

Trust & Estates

Taxes and Planning

TM Financial Services

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NY Estate Filing Requirements (2010) – 7/2/11 Technical Memo

Form 1041 Fundamentals

Although historically, the income tax returns of estates and trusts have been audited less frequently by the IRS than any other type of income tax return, their audit rates have soared over 40% in recent years. With less and less Form 706s to review it's a safe bet that the audit rate for 1041s will continue to rise. Here's a look at some of the basics of Form 1041.

When must a 1041 be filed

Estates –

- Gross Income is \$600 or greater
- There is a nonresident alien beneficiary

Trusts –

- Gross Income is \$600 or greater
- Any taxable income
- There is a nonresident alien beneficiary

Tax Rates

The tax rates for estates and trusts range from 15% to 35%. The tax brackets are far more compressed than the brackets for individuals, the result being that an entity reaches the top rate of 35% at taxable income of \$11,350.

A few months ago we discussed the state ramifications of making the federal election for modified carryover basis for 2010 estates. The issue was whether one would receive a step up in basis for state purposes when the federal carryover basis election was made as the state estate tax still has to be paid. As most states use federal cost basis for determining gain or loss on the sale of assets, it was feared that the worst of both worlds would result as far as state taxes go – payment of an estate tax and later a capital gains tax liability upon disposition of the asset because no step-up was received (above and beyond \$1,300,000).

While New Jersey and Connecticut have been silent in addressing the issue, New York released TSB-M-11(9)M on July 29, 2011. As expected New York chose to follow the scenario just described – “Under the federal 2010 Tax Relief Act, when the estate of an individual dying in 2010 elects not to file a federal estate tax return, the modified carryover basis rules under the federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) apply to the assets transferred to the beneficiaries of the estate property. Although the date of death value must be used for purposes of the New York State estate tax, the New York State personal income tax is based on the information reported on the federal

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Filing due dates

The due date for filing for trusts is April 15 and for estates the fifteenth day of the fourth month following the end of the fiscal year. Unlike a trust, an estate is permitted to select a fiscal year. The most common exception to this is a revocable trust with respect to which the trustee and the executor have filed a Form 8855, making a §645 election to merge the trust with the estate. There are number of advantages to this election:

- The trust can adopt a fiscal year as part of the estate.
- The active participation rule related to passive losses and the \$25,000 rental real estate allowance is waived.
- A savings on tax preparation fees.
- A deduction can be taken for funds set aside for a charity. Normally a trust can only deduct amounts actually paid out.
- The merged estate/trust is entitled to a \$600 personal exemption instead of either \$300 or \$100 for a trust depending upon whether all income is distributed.
- Unlike a trust, an estate need not make estimated taxes for two years following the decedent's death.

An automatic extension for 5 months can be obtained by the executor or grantor by filing Form 7004.

Unlike gift & estate returns, the IRS accepts e-filed estate or trust income tax returns.

Aggregation of trusts

If two or more irrevocable trusts have substantially the same grantor(s) and beneficiary(s) and the principal purpose for the use of two trusts is tax avoidance, the trusts must be aggregated and consolidated on one Form 1041.

Separate Shares

If a trust or estate's beneficiaries have substantially independent shares, the DNI allocable to each

beneficiary is calculated as if a separate trust or estate actually existed. By independent it is meant that the economic interest of one beneficiary does not affect and is not affected by the economic interest of another beneficiary. Separate shares is important in a situation where income is accumulated for one beneficiary but a distribution is made to another of both income and principal that is in excess of the income that would be allocated to him if there actually had been a separate trust or estate.

Estimated Tax payments

Trusts are required to make quarterly estimated payments similar to individuals. An estate is exempt from this requirement for two tax years after the death of the decedent. The trustee is permitted to elect to allocate estimated payments to beneficiaries in whole or partially.

Capital Gains

In general capital gains are taxed to the estate or trust rather than the beneficiaries unless :

- They are allowed by the governing document
- They are permitted by state law; or
- The capital gains are actually distributed

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NY Estate Filing (continued from page 1)

income tax return, including income and federal adjustments to income. As a result, when the assets transferred upon the individual's death are subsequently sold, the same modified carryover basis used to report any capital gain/loss for federal income tax purposes must be used for New York State personal income tax purposes".

This result highlights the need for careful planning as to the 2010 election. An estate over \$5,000,000 will not necessarily fair better under the modified carryover basis regime especially if the estate contains significant appreciated assets which will result in both estate taxes and capital gains at the state level.

Charitable Trusts

	Created	Deduction At Funding	1041 Inc. Tax Deduct. Annually	Taxation Of Income	In Grantor's Estate
Charitable Lead Trusts (CLT)					
<u>Qualifying Non-grantor</u>					
(Living Family Lead Trust) a)	Intervivos	Gift b)	Yes	Trust	
(Testamentary Lead Trust) a)	Testamentary	Estate c)	Yes	Trust	
<u>Non-Qualifying Non-grantor</u>					
(Charitable Income Trust)	Intervivos		Yes	Trust	
<u>Grantor</u>					
(Living Grantor Lead Trust) a)	Intervivos	Inc. Tax b)		Grantor	Yes d)
(Super Grantor Lead Trust) a)	Intervivos	Inc. Tax b)		Grantor	e)
Charitable Remainder Trusts (CRT)					
Intervivos g)	Intervivos	Gift & Inc. f)		Beneficiaries	
Testamentary g)	Testamentary	Estate		Beneficiaries	

- | | |
|---|--|
| <p>a) Structured as either Annuity Trust (CLAT) or Unitrust (CLUT)</p> <p>b) Deduction for NPV of lead interest</p> <p>c) Deduction for NPV of income stream</p> <p>d) Includable because of retention of reversionary interest in corpus in excess of 5% (§2036)</p> | <p>e) §675 power for grantor status but no reversionary interest</p> <p>f) Deduction for actuarial value of remainder</p> <p>g) Either Annuity Trust (CRAT) or Unitrust (CRUT)</p> |
|---|--|

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The **sale of a decedent's personal residence** by the estate will not qualify for the \$250,000 annual exclusion. The step up in basis though, generally serves to minimize any gain. In fact, after selling costs are taken into account, a loss on the sale is not uncommon. The property is not a personal residence in the hands of the estate and as such recognition of a capital loss is permitted. The loss can be carried forward and in the year of termination of the trust or estate, distributed to the beneficiaries.

Income in respect of a decedent

When an estate receives payment on assets included on the decedent's Form 706, it is allowed an income tax deduction for the amount of the federal estate taxes paid on the item. A common example is a distribution from an IRA. The distribution is taxable income to the estate in the year received but it receives a deduction as the full date of death value was included on the estate return.

DNI and the Income Distribution Deduction

The purpose of Distributable Net Income (DNI) is to ensure that the taxable income of the estate is taxed only once, either at the entity level or to the beneficiaries. Generally beneficiaries must report income distributed to

them or required to be distributed. The total income reported by the beneficiaries as reflected on their schedule K-1s is equal to the trust or estate's income distribution deduction.

The income distribution deduction is computed on schedule B and is the lesser of:

- DNI less net tax-exempt income; or
- The amounts actually distributed or required to be distributed (only applies to simple trusts or estate & complex trusts that are required to distribute a portion of their income) less net tax-exempt income.

The first of the above is calculated using income tax rules while the second is computed using principles of fiduciary accounting, i.e. the Uniform Principal & Income Act. As such, DNI includes capital gains & losses and deductible expenses must be reduced for amounts allocated to tax-exempt income. Fiduciary accounting income excludes capital gains as well as expenses allocated to principal under either the terms of the governing document or local law.

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Trusts & Estates Taxes and Planning

IRS	General Information	800-829-1040
	EINs	800-829-4933
	Form 706 & 709	866-699-4083
NJ	General Information	609-826-4400
	Estate & Inheritance	609-292-5033
NY	General Information	518-457-5181
	Estate Tax	518-457-5387
CT	General Information	860-297-5962
PA	General Information	717-787-8201

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For a simple trust, a distribution of the trust's income is considered to have been made, regardless of whether one was actually paid and therefore beneficiaries may have to report income that hasn't been received.

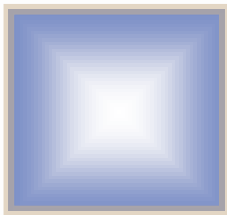
Where to deduct common estate/trust expenses:

Administrative	706 or 1041 (or split)	Funeral	706
Medical	706 or 1040 (decedent's final)	Interest & Taxes	706 and 1041

In the year of termination of the estate or trust, no tax return is filed. All items of income & expense will pass through to the beneficiaries including any unused tax carryovers, e.g. NOL carryovers, Capital loss carryovers and excess deductions on termination (administrative expenses in excess of income). Suspended passive activity losses are not passed on to the beneficiaries but increase the basis of the related assets.

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