<sup>13</sup> Once made, it is irrevocable.<sup>14</sup> There is no express provision permitting the IRS commissioner to terminate an election under any circumstance.

Even if there is no executor when the election is made, but one is appointed later, the after-appointed executor must join in the election for the election to continue.<sup>15</sup> When and how this is done is discussed below. If the election is terminated because an after-appointed executor fails to agree to the election, the termination occurs as of the day before the executor is appointed. That the election will terminate when there is a nonconsenting, after-appointed executor is implicit in the statute, which requires that the executor participate in making the election, whenever there is one.

## ***Time for making the election***

Section 645(c) provides that the election must be made no later than the due date for filing the first income tax return of the estate (not that of the trust) after the grantor's death. For purposes of the election deadline, the income tax filing date of the estate includes extensions. If income is not sufficient to meet Form 1041 filing requirements, the election form must still be filed by the time when Form 1041 would have been due, including extensions.<sup>16</sup>

The election by the trustee of the trust is not dependent on the calendar tax year of the trust, but on the tax year of the estate, which might not be a calendar year. The election must be filed on or before the due date, including extensions, of the estate's Form 1041 (income tax return of estates and trusts). Even if there isn't enough income to require an income tax return to be filed, the election is due then, together with Form 1041.<sup>17</sup>

### Example.

A decedent dies on November 1, 2003. The estate of the decedent may elect to end the first tax year at the end of any calendar month through October 31, 2004. Assuming that the first income tax return of the estate covers the period beginning on November 1, 2003, and ending on October 31, 2004, the election may be made by February 15, 2005, the due date of the return, or, if an extension to file for an additional six months has been granted, the election may be made by August 15, 2005.

According to instructions accompanying Form 1041 for tax years beginning in 2002, the election is always made by attaching the election to Form 1041. The instructions also provide that if the return was filed on time, an election may be made on an amended return filed no later than six months after the due date of the return, including extensions. At the top of the amended return, the taxpayer is required to write "Filed pursuant to section 301.9100-2." The instructions say the amended return should be sent to the same address used for the original return.

As noted earlier, if there is no estate, the election must be made by the due date of the trust's income tax return, plus extensions, taking into account the election. "Taking into account the election" should mean a trust has as long as an estate would have, given the estate's ability to elect a year-end other than a calendar year.

However, it appears that a trust could get caught out in the cold, because the filing date extensions granted to the trust itself will control. Thus, if the QRT files for extensions based on the calendar year, the election must be made before those extensions lapse, even though the trust doesn't effectively choose its tax year until it files its first return. This problem might be especially troublesome if there are multiple trusts. This is when relief under reg. section 301.9100-2, discussed above, might be especially helpful.

The best practice may be to decide about both the election and the fiscal year well before April 15 of the year following the decedent's death. In that case, all trustees of all electing trusts can act according to the same plan.

If there was no executor at the time of the election, but one is appointed later, a revised election form must be filed with the IRS that includes the executor's consent to the election. The requirement to file a new election form is not in the part of the regulations dealing with how to make an election. Instead, it is in the part of the regulation that sets forth conditions that those joining in the original election agree to. In yet another part of the regulation, we learn that there is a 90-day time limit on making the revised election bearing the consent.<sup>18</sup> Usually the 90-day time limit will cause the revised election to be filed without its being attached to a Form 1041. It would seem advisable to attach a copy of this election to the next Form 1041 filed, to explain why the election is being revised and to indicate the date of appointment as well as the date when the new election was filed. The regulation says the IRS may provide other guidance about how to notify the IRS that the executor has consented to the election. The regulation further requires that that guidance, if issued, be followed.

Reg. section 1.645-1(g) explicitly provides that the election terminates if an after-appointed executor fails, within 90 days of appointment, to agree to the election.

## ***Form of the election***

Beginning with elections filed after December 24, 2002, the regulation specifies use of an IRS form, if available, signed under penalties of perjury by the trustee and the executor, if there is one.<sup>19</sup>

The preamble to the final regulations states that the election will be made on Form 8855, which the IRS will make available within six months after publication of the final regulations. The regulations were issued on December 24, 2002. The author was unable to locate this form as of this writing.

Alternatively, the final regulation requires that taxpayers follow published guidance for making the election. The most recently published guidance before issuance of the final regulations was Notice 2001-26, 2001-13 IRB 942 (see Doc 2001-5821 (3 original pages) [PDF] or 2001 TNT 40-7 ), permitting taxpayers to use reporting procedures under either the proposed regs or under Rev. Proc. 98-13; however, this was permitted only until the effective date of the final regulations, which was December 24, 2002.

To summarize, the final regulation requires that IRS forms be used or IRS guidance be followed, both of which have yet to arrive. The guidance in effect before December 24, 2002, has expired. We find ourselves in a guidance gap.

Those needing to make an election will have to analyze the conditions to making the election required under the final regulation, discussed next, in addition to setting forth necessary information similar to that called for in prop. reg. section 1.645- 1(c).

It would help if the IRS would provide a means of confirming that elections are effective in this period of no guidance, and of curing or perfecting elections that may have fallen short.

## ***Conditions imposed on election participants***

The regulation imposes conditions that must be agreed to by those joining in the election. What the conditions are and how they apply depend on whether an executor exists. Reg. section 1.645- 1(c)(1)(ii) sets forth the conditions when there is an executor, while reg. section 1.645-1(c)(2)(ii) sets forth the conditions when there is no executor. The discussion below attempts to combine both cases, while still highlighting differences.

Each taxpayer joining in the election (for purposes of this article, "election participant") agrees to the election. The regulation explicitly lists this as a condition, even though it seems obviously implicit in making the election, since each taxpayer signs the election form.

One election participant must be selected to file the return on behalf of all election participants. That election participant agrees to file a "complete, accurate and timely Form 1041." The executor, if there is one, automatically assumes that role. Otherwise, when more than one QRT elects into section 645, one trustee must be appointed to file on behalf of all electing QRTs, and that trustee must also accept the appointment. There is no procedure for running this election, and so far no procedure for reporting the selection, other than simply assuming the "office" of filing trustee and filing the return. For our purposes, the taxpayer selected to file on behalf of the group will be called the filer.

The filer accepts substantial administrative burdens relating to the filing and administration of tax returns. The issue will undoubtedly arise as to who should pay the costs of assembling information, preparing workpapers, preparing returns, accepting funds for payment of taxes, paying taxes, responding to concerns of election participants, responding to IRS inquiries or examinations, and keeping election participants informed about tax matters. The filer will also have to be sensitive to how tax-related decisions will be made that could affect election participants other than the filer. How costs will be shared could be the subject of a negotiated agreement, preferably reduced to writing.

All election participants agree to timely furnish to the filer all information necessary to file a "complete, accurate and timely Form 1041" for the group.

All election participants agree to allocate the annual tax burden of the combined tax return among the participants "in a manner that reasonably reflects the tax obligations of each" election participant. This can become a complex and contentious issue. Entering into a tax-sharing agreement could smooth the way. Some of the issues that could arise might include, without limitation, effect of losses realized by one entity but currently deductible because the group has offsetting income or gains; how alternative minimum taxes might have applied or not applied but for the election; the effect of failure by an election participant to reimburse another; how the presence of exempt income affects deduction of trustee's fees; how expenses subject to reduction of miscellaneous itemized deductions by 2 percent of adjusted gross income is affected for each election participant versus the combined return; the effect of state, and perhaps multistate, taxes; what constitutes timely reimbursement of taxes paid by one member of the group but allocated to another; and what consequences might attach to untimely reimbursement.<sup>20</sup> One place to look for ideas about how to identify and address tax allocation issues might be the consolidated return rules that apply to corporations. Applying tax allocations methods similar to the consolidated return rules might satisfy the standard of reasonableness.<sup>21</sup>

Each election participant other than the filer is responsible for ensuring timely payment of the tax attributable to each participant. The filer agrees to ensure timely payment of only the filer's tax obligation. The filer does not assume the obligation to ensure timely tax payment of any other election participant. The preamble to the regulation points out that an election under section 645 does not treat the election participants as a unity under subtitle F, which relates to procedure and administration and governs the question of who is liable for the tax.

If there was no executor when the election was made, but one is appointed later, and if the executor agrees to the election, the trustees agree, as a condition of their original election, that a new election form will be filed with the executor. The new election must be filed within 90 days of the appointment of the executor.<sup>22</sup> Failure to timely file a new election terminates the election that had been made as of the day before the appointment of the executor.

There is no guidance about what to do if the filer and newly appointed executor don't find out about each other until it is too late to file the new election. Does every QRT under a section 645 election have an obligation to detect the appointment of an executor? Does every executor have an obligation to find out if there is one or more trusts under a section 645 election? Often this will not be a problem because it will be the trustee of a QRT who

will initiate the action to open the probate estate. At a minimum, it is advisable to include on a periodic checklist a reminder question designed to discover whether a new election needs to be filed.

Note that the 90-day deadline is a regulatory deadline. The IRS is authorized to extend regulatory deadlines under reg. sections 301.9100-1 and following, provided the conditions of those regulations are met and a request for a private letter ruling is submitted.

There is no guidance in the regulation as to whether the tax year adopted before the executor joined the election is binding on the executor and the entire group of election participants after the new election form is filed. Because the electing QRTs were treated as the estate for all income tax purposes under the original election, it would seem reasonable that the executor, by agreeing to the new election, will assume the tax year adopted under the original election.

### ***Form 1041 before the election is made***

Only one election participant will become the filer, as discussed earlier. Other election participants, or potential election participants, will always be trusts that are QRTs. If there is no executor, the filer will be a QRT.

If the filer is a QRT, that trust will file under its taxpayer identification number, but the trust will file as an estate.<sup>23</sup> On the first page of Form 1041, there is a series of boxes indicating the type of entity filing. Obviously, we are being told to check the box indicating that the entity filing is an estate. Less obvious is what taxpayer name to use at the top of the form. Should the entry be in the form of "Estate of Ichabod Crane"? Or should it be in the form of "The Ichabod Crane Family Trust"? The former fails to identify who is actually filing. The latter could confuse the IRS because of the obvious inconsistency between the name of the entity and the type of entity indicated by checking the box. If the latter is the correct name form, should a notation be added that the trust is filing as an estate pursuant to an election under section 645? A hint in the Form 1041 instructions would be welcome.

In the absence of an effective election, a QRT is required to file on the calendar-year basis. If a tax year other than a calendar year is anticipated under the election, the trustee of a QRT must decide whether it is necessary to file a short period income tax return. The short period begins on the date of the decedent's death and ends on the next occurring December 31.

The regulation provides that there is no need to file a short period return for a QRT if a section 645 election will be made.<sup>24</sup> The election relates back to the date of death. However, this approach bears risk. The regulation points out that if for any reason it turns out that the election was not made or was not an effective election, interest and late filing penalties will apply to the QRT for the short period. The rule depends on what the trustee of the QRT expects. Not filing a short period return is an option. On the other hand, a short period return may be filed, even though not required.

If the trustee is uncertain whether a section 645 election will be made or knows the election will not be made, a short period return is required.<sup>25</sup>

If a short return is filed for a QRT as a trust and an election is later made, the short period return of the QRT must be amended.<sup>26</sup> If there is an executor, or if the trust is not the filer, all items of income, deduction, and credit reported on the short period return of the QRT revert to zero and are reported instead on the income tax return filed on behalf of the related estate. Presumably, this will give rise to a claim for refund by the QRT filing the amended short period return. Attachment to the amended return of a copy of the election is required under the Form 1041 instructions (2002).

If there is no executor, and the QRT that filed a short period return makes or joins in a section 645 election and becomes the filer, the amended return must be filed by the due date of the QRT, taking into account the trustee's section 645 election.<sup>27</sup> The tax year under the election of the QRT could end using a month- end other than December, because estates may do so, as discussed earlier.<sup>28</sup> The amended return filed under the election must follow the rules applicable when the election is in effect. For example, the QRT assuming the role of filer must file the Form 1041 as an estate.

### ***Form 1041 while the election is in effect***

The election period begins with the date of the decedent's death.

The income test for whether a return must be filed is \$600 and applies to the combined income of the election participants.<sup>29</sup>

While the election is in effect, only one Form 1041 is filed each year for as many election participants as there may be for a single related estate. That return is filed under the tax identification number of the filer. As noted above, the estate becomes the filer if there is an executor; otherwise, a trust becomes the filer. Election participants that are trusts but that are not the filer are not required to file Form 1041 while the election is in effect, except when the final year of the trust occurs on or before when the election terminates, as discussed later.<sup>30</sup>

If there is more than one election participant, it will be helpful to prepare consolidation workpapers. Practitioners may wish to include tax accounting consolidation schedules as an attachment to Form 1041 detailing, by election participant and on a combined basis, income, deductions, gains, losses, alternative minimum taxable income, distributable net income, credits, distributions deductions, and allocation of tax liability to election participants. Note that there is no special requirement to eliminate income, gains, losses, or deductions that occur in transactions between election participants, other than rules that would apply in related-party transactions even if there were no election.

Apparently, if the estate is the filer, it will continue that role for the entire election period, even if the estate has no assets. Reg. section 1.641(b)-3 describes when termination of trusts and estates occurs for all purposes of the income taxation of trusts and estates. For an estate, T.D. 9032 added a sentence at the end of reg. section 1.641(b)-3(a) providing that an estate participating in a section 645 election does not terminate at any time before the section 645 election terminates. At a minimum, the executor is required to sign the return, which means the appointment as executor will have to last at least as long as the section 645 election. The executor should not allow his or her appointment to terminate before the section 645 elections terminate and the final return is filed. Otherwise, legal authority to file returns may be lacking.

## ***Form 1041 when executor appointed after election is made***

If an executor is appointed after the trustee of a QRT has made a valid election (for purposes of this article, "after-appointed executor"), and the executor consents to the trustee's election and the IRS is properly notified of the consent, the filer will have been the trustee of a QRT up to that point. Reg. section 1.645-1(g)(2)(i) requires amendment of past returns to disclose the executor and include all items of income, deduction, and credit of the estate in those past returns. The amended returns are filed under the trustee's tax identification number under which those past returns were filed. The amended return filed for the tax year before the appointment of the executor must indicate that it is a final return.

Now, a QRT has been filing as an estate up to the time when the executor has been appointed, under the tax identification number (TIN) of the QRT. After the executor has been appointed, the executor files on behalf of the estate (assume the executor agrees to the election), under the TIN of the executor. At first blush this holds potential for confusion at the IRS. But the regulation comes to the rescue. The amended returns of the QRT are required to disclose the name and TIN of the related estate.<sup>31</sup> Also, in spite of the indication that the last amended return is identified as a final return, the QRT that had been filing as the estate under the TIN of the QRT and the executor filing under the TIN of the estate will be considered one and the same taxpayer.<sup>32</sup>

Beginning with the tax year that includes the appointment of the executor, and for all future tax years during the election period, Form 1041 is filed by the executor under the TIN of the estate. Note that the appointment of the executor does not end the tax year of the QRT. The regulation merely requires that the change be made for the tax year that includes the appointment.

What if an after-appointed executor agrees to the election, but the statute of limitations has expired on one or more returns of electing QRTs? Then the executor must file returns that include items other than those included in returns filed for years that are closed for the QRT under the statute of limitations.<sup>33</sup> Further, the executor is prohibited from claiming any personal exemption in those years.

If an after-appointed executor does not agree to the election, the section 645 election terminates. The executor must file Form 1041 under the TIN of the estate for all taxable years ending after the decedent's date of death, for each year that the filing requirements are met.<sup>34</sup> Returns for past years that the estate must file might cover years when the QRT has already filed as an estate. For those years, returns of the estate would exclude income, gains, losses, deductions and credits that had been included in the returns of the electing QRT filing as an estate. Returns of the estate covering tax years when the QRT filed as an estate would exclude the QRT's income, gains, losses, deductions, and credits filed. The QRT, on the other hand, is not required to file any amended returns. Since the election of the QRT ends on the day before appointment of the executor, it would seem that the return ending the tax year on that date should be filed by the QRT and that it should report all items of income, gains, losses, deductions and credits up to that date, but excluding items of income, etc., of the estate, because that would be consistent with the continuation of the election to that point. However, the regulations do not explicitly state this to be the case. The QRT is required to obtain a new TIN.

Still more confusion may lie in wait. Assume that the after- appointed, nonconsenting executor has income sufficient to file Form 1041 in one or more of the years when the QRT filed as an estate. The executor will be filing Form 1041 for that same estate under a different TIN. Will the IRS be able to correctly receive these new returns without questioning the returns filed by the QRT?

The statute of limitations runs for any election participant according to the return filed for each tax year by the filer. Reg. section 1.645-1(e)(3)(ii) points out that the statute of limitations cannot apply to a related estate until it files a return. Thus, an estate that is opened or discovered after to the filing of a section 645 election cannot avail itself of the statute of limitations without actually filing a return. Further, the date when any amended returns are filed must be taken into account.

As noted above regarding the charitable deduction, reg. section 1.645-1(e)(2)(iv) applies the governing instrument requirement of section 642(c) separately to each election participant.

### ***How the separate share rules apply***

Reg. section 1.645-1(e)(2)(iii) applies the separate share rules of section 663(c) to election participants when there are multiple election participants. This means that electing QRTs and the related estate are each treated as separate shares. Also, any election participant might have its own separate shares, meaning the rules will first apply at the section 645 election level, to treat election participants as separate shares, and then, to the extent that an election participant has its own separate shares, at the entity level to each election participant.

In determining the distributions deduction under section 661 on Form 1041, the distributable net income (DNI) of each election participant making distributions must first be determined. The amount to be reported to, and included in the income tax return of, the distributee is determined under section 662 in the same manner.

Interentity transfers between election participants reduce the DNI of the transferor and increase the DNI of the transferee. The income tax character of the adjustment carries from the transferor to the transferee. Practitioners may wish to include a consolidating schedule reconciling DNI of each election participant to the Form 1041 as filed, as an attachment to Form 1041. Schedule K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.) isn't likely to accomplish the same thing, since there is but one Form 1041 filed on behalf of all election participants and no Schedule K-1 will be issued to any election participant.

The regulation presents an example in which a QRT and its related estate make a valid section 645 election. While the election is in effect, the estate, under the decedent's will, distributes all of its assets to the trust, after payment of debts, expenses, and taxes. The distribution from the estate to the trust carries all of the estate's DNI from the estate to the distributee-trust. Next the distributee-trust itself makes a distribution to its beneficiaries that carries out to the trust beneficiary the DNI that originated in the estate but was transferred to the trust, along with the trust's own DNI.

## ***And at Midnight, Carriages Turn Back Into Pumpkins***

The section 645 election terminates on the day when all election participants have distributed all assets or, if earlier, the day before the applicable date. Also, the election terminates if an executor is appointed after the trustee of a QRT has made a valid election, unless the executor agrees to the election made by the trustee of the QRT and the IRS is properly notified of the consent.<sup>35</sup> The election terminates as of the day before the date when the nonconsenting, after-appointed executor is appointed. The danger of the applicable date is that it must be closely monitored.

Example. Decedent dies on August 12, 2004, leaving an estate not required to file an estate tax return. The entire estate was held in a QRT, which elects to be treated as an estate under section 645 (there is no executor). The section 645 applicable date is August 12, 2006. Assume that the electing QRT still exists on the applicable date. The section 645 election terminates on August 11, 2006, one day before the applicable date.

Except when all election participants distribute all of their assets, there will always be at least six months' warning before the applicable date occurs (there is a two-year minimum duration whether or not an estate tax return must be filed). The challenge is to discover and recognize the event that triggers the applicable date, and then calendar the time for filing the return.

As discussed earlier, the estate will not terminate for income tax purposes under newly amended reg. section 1.641(b)-3(a) until the section 645 election terminates.

There is no provision requiring a QRT to continue its existence if all of its assets are distributed. Assume there is only one QRT and a related estate. Logically, it is possible for the estate to continue, but not a QRT. If the QRT terminates, so does the need for the election, because the election affects the entity classification of the QRT and not that of the estate. However, reg. section 1.645-1 does not spell this out.

Also, it is possible for one of several QRTs under an election to go out of existence. If that happens the election needs to continue for the benefit of the remaining QRTs, but it serves no purpose to continue to pretend that the QRT that has distributed all of its assets continues to exist. In that case it would seem logical to conclude that the election continues even though one QRT terminates. However, reg. section 1.645-1 does not spell this out either.

The applicable date is two years after the date of the decedent's death if no estate tax return is required to be filed. Whether an estate tax return is required will usually be a simple determination, but the importance of making a correct determination is amplified if a section 645 election has been made. What if an estate tax return was filed but was not required to be filed? Conversely, what if it is believed in error that no return was required? Either error could lead to an error in identifying the applicable date and incorrect income tax returns.

When an estate tax return must be filed, the applicable date occurs on the later of two dates.<sup>36</sup> The two dates are: (1) the second anniversary of the decedent's death, and (2) the six-month anniversary of the final determination of liability for estate tax. Presumably, the final determination of liability for estate tax means the federal estate tax and does not include state or local estate, death, or inheritance taxes. Apparently to peg the date as

early as possible to avoid undue delay in terminating the section 645 election, yet recognizing the difficulty of doing so, the regulation lists five events, the earliest occurrence among them tolling the applicable date. The events listed serve the sole purpose of fixing the applicable date. The listed events, the earliest occurrence of which fixes the applicable date six months later, are:

### ***Final determination by closing letter***

The final determination is deemed made six months after the date when the IRS issues a closing letter. Filing a claim for refund of estate taxes may create an exception to further extend this date. If a claim for refund is filed within 12 months of the IRS closing letter issuance date, the applicable date is held open and the rule regarding claim of refund discussed below applies instead. However, if a claim for refund is filed outside the 12-month period, the applicable date occurs without regard to the claim for refund, even though a claim for refund is outstanding.

Reminder. Add six months to arrive at the applicable date. Although the final determination is deemed made six months after the date when the closing letter is issued, the applicable date is another six months after that. So the applicable date is 12 months after the date of issuance of the closing letter.

### ***Final disposition of claim for refund of estate taxes***

This is the date when all items have been either allowed or disallowed by the IRS. However, the date is not fixed if a suit is instituted within six months after a final disposition of the claim. If a waiver of notification regarding disallowance is filed before the claim is disallowed, the date of the waiver is treated as the date of final disposition.

### ***Final disposition by settlement agreement***

If a dispute with the IRS is settled, the date when the settlement agreement is executed becomes the date of final disposition.

### ***Final disposition by adjudication***

When a court of competent jurisdiction resolves the liability for estate tax, the date of final disposition is the date of issuance of the pronouncement by the court (decision, decree, or other order). Final disposition does not occur, however, if an appeal is filed within 90 days.

### ***Expiration of the statute of limitations***

Final disposition occurs on the date when the statute of limitations provided under section 6501 expires.

Notice 2003-33

Notice 2003-33 was issued in response to requests by practitioners to rely on the definition of what constitutes a final determination of the liability for estate tax in the final regulation, discussed immediately above, for decedents dying before December 24, 2002 (the effective date of that definition under the final regulations). The notice permits

this, as long as a Form 1041 treating the section 645 election as terminated has not been filed.

### ***Deemed distribution on termination of the election***

On termination of the election, reg. section 1.645-1(h)(1) creates two fictions. The first is that a new trust is deemed to be formed. The second fiction is that all assets of all election participants that are trusts are deemed to be distributed to the new trust on the last day of the election period. Shares that may exist under section 663(c) separate share rules are given effect. All items of income, including net capital gains of each electing trust, are thus carried out of the final combined Form 1041 of the election participants and included in income of the new trust, using the mechanisms of distribution deductions and distributable net income under sections 661 and 662. Note that these fictions of reg. section 1.645-1(h)(1) do not apply to the estate.

The regulation does not say what happens next. There is no requirement to obtain a TIN for the fictitious trust or to file a return of any kind on its behalf, or to issue it a Schedule K-1 (Beneficiary's Share of Income, Deductions and Credits, etc.) of Form 1041. One is left to assume that the effect of the distribution is to remove the taxable income and capital gains of each electing trust from the "estate" tax return and carry those items to be taxed as trusts into the first trust tax year following the termination of the election.

This has two immediately obvious implications. The first is that the income in the last period of election will ultimately be taxed under the trust rules, not the estate rules, since the items of income are deducted from the final return filed under the section 645 election and transferred to the fictitious new trust. Second, the tax will be deferred on that income for up to 23 months. For example, assume that the tax year of an electing QRT and its estate ends on January 31 of each year and that the election terminates on January 25, 2003. Income attributed to the trust from February 1, 2002, through January 25, 2003, is taxed to the "new trust," which is required to adopt a calendar tax year. Income and capital gains realized by the trust from February 1, 2002, through January 25, 2003, will be reported on the final income tax return for the election period, but will be included in distributable net income and offset by a distributions deduction. The new trust will include the items of income in its taxable income for the short tax year beginning January 26, 2003, and ending December 31, 2003. The trust will be taxed as a trust and not as part of a related estate.

### ***Form 1041 after termination of the election***

If there is an executor and the related estate continues after termination of the election period, the estate goes on filing on the basis of whatever tax year-end was in use before the election terminated, using its TIN acquired after the decedent's death. No short year is created for the estate through the termination of the election. Thus, the items of income, deduction, and credit to include in the estate for the tax year of the estate that contains the election are the items of the estate for the entire tax year of the estate, and the items for all electing QRTs up to and including the day when the election terminates.

If there is an executor, a QRT that terminates concurrently with the end of the election period must file a final return following the termination of the election period. The tax year of the QRT ends when the election does. No items of income, deductions, and

credits are included in the final return. Instead, all items of income, deductions, and credits must be reported on the return filing as an estate, not the final return filed under the name and TIN of the trust. Remember to check the box indicating that the return is final. That filing will notify the IRS that the trust no longer exists.<sup>37</sup> We hope these null returns will not be rejected by IRS service centers receiving them.

Any QRT that terminates during the election period must file a final Form 1041 to notify the IRS that it has gone out of existence.<sup>38</sup>

A former electing QRT that is not the filer but continues its existence after the termination of the election period files on the calendar-year basis, as required by section 644. Postelection period returns filed by a former QRT should be filed under the name and TIN of the trust, indicating that the return is filed on behalf of a trust. Because the trust was treated as part of the taxable estate during the election period, the first return of the trust filed for the period beginning with the applicable date should logically be the first return of a new trust. There will be a short period return beginning on the applicable date and ending on the following December 31. One critical item to monitor is the need for the trust to pay estimated taxes. There is no explicit guidance about whether the prior-year tax exception to the penalty for failure to pay estimated taxes is available, or if so, how that would work, but there appears to be no logical way that an underpayment penalty exception could apply, since the existence of the trust has been ignored for all purposes of the income tax, up until the applicable date.

The possible closing of tax years upon termination of the election is dealt with in reg. section 1.645-1(h)(2).

### ***Tax Identification Number of Estate***

If there is an executor, a TIN must be obtained for the estate. It will be the TIN used for filing the Form 1041 on behalf of the combined group of election participants.

If an executor is appointed for a related estate after a section 645 election is made, the executor must obtain a TIN following the appointment. This will be so even if the executor consents to the section 645 election. As noted above, the TIN of the estate is used prospectively to file the Form 1041 of the estate and any electing QRTs.

### ***Tax Identification Number of QRT***

Following the death of the decedent, each QRT must obtain a TIN. That must be done regardless of whether the election is made.<sup>39</sup> The TIN is provided by the trustee to the payers of the QRT.<sup>40</sup> If the election is made and there is no executor, the trust uses this same TIN to file Form 1041 as an estate.<sup>41</sup>

Once the election terminates, a new TIN may be required even when there was no executor for a QRT that is filing as the estate - that is, the filer.<sup>42</sup> Further, a trust must obtain a new TIN when, at the time that the section 645 election was made, there was no executor, the trust became the filer of income tax returns as an estate, and sometime after the election was made, an executor was appointed. Trustees of trusts must further review the instructions to Form 1041 to determine if a new TIN is required for any other reason, according to reg. section 301.6901-1(a)(4)(i). Of course, once a new TIN is obtained, it must be supplied to payers of the trust.

All final TIN rules are effective for trusts of decedents dying on or after December 24, 2002.

## Conclusion

Section 645 offers an important opportunity to trusts and estates to treat trusts as part of a related estate for all purposes of the income tax. The election comes with complexity, and that always has the potential to increase compliance costs. The final regulations provide a well-drafted, detailed set of guidelines for those wishing to make this election. With vigilance as to due dates and mastery of the final regulations, practitioners can help clients successfully evaluate, plan for, and navigate this valuable option.

Not all implications of the election are immediately obvious. The need to plan for the administration of the election and related costs, and the allocation of taxes to taxpayers who join in the election, should be discussed and agreed to in advance.

And remember, the election is temporary.

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## FOOTNOTES

1 All references are to the Internal Revenue Code and related regulations.

2 Reg. section 1.645-1(e)(3)(i), applicable when there is no executor.

3 Reg. sections 1.645-1(e)(2)(i) (executor present) and 1.645-1(e)(3)(i) (no executor present).

4 Although the treatment for estates and qualified revocable trusts is the same, it is included here because of its relationship to section 645.

5 Note 3 *supra*.

6 *Id.*

7 Reg. sections 1.645(e)(2)(ii)(A) (executor present) and 1.645(e)(3)(ii) (no executor present).

8 Reg. section 1.645-1(e)(2)(ii) (executor present). There is no parallel provision in reg. section 1.645-1(e)(3) if there is no executor. However, because the filing entity is treated as an estate, the same \$600 exemption should apply.

9 *Id.*

10 Reg. section 1.645-1(b)(6).

11 Reg. section 1.645(b)(2).

12 Reg. section 1.645-1(b)(4).

13 Reg. sections 1.645-1(c)(1)(i) (executor present) and 1.645(c)(2)(i) (no executor present).

14 Section 645(c).

15 Reg. section 1.645(g).

16 Reg. sections 1.645-1(c)(1)(i) (executor present) and 1.645-1(c)(2)(i) (no executor present).

17 Reg. sections 1.645-1(c)(1)(i) (executor present) and 1.645-1(c)(2)(i) (no executor present).

18 Reg. section 1.645-1(g).

19 Note 16 supra.

20 Query whether section 7872 might apply to impute interest between election participants when reimbursement is untimely?

21 See section 1552(a) and related regulations; see also reg. section 1502-33(d). Query whether these agreements might become the subject of future private letter rulings?

22 Reg. section 1.645-1(g)(1).

23 Reg. section 1.645-1(e)(3)(ii).

24 Reg. section 1.645-1(d)(2)(i).

25 Reg. section 1.645-1(d)(2)(ii).

26 Reg. section 1.645-1(d)(2)(ii)(B)(1).

27 Reg. section 1.645-1(d)(2)(ii)(B)(2).

28 Of course, if the time for selecting a tax year other than a calendar year has passed because the due date including extensions for filing the first return for the desired tax year has passed, the tax return of the estate must be filed on the calendar- year basis.

29 Reg. section 6012-3(a)(1)(iv).

30 Reg. sections 1.645-1(e)(2)(ii) (executor present) and 1.645-1(e)(3)(ii) (no executor present).

31 Reg. section 1.645(g)(2)(i).

32 Reg. section 1.645(g)(2)(ii).

33 Id.

34 Reg. section 1.645(g)(2)(ii).

35 Reg. section 1.645-1(g)(1).

36 Reg. section 1.645-1(f)(2)(ii).

37 Reg. section 1.645(h)(2)(i)(B).

38 Reg. section 1.645-1(h)(2)(ii).

39 Reg. sections 1.645-1(d)(1) and 301.6109-1(a)(3).

40 Reg. section 301.6109-1(a)(3)(ii).

41 Reg. section 1.645-1(e)(3)(iii).

42 Reg. section 301.6109-1(a)(4)(i).

END OF FOOTNOTES

Comment on this story

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