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A PRACTICAL GUIDE TO THE 645 ELECTION

By James P. Lamping, Esq. and Cleet E. Snyder, CPA***

I. INTRODUCTION

Internal Revenue Code section 645[1] provides for an election to treat a revocable trust as part of a decedent's probate estate for income tax purposes.[2] This procedures sounds uncomplicated; however, the fact that this election (the "645 election") results in the application of a different set of income tax rules to a revocable trust can have a significant impact upon income tax liabilities generated during the trust administration. This article will discuss the implications of making the 645 election, as well as related procedural considerations.

As discussed in detail below, there are a number of distinctions between the income tax treatment of probate estates and trusts. A full analysis of every distinction between the income taxation of probate estates and trusts is beyond the scope of this article. Instead, this discussion is designed to highlight some of the most important implications of causing a trust to be subject to the income tax rules applicable to probate estates by virtue of the 645 election.[3]

II. HISTORY AND OVERVIEW

A. The History of Section 645

Historically, trusts were sometimes used as income tax avoidance devices.[4] Congress reacted by enacting legislation designed to minimize the income tax advantage to be gained by creating trusts.[5] However, probate estates remained subject to somewhat less stringent rules.[6] The rationale for this distinction was likely twofold. First, a probate estate comes into existence due to a person's death, rather than the discretionary creation of a trust. Consequently, the creation of the taxpaying entity is not motivated by tax avoidance purposes. Second, a probate estate is a transitory entity that is ultimately designed to pass assets to beneficiaries, rather than to retain assets on an ongoing basis as a trust might be used. This is confirmed by the fact that a probate estate that remains open longer than the time necessary to transfer assets to beneficiaries is disregarded for income tax purposes.[7]

The increasing popularity of revocable trusts as probate avoidance devices created a disconnect between the income taxation of trusts and probate estates. Much like a probate estate, a revocable trust may serve as a transitory entity that after the settlor's death exists for the purpose of transferring assets to another person or trust, rather than retaining assets for a prolonged period of time.[8] However, even though a post-death trust administration and a probate administration serve essentially the same purposes, they are often subject to different income tax rules.

This disparity between the taxation of probate estates and revocable trusts did not further the tax policy of curbing the use of trusts as income tax avoidance devices, and often led to inequitable results.[9] In recognition of this fact, Congress enacted Internal Revenue Code section 646 in 1997,[10] and the IRS issued guidance regarding its operation in 1998.[11] This statute was recodified as Internal Revenue Code section 645 in 1998,[12] and final regulations were issued in 2002.[13]

The substance of section 645 is that the trustee of a trust that was revocable by the decedent on the date of his or her death may elect to treat the trust as part of the decedent's probate estate for income tax purposes, provided that certain conditions are met. In order to limit the use of the 645 election to trusts that serve as alternatives to probate, the duration of the election is generally limited to two years from the date of death, with an exception for trusts with unresolved estate tax liabilities.[14] By contrast, the duration of a probate estate for income tax purposes is limited to a reasonable period under the facts and circumstances of the particular case.[15] Despite this limitation, the 645 election is often a useful tool for trusts.

B. Overview of Section 645

Section 645 provides for an election to treat a trust as part of the decedent's probate estate for income tax purposes, if certain conditions are satisfied. If those requirements are met, the trust:

> shall be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable date. [16]

1. Qualified Revocable Trust

First, the trust must be a "qualified revocable trust" (QRT), which requires that the trust have been revocable by the decedent on the date of his or her death.

> The term "qualified revocable trust" means any trust (or portion thereof) which was treated under section 676 as owned by the decedent . . . by reason of a power in the grantor (determined without regard to section 672(e)).[17]

Not every revocable trust under section 676 is a QRT; the power of revocation must be held by the *decedent*. Treasury Regulation section 1.645-1(b)(1) provides:

> . . . A trust that was treated as owned by the decedent under section 676 by reason of a power that was exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent's spouse is a QRT. A trust that was treated as owned by the decedent under section 676 solely by reason of a power held by a nonadverse party or by reason of a power held by the decedent's spouse is not a QRT.

However, a garden variety revocable trust will qualify for the 645 election following the settlor's death.[18]

2. Election

Second, both the executor of the decedent's probate estate (if there is a probate estate) and the trustee of the QRT must make the 645 election.[19] The election must be made by the due date (including extensions) for filing the income tax return for the first taxable year of the decedent's probate estate.[20] Once it is made, the 645 election is irrevocable.[21]

3. Applicable Date

The revocable trust will only be taxed as part of the probate estate for a limited time – until the "applicable date."[22] The applicable date is two years after the date of the decedent's death, if no estate tax return is required to be filed, or six months after final determination of the decedent's estate tax liability.[23]

This time limitation appears to address the concern that a trust should only be eligible to take advantage of the 645 election during the period that would be necessary to complete a post-mortem probate administration. "Section 645 (enacted by P.L. 105-34, [section] 1305(a) and originally designated as [section] 646), which allows an executor of the estate of a decedent dying after August 5, 1997 to elect to treat the decedent's revocable trust as part of the estate for federal income tax purposes, may give an indication of the time Congress considers reasonable to complete the administration of an estate."[24]

The mechanics and duration of the 645 election are discussed in more detail in Section V. below.

III. IMPLICATIONS OF THE 645 ELECTION

Making the 645 election causes the trust to be taxed as a probate estate rather than a trust during the period of the election. This has a number of effects, some or all of which may be relevant is a particular case.

A. Election to Use Fiscal Year End

Trusts generally are required to use a calendar year for income tax purposes.[25] However, an estate is not subject to this limitation, and the personal representative of a probate estate may choose a fiscal year, rather than a calendar year, for income tax purposes.[26] This means that the trustee of a trust making a 645 election also may select a fiscal year for income tax purposes. When an executor has been appointed, a single tax return will be filed by the executor using the probate estate's taxable year, which may be a fiscal year.[27] When no executor has been appointed, "[t]he trustee may also adopt a taxable year other than a calendar year."[28]

The end of the fiscal year must be the last day of a month that is not more than twelve months after the date of death.[29] For example, if a decedent died on October 15, 2010, the latest possible fiscal year end would be September 30, 2011.[30] However, it is possible to elect a fiscal year end that is the last day of any earlier month. For example, the estate of a decedent dying on October 15, 2010 could select a fiscal year end that is as early as October 31, 2010, resulting in a first fiscal year that is just over two weeks in duration. As a practical matter, the fiscal year end is usually sometime between the earliest and latest possible dates. A number of factors should be considered in selecting the date of a fiscal year end.

The anticipated timing of income and deductions may militate in favor of selecting a fiscal year end. More specifically, the selection of a fiscal year end may permit the matching of income and deductions during a single tax year. For example, suppose that a trust has a $10,000 deduction generated in December 2010 and $10,000 of income produced in January 2011. A calendar year end would mean that the deduction and the income occurred in separate tax years, which may mean that the deduction would go unused. By contrast, a fiscal year that includes both December 2010 and January 2011 would mean that both the deduction and the income would be included in a single tax year.

The personal representative is not required to select a fiscal year end in advance, but rather may wait until after the end of the desired fiscal year to make the decision. The details are discussed in Section V.A. below. This flexibility may permit the use of hindsight to select a fiscal year end that results in the best matching of income and deductions. In addition, this means that a fiscal year may be used to avoid the imposition of penalties and interest when the deadline for filing the first tax return on a calendar year basis has already passed.[31]

A fiscal year also may be useful to defer the payment of income taxes. For example, suppose that a trust receives income after the settlor dies on July 15, 2010. If the trust uses a calendar year end, a distribution carrying out distributable net income during 2010 will be reported on the beneficiary's 2010 income tax return.[32] The beneficiary must pay any income tax on the distribution when his or her return is filed on April 15, 2011. By contrast, if a trust using a fiscal year end distributes income during a fiscal year ending in 2011, the beneficiary would report that distribution on his or her 2011 income tax return, and any resulting income tax liability would be due on April 15, 2012.[33] This would be true *even if* the actual distribution occurred during the 2010 calendar year. However, a taxpayer required to make estimated tax payments under IRC section 6654(d) may not achieve as much of a deferral.

Apart from the potential deferral of income taxes, the use of a fiscal year to shift income into a beneficiary's later tax year may also offer the opportunity for the beneficiary to receive income during a year in which he or she is in a lower income tax bracket.

Even when these concerns are not present, a fiscal year may make sense. If an administration is expected to be completed within one year of the date of death, a fiscal year may be used to reduce the number of income tax returns that must be filed. For example, suppose that a decedent died on July 1, 2010, and it is anticipated

that the administration will be completed by June 30, 2011. The use of a calendar income tax year would require two income tax returns to be filed for the trust. One trust tax return would be filed for the period from July 1, 2010 to December 31, 2010, and a second return would be filed for the period from January 1, 2011 to June 30, 2011.[34] By contrast, a fiscal year ending on June 30, 2011 would only require that a single income tax return be filed, for the period from July 1, 2010 to June 30, 2011.

That is not to say that a fiscal year will always be helpful. When an administration is expected to last beyond the 645 election period, the 645 election may be disadvantageous because a partial year return may be required for the period following its termination, as discussed in Section V.C. below. Moreover, if the probate estate and the trust generate income in different calendar years, it is possible that reporting all income on a single return would result in a slightly higher income tax liability.[35] Any economy to be gained by filing a single return may therefore be lost.

B. Complex Trust Treatment

A probate estate is subject to the same rules as a complex trust for purposes of determining distributable net income.[36] As a result, a trust coming under the income tax rules applicable to probate estates also will be considered a complex trust. This may be of no consequence because most administrative trusts would be considered complex trusts in the absence of a trust provision providing otherwise. However, even when the trust instrument provides that the administrative trust will be a simple trust, the 645 election will cause it to be treated as a complex trust because it will be combined with the probate estate for income tax purposes.[37] This means that the personal representative must be mindful of the rules relating to complex trusts following the 645 election.

Those rules include the tier rules for allocating income among beneficiaries[38] and the election to have income distributed within sixty-five days of the end of the year treated as having been distributed during the tax year.[39] Attention also should be paid to the separate share rules discussed in Section III.F. below.

C. Real Estate Passive Activity Rules

The 645 election may offer an advantage when a trust holds real estate that is subject to the passive activity rules, as probate estates receive more favorable treatment in this context.[40] Losses from passive activities generally cannot be used to offset income from non-passive sources such as interest, dividends and wages.[41] However, a limited exception exists for estates with losses arising from real estate rental activities when the decedent actively participated in the activity prior to death.[42] For purposes of this exception, active participation is defined as making management decisions, such as approving new tenants, deciding on rental terms or approving expenditures.[43] If the exception applies, the estate may recognize up to $25,000 of the losses, and the deduction equivalent of tax credits that are attributable to rental real estate, against income from non-passive sources during the tax years ending less than two years after the taxpayer's death.[44]

By making the 645 election, a qualified revocable trust would be eligible for this probate exception to the passive activity rules.

D. Extending Period Trust is Allowed to Hold S Corporation Stock

A qualifying revocable trust may hold S corporation stock for two years after the date of the settlor's death without terminating the S election.[45] After the initial two year period, the S corporation stock must be transferred to a qualified subchapter S trust, an electing small business trust or another qualified shareholder in order to maintain the S election. Estates are not subject to this two year limitation.[46] The 645 election may extend the period that a trust may hold S corporation stock.

However this benefit is only available if the decedent's estate is required to file an estate tax return. If a trust is part of a taxable estate that is not required to file an estate tax return, the 645 election is only effective for two years from the date of death.[47] In other words, the 645 election would terminate at the same time the two year period for a trust to hold S corporation stock would have expired in any event, and no advantage has been gained. By contrast, when a trust is part of a taxable estate that is required to file an estate tax return, the 645 election remains effective until the later of two years after the date of death or six months after the final determination of estate tax liability.[48] For example, if the IRS does not issue a closing letter until two years after the date of death, the 645 election would remain active until two years and six months after the date of death.[49] As a result, the trust could continue to hold the S corporation stock until that time without terminating the S election.

E. Related Party Rules and Satisfaction of Pecuniary Amounts in Kind

The 645 election also may offer advantages when assets that have changed in value are used to satisfy a pecuniary bequest in kind. In order to explain the issue, some background is necessary. The distribution of appreciated assets in kind to satisfy a pecuniary bequest will trigger a taxable gain, referred to as "Kenan gain" because of the case that established this doctrine.[50] In other words, the transaction will essentially be treated as though the personal representative had sold the appreciated asset, recognized gain on the sale, and then distributed the proceeds to the beneficiary.[51] For example, suppose that a beneficiary is entitled to a $100,000 pecuniary bequest in a testamentary instrument. The personal representative distributes stock with a basis of $80,000 and fair market value of $100,000 to the beneficiary. This transaction will result in the trust having a taxable gain of $20,000, i.e. $100,000 minus $80,000. This concept also applies when appreciated assets are used to fund subtrusts under a pecuniary marital deduction formula with date of distribution funding.[52]

The in kind distribution of assets that have depreciated in value to satisfy a pecuniary bequest presents a more difficult issue. Strictly speaking, the term "Kenan loss" is not accurate because the Kenan case did not address the issue of losses; however, the concept is the inverse of the Kenan case.[53] For example, suppose that a trustee distributes assets with a basis of $120,000 and a fair market value of $100,000 to satisfy a $100,000 pecuniary bequest under a marital deduction formula. The issue is whether the trustee will be treated as though he or she sold the assets and distributed the proceeds to satisfy the pecuniary bequest, recognizing a loss as a result. While it is clear that a gain will be recognized if appreciated assets are used to satisfy the pecuniary bequest, the treatment of losses is not as straightforward.

In order to prevent related parties from colluding to create losses, federal tax law includes loss recognition rules for transactions between certain related parties. In particular, Internal Revenue Code section 267(a)(1) provides, in relevant part, that "[n]o deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b)." Subsection (b) of this statute goes on to provide a list of related parties coming under the aegis of this prohibition. As relevant in this context, subsection (b)(6) precludes recognition of losses in transactions between "[a] fiduciary of a trust and a beneficiary of such trust." In other words, while Kenan gain may be recognized when a trustee of a trust uses appreciated property to satisfy a pecuniary bequest, the general rule is that the trustee may not recognize losses when depreciated property is used for that purpose.[54] This means that losses may not be used to offset gains if a combination of appreciated and depreciated assets are used by a trustee to satisfy a pecuniary bequest.

However, there is a specific exception permitting the recognition of losses by probate estates, but not trusts, in this context. An executor of an estate and a beneficiary of that estate are related parties prohibited from recognizing losses, "[e]xcept in the case of a sale or exchange in satisfaction of a pecuniary bequest . . . ."[55] The 645 election causes the trust to be subject to the income tax rules applicable to probate estates during the effective period of the election. As a result, the trustee of a QRT also may recognize losses, as well as gains, when making in kind distributions of assets to satisfy pecuniary bequests during the 645 election period. The use of the 645 election to bring the trust under the income tax provisions applicable to probate estates therefore offers a distinct advantage in this context.

F. Separate Share Rule

The 645 election results in a particular application of the separate share rule when the trust and probate estate both generate income. As background, the separate share rule provides that distributable net income is only carried out to a beneficiary to the extent attributable to his or her separate share in a trust or probate estate.[56] For example, suppose that a trust with two equal residuary beneficiaries has $10,000 of distributable net income. The separate share rule means that one half of the distributable net income, or $5,000, is attributable to the share of each of the two beneficiaries. If $10,000 is distributed to one beneficiary and nothing is distributed to the other, only $5,000 of distributable net income (the amount attributable to the share of that beneficiary) will be carried out and taxed at the beneficiary level. The remaining $5,000 attributable to the share of the other beneficiary which was not distributed will be taxed at the trust level.[57]

Even after a 645 election, the trust and the probate estate are generally viewed in isolation for purposes of determining distributable net income under the separate share rule. Treasury Regulation section 1.663(c)-4(a) provides that " . . . a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares." In other words, the separate share of each beneficiary in the probate estate is viewed separately from the share of each beneficiary under the trust.[58] That is true even though the income generated by the probate estate and the trust are both being reported on a single income tax return following the 645 election.[59] Moreover, that is the case even when the entire probate estate will ultimately pass to the trust.

If there is a pour over will, the beneficiary of the separate share from the probate estate will be the trust, but these shares are not combined for purposes of determining distributable net income. Instead, income from the probate estate must be *actually distributed* to the trust in order to carry out distributable net income from the separate share of the probate estate.[60] For example, if the probate estate has $10,000 of distributable net income during the tax year, it must actually make a distribution of $10,000 to the trust in order to prevent the income from being taxed at the probate estate level. This will have the effect of producing a deduction of $10,000 for the probate estate and adding $10,000 to the distributable net income of the trust. The trust will then need to make a distribution of this $10,000, in addition to the distributable net income generated by the trust itself, in order to prevent the taxation of the income at the trust level. The distributable net income of the probate estate will not be taxed to the beneficiaries of the trust if the estate fails to make any distribution to the trust, even if the trust distributes an amount equal to the combined income reported on the income tax return.[61] Again, the separate shares of the probate estate and trust are viewed in isolation for purposes of determining distributions of distributable net income.

IV. CONSIDERATIONS WHEN A CALIFORNIA RESIDENT HAD A NON-CALIFORNIA TRUST

California law requires that the 645 election be applied for California state income tax purposes once it has been made for federal income tax purposes.[62] The decision to make the 645 election therefore requires careful attention when the decedent was a California resident, but had a revocable trust outside of California.

For example, suppose that a decedent who was a resident of California at the time of his or her death was the settlor of a South Dakota revocable trust with a corporate fiduciary in that state acting

as trustee, and the beneficiaries are not California residents.[63] A trust will only be subject to income taxes in California to the extent that the trustee or a beneficiary is a California resident, or if the income was produced in California.[64] In other words, all of the non-California situs income produced by the South Dakota trust in this example would escape California income taxes. Indeed, that trust income may not be subject to any state income tax because South Dakota does not have a state income tax.

By contrast, all income generated in a probate estate with a decedent who was a resident of California will be subject to California income taxes, regardless of the residence of the personal representative or the beneficiaries.[65] This means that when income generated by a non-California trust is taxed as part of the California probate estate for income tax purposes, it will be subject to California income tax, whereas it would have escaped California income taxes completely (assuming the income was not otherwise derived from California sources), and may have escaped state income taxes entirely if the trust had a situs in a state with no state income taxes, had the 645 election not been made.

While this is a fairly narrow set of circumstances, it may have a significant impact on the income tax liability of a trust when it does apply. Depending upon other factors, it may still make sense to consider making the 645 election; however, the impact of state income taxes should not be overlooked.

V. THE MECHANICS AND DURATION OF THE 645 ELECTION

A. How to Make the Election

1. If an Executor Has Been Appointed

When an executor has been appointed, the 645 election must be made by the executor and the trustee of each trust subject to the election on Form 8855 no later than the due date of the first income tax return for the probate estate.[66] Once made, the 645 election is irrevocable.[67]

The division of responsibilities between the executor and the trustee following the 645 election is established by regulation.[68] As a practical matter, the executor and the trustee will often be the same person; however, it is necessary to be cognizant of these rules when that is not the case.

With the exception of actually filing the income tax return, the trustee and executor retain many of the responsibilities they would have had in the absence of the 645 election. The trustee is responsible for providing the executor with the information attributable to the income of the trust that is necessary to prepare the combined income tax return.[69] It is the responsibility of the executor to prepare and file the return.[70] By making the 645 election, the executor and trustee each agree to allocate the income tax liabilities attributable to the probate estate and the trust, respectively.[71] The executor is responsible for paying the income taxes attributable to the income of the probate estate, and the trustee is responsible for paying the income tax liability attributable to the trust.[72] In other words, the fact that the trust is taxed as part of the probate estate does not absolve the trustee of all of his or her obligations following the 645 election. The trustee will still be responsible for gathering information and arranging for payment of the trust's income tax liabilities.

2. If No Executor Has Been Appointed

The 645 election is available even in the absence of a formal probate administration. A 645 election may be made by a trustee acting alone if the trustee represents that, to his or her knowledge and belief, there is no executor and one will not be appointed.[73] Following the election, the trust will be subject to the income tax rules applicable to probate estates, even though no probate administration has been opened.[74] Among other things, this means that the trustee may elect to use a fiscal year end for income tax purposes.[75] Just as is the case when an executor has been appointed, the deadline to make the election is the date of that the first income tax return would be due for the QRT (taxable as a probate estate), including extensions.[76] In other words, the trustee may wait until the probate estate's income tax return would be due using a fiscal year end. This is true regardless of whether there is sufficient income to require the filing of an income tax return.[77] Not surprisingly, the trustee will then be responsible for filing the income tax return on behalf of the trust and paying the income tax following the election.[78]

In most cases, only one trust will be eligible for the 645 election.[79] However, it is possible for more than one trust to make the 645 election.[80] In that circumstance, if no executor has been appointed, one trustee must essentially accept the responsibilities incumbent upon an executor joining the election with a trust.[81] For example, one trustee must accept responsibility for filing the income tax return.[82] In addition, each trustee of a trust joining the 645 election must agree to apportion the tax liabilities between the several trusts and provide information necessary to prepare the income tax return.[83]

3. If An Executor Is Appointed After The Trustee Has Made The 645 IRS Election

As discussed above, a trustee may make the 645 election when it is expected that no executor will be appointed. If an executor is later appointed, the executor has 90 days from his or her appointment to agree to the election and to notify the IRS by filing a revised election form, or the election will terminate as of the date the executor was appointed.[84] There is no exception if the trustee and the executor are the same person. As a result, the election must be joined by the executor acting in that capacity. The executor is then required to file an amended income tax return to reflect the income attributable to both the probate estate and the trust.[85]

If the election is terminated due to the refusal of the executor to agree to it or the failure to meet the ninety day deadline, the executor must then file income tax returns following the death of the decedent.[86] In that event, the trustee is not required to amend

the income tax return for the trust but must obtain a new taxpayer identification number for the trust.[87]

B. The Duration of the 645 Election

Under most circumstances, the duration of the 645 election will depend upon whether the decedent's estate was required to file an estate tax return. If no estate tax return is required to be filed, the 645 election terminates the day before the second anniversary of the decedent's death, unless all assets of the trust and estate have been distributed sooner.[88] When an estate tax return is required to be filed, the 645 election terminates the later of two years from the date of death or six months after the final determination of the estate tax liability.[89] Treasury Regulation section 1.645-1(f)(2) provides detailed rules regarding the date of final determination of estate tax liability for purposes of section 645. These rules appear to be consistent with the policy of limiting the 645 election to the period necessary to complete the administration of the decedent's estate and distribute its assets, because an administration normally cannot be brought to a conclusion unless the estate tax liability has been satisfied.[90]

C. Following the Termination of the 645 Election

At the end of the election period, the assets of the trust subject to the 645 election are deemed to have been distributed to a new trust that is not subject to the 645 election.[91] This has the effect of providing the combined probate estate and trust with a full deduction for the distributable net income attributable to the separate share of the old trust, followed by the payment of income to the new trust.[92]

Upon termination of the section 645 election, the "new" trust will be taxed on a calendar year basis because it will then be subject to the income tax rules applicable to trusts.[93] As a result, the trust will be required to file an income tax return for the period from the end of the fiscal year end to the end of the calendar year following the termination when a fiscal year end was selected. If an executor has been appointed, the probate estate will continue to file income tax returns using the fiscal year end applicable during the 645 election period.[94]

VI. CONCLUSION

Revocable trusts are commonly used for probate avoidance purposes in California. By using the 645 election to cause a trust to be subject to the income tax rules applicable to probate estates, it is possible to obtain the advantages of probate avoidance without suffering many of the negative income tax consequences associated with trusts. While that is a fair result, the specific effects of this tax treatment must be weighed in each case, and it is necessary to be mindful of the practical and procedural aspects of the election in order to obtain its benefits and use it most effectively.

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1. All references to "section" in this article are to the indicated section of the Internal Revenue Code of 1986, as amended (hereafter, "IRC"), unless otherwise indicated.

2. The term "probate estate" is used in this article, rather than the generic term "estate," in order to avoid confusion with the concept of a taxable estate for estate tax purposes or a "trust estate." For purposes of clarity, the 645 election may be made even when no formal probate of the decedent's estate has been opened.

3. Some of these distinctions may be significant in a particular case, even if they aren't commonly used. For example, the charitable set aside rule applies to probate estates but generally does not apply to trusts. IRC, section 642(c). However, the 645 election means that the trust, which will then be subject to the income tax rules applicable to probate estates, may take advantage of the charitable set aside rule. Treas. Reg. section 1.645-1(e)(2)(i).

4. See generally, Acker, BNA Tax Management Portfolio 852-3rd, Income Taxation of Trusts and Estates (hereafter, "Acker"), section II.E.

5. *Ibid*.

6. See, e.g., IRC section 267, discussed in Section III.E. of this article.

7. See, e.g., *Johnson Est. v. Comr.* (1987) 88 T.C. 225; *Wylie v. U.S.* (N.D. Tex. 1968) 281 F. Supp. 180; *McCauley v. U.S.* (E.D. Ark. 1961) 193 F. Supp. 938; *Berger Est. v. Comr.*, T.C. Memo 1990-554; *Miller v. Comr.* (8th Cir. 1964) 333 F.2d 400, aff'g. (1963) 39 T.C. 940; *Brown v. U.S.* (5th Cir. 1989) 890 F.2d 1329.

8. As summarized in Rev. Proc. 98-13, 1998-1 C.B. 370, "[b]oth estates and trusts can function to settle the affairs of a decedent and distribute assets to heirs. In the case of a revocable inter vivos trust, the grantor transfers property to a trust that is revocable during the grantor's lifetime. When the grantor dies, the power to revoke ceases and the trustee performs the settlement functions typically performed by an estate executor. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. at 711 (1997)."

9. See generally Acker, *supra*, at section III.G., p. A-27, which summarized the purpose of the 645 election as follows:

   According to the House Report, the use of revocable trusts may offer nontax advantages for estate planning as compared to a traditional estate plan. But differences in the federal tax treatment of revocable trusts and estates (*e.g.*, estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes but post-death revocable trusts are allowed deductions only for amounts actually paid to charities) may discourage individuals from using trusts where they might otherwise be appropriate or efficient. The amendment is intended to minimize the tax differences between estates and trusts that essentially serve the same estate administration function during a reasonable period of administration.

10. Taxpayer Relief Act of 1997 (hereafter, "1997 TRA"), Pub. L. No. 105-34 (Oct. 1, 1997), section 1305(a).

11. Rev. Proc. 98-13, 1998-1 C.B. 370.

12. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998).

13. Treas. Reg. section 1.645-1, T.D. 9032, 67 Fed. Reg. 78371, issued December 24, 2002.

14. See discussion in Section V.B. of this article.

15. Treas. Reg. section 1.641(b)-(3)(a) provides:

    > The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. . . . However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. . . . Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

    As summarized in Russell v. Comr., T.C. Memo 1962-223, p. 62-1303:

    > The administration of an estate shall be deemed terminated for tax purposes when the ordinary duties of administration have been completed and the assets are ready for distribution [citation omitted]. . . . The question as to when an estate is deemed terminated for income tax purposes *is largely a question of fact to be resolved by the entire record* . . . . (Emphasis added.)

16. IRC, section 645(a).
17. IRC, section 645(b)(1).
18. As used hereafter in this article, the term “trust” or “revocable trust” refers to a qualified revocable trust unless otherwise noted.
19. IRC, section 645(a).
20. IRC, section 645(c).
21. *Ibid*.
22. IRC, section 645(a).
23. IRC, section 645(b)(2).
24. Acker, *supra*, at Section III.C.1., p. A-12.
25. IRC, section 644(a).
26. IRC, sections 441(b) and 7701(a)(1), (14).
27. Treas. Reg. section 1.645-1(e)(2).
28. Treas. Reg. section 1.645-1(e)(3).
29. Treas. Reg. section 1.441–1(b)(5)(A).
30. If the decedent died on October 15, 2010, the last day of the preceding month would have been September 30, 2010. The last possible fiscal year end would therefore be September 30, 2011, twelve months later.
31. If a 645 election is not made, or if there is uncertainty regarding whether the 645 election will be made, the trust must file its return on a calendar year basis:

    > If the trustee of the QRT and the executor of the related estate, if any, do not treat the QRT as an electing trust as provided under paragraph (d)(2)(i) of this section, or if the trustee of the electing trust and the executor, if any, are uncertain whether a section 645 election will be made for a QRT, the trustee of the QRT must file a Form 1041 for the short taxable year beginning with the decedent’s death and ending December 31 of that year (unless the QRT is not required to file a Form 1041 under section 6012 for this period). Treas. Reg. section 1.645-1 (d)(2)(ii).

    The reason that an initial calendar year income tax return must be filed for the trust if there is uncertainty regarding whether the 645 election will be made is that penalties and interest may be imposed if it is later decided that the trust will not be subject to the 645 election:

    > If a section 645 election will be made for a QRT, the executor of the related estate, if any, and the trustee of the QRT may treat the QRT as an electing trust from the decedent’s date of death until the due date for the section 645 election. Accordingly, the trustee of the QRT is not required to file a Form 1041 for the QRT for the short taxable year beginning with the decedent’s date of death and ending December 31 of that year. However, if a QRT is treated as an electing trust under this paragraph from the decedent’s date of death until the due date for the section 645 election but a valid section 645 election is not made for the QRT, the QRT *will be subject to penalties and interest for failing to timely file a Form 1041 and pay the tax due thereon.* (Emphasis added.) Treas. Reg. section 1.645-1(d)(2)(ii).

32. It should be noted that IRC section 663(b) permits an executor or trustee to elect to have a distribution made within 65 days of the end of the taxable year treated as though it were paid during the preceding year. In other words, the trustee of a trust that reports income on a calendar year basis could treat 2010 income paid before March 6, 2011 (i.e., 65 days after December 31, 2010) as having been paid during the 2010 tax year.
33. IRC section 662(c) provides:

    > If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

34. Technically, the 2011 calendar income tax year would end on December 31, 2011; however, this example assumes that all distributions would have been made by June 30, 2011, meaning that the income tax return would only cover the period prior to that date. That is the case because, in the absence of a 645 election, a trust will be required to file an income tax return on a calendar year basis. IRC, section 644(a).
35. Estates and trusts reached the highest income tax bracket at $11,200 in 2010. Assuming that both the probate estate and the trust are in the maximum income tax bracket, it would be possible to save $1,024.50 in income tax based on 2010 brackets by spreading income across two returns. The incremental differences between the lower and highest bracket are as follows: (20% x $2,300 = $460), (10% x $3,050 = $305), (7% x $2,850 = $199.50), (2% x $3,000 = $60). Total = $1,024.50. In addition, the consolidated return would only permit the use of the estate exemption of $600, and would not allow the use of the exemption of $100 or $300 applicable to simple or complex trusts, respectively. Treas. Reg. sections 1.642(b)-1 and 1.645-1(e)(2)(ii).
36. Treas. Reg. section 1.661(a)-1.
37. Treas. Reg. sections 1.661(a)-1, 1.645-1(d)(2)(i) (a single tax return is filed for the trust and probate estate).
38. IRC, section 662.

39. IRC, section 663(b). It bears emphasis that making the election is not sufficient to carry out the distributable net income to the beneficiaries. The distribution must actually be made within the sixty-five day period in order for it to be treated as though it was distributed in the previous year.

40. Treas. Reg. section 1.645-1(e)(2) observes that the special offset for real estate activities under Internal Revenue Code section 469(i) also applies to trusts during the 645 election period.

41. IRC, sections 469(a), (d).

42. IRC, section 469(i)(4)(A).

43. Sen. Rep. No. 99-313, 2d Sess. (1986), pp. 737-738; Instructions to Form 1040, Schedule E (2010), p. E-3.

44. IRC, section 469(i)(4)(A).

45. IRC, section 1361(c)(2)(A)(ii).

46. IRC, section 1361(b)(1)(B).

47. IRC, section 645(b)(2)(A).

48. IRC, section 645(b)(2)(B).

49. Treas. Reg. section 1.645-1(f)(2)(ii)(A). This example assumes that a claim for refund is not filed within twelve months after the issuance of the closing letter.

50. *Kenan v Commissioner* (2d Cir. 1940) 114 F.2d 217.

51. Treas. Reg. section 1.1014-4(a)(3) provides:

> The principles stated in subparagraphs (1) and (2) of this paragraph do not apply to property transferred by an executor, administrator or trustee, to an heir, legatee, devisee or beneficiary under circumstances such that the transfer constitutes a sale or exchange. In such a case, gain or loss must be recognized by the transferor to the extent required by the revenue laws, and the transferee acquires a basis equal to the fair market value of the property on the date of the transfer. Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of $1,000 and the basis of the securities in the hands of the beneficiary would be $10,000. As a further example, if the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000 on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.

52. Rev. Rul. 60-87, 1960-1 C.B. 286, clarifying Rev. Rul. 56-270, 1956-1 C.B. 325.

53. The fact that the term "Kenan loss" is technically inaccurate does not stop many practitioners from using this term as a convenient shorthand.

54. Technically, the loss is not lost forever, it is merely suspended until the beneficiary sells the asset. Treas. Reg. section 1.267(d)-1. However, this means that gains and losses may not be netted against each other when a combination of appreciated and depreciated assets are distributed in kind in satisfaction of a pecuniary bequest.

55. IRC, section 267(b)(13) (emphasis added).

56. IRC, section 663(c).

57. It should be noted that a pecuniary gift or a gift of specific property does not constitute a separate share. Treas. Reg. section 1.663(c)-4(a) provides that ". . . a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share."

58. Treas. Reg. section 1.645-1(e)(2)(i)(A) states that:

> Under the separate share rules of section 663(c), the electing trust and related estate are treated as separate shares for purposes of computing distributable net income (DNI) and applying the distribution provisions of sections 661 and 662. Further, the electing trust share or the related estate share may each contain two or more shares. Thus, if during the taxable year, a distribution is made by the electing trust or the related estate, the DNI of the share making the distribution must be determined and the distribution provisions of sections 661 and 662 must be applied using the separately determined DNI applicable to the distributing share.

59. IRC, section 663(c); Treas. Reg. section 1.645-1(e)(2)(ii).

60. Treas. Reg. section 1.645-1(e)(2)(iii)(B) provides:

> A distribution from one share to another share to which sections 661 and 662 would apply if made to a beneficiary other than another share of the combined electing trust and related estate affects the computation of the DNI of the share making the distribution and the share receiving the distribution. The share making the distribution reduces its DNI by the amount of the distribution deduction that it would be entitled to under section 661 (determined without regard to section 661(c)), had the distribution been made to another beneficiary, and, solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. The distribution has the same character in the hands of the recipient share as in the hands of the distributing share. . . .

61. Treas. Reg. section 1.645-1(e)(2)(iii)(B).

62. Rev. and Tax. Code, section 17751.

63. There may be a number of reasons why a settlor may want to create a revocable trust with a situs in another state. For example, South Dakota has abolished the rule against perpetuities. S.D. Codified Laws, section 43-5-8.

64. Rev. and Tax. Code, section 17742. Cal. Admin. Code Tit. 18, section 17742(a) provides, in relevant part:

> In the case of an estate, if the decedent and noncontingent beneficiaries are all nonresidents of this State, and, in the case of a trust, if the fiduciaries and noncontingent beneficiaries are all nonresidents of this State, only income from real or personal property located in this State (see Reg. 17951-3), business carried on within this State (see Reg. 17951-4), and intangible personal property having a business or taxable situs in this State (see Section 17952) is taxable.

65. Rev. & Tax. Code, section 17742(a).

66. Treas. Reg. section 1.645-1(c)(i); Instructions to IRS Form 8855.

67. IRC, section 645(c).

68. Treas. Reg. section 1.645-1(c)(1)(ii).

69. Treas. Reg. section 1.645-1(c)(1)(ii)(A)(2).

70. Treas. Reg. section 1.645-1(c)(1)(ii)(B)(2). In order to start the statute of limitations running for both the probate estate and the trust, it is necessary to properly identify the trust on the income tax return filed by the executor. Treas. Reg. section 1.645-1(e)(2)(ii)(A).

71. Treas. Reg. sections 1.645-1(c)(1)(ii)(A)(3) and (B)(3).

72. Treas. Reg. sections 1.645-1(c)(1)(ii)(A)(4) and (B)(4).

73. Treas. Reg. section 1.645-1(c)(2)(ii)(E).

74. Treas. Reg. section 1.645-1(e)(3)(i).

75. *Ibid*.

76. Treas. Reg. section 1.645-1(c)(2)(i).

77. *Ibid*.

78. Treas. Reg. section 1.645-1(c)(2)(ii)(D).

79. That is the case because most estate plans will have only one revocable trust coming within the definition of a "qualified revocable trust" discussed above. However, some estate plans do include more than one revocable trust. For example, a separate revocable trust may be used when a married person desires to segregate separate property from community assets held in a joint trust with his or her spouse.

80. Treas. Reg. section 1.645-1(c)(3).

81. *Ibid*.

82. *Ibid*.

83. Treas. Reg. section 1.645-1(c)(2)(ii)(C).

84. Treas. Reg. section 1.645-1(g)(1). See also Treas. Reg. section 1.645-1(g)(3) (termination of election for failing to meet 90 day deadline).

85. Treas. Reg. section 1.645-1(g)(2). This means that once the election is joined by the executor, it is effective as of the date of the decedent's death.

86. Treas. Reg. section 1.645-1(g)(3).

87. *Ibid*.

88. IRC, section 645(b)(2)(A); Treas. Reg. section 1.645-1(f)(2)(i).

89. IRC, section 645(b)(2)(B); Treas. Reg. section 1.645-1(f)(2)(ii).

90. Prob. Code, section 11640.

91. Treas. Reg. section 1.645-1(h)(1).

92. Of course, the new trust will then need to make a distribution to beneficiaries in order to carry out its distributable net income. Treas. Reg. section 1.645-1(h)(1) provides that ". . . the new trust shall include the amount of the deemed distribution in gross income to the extent required under section 662."

93. Treas. Reg. section 1.645-1(h)(4)(ii).

94. Treas. Reg. section 1.645-1(h)(4)(i).

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