

An aerial photograph of a lush green agricultural field, showing neat rows of crops stretching across the landscape. The perspective is from a high angle, looking down at the field.

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# New Year, Fresh Start: Tax-Planning Tools for Fiduciary Income Tax

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The importance of fiduciary income tax planning is often overlooked by fiduciaries. Proper and diligent planning can yield tremendous benefits to estates, trusts, and beneficiaries if fiduciaries are on top of income tax planning strategies, elections and deadlines. Although last year has come to a close, fiduciaries still have some tools at their disposal that they can use to minimize last year's tax bill to estates, trusts and beneficiaries. Below are a number of considerations, strategies, and elections that fiduciaries should have on their radar as we start the new year.

## Deemed Distributions From Simple Trusts

A simple trust is a trust where the income is required to be distributed currently, there are no amounts paid, permanently set aside, or used for charitable purposes, and there are no other distributions from the trust in the tax year. Because a simple trust's terms require income to be paid currently, the income is deemed to have been paid for tax purposes even if it is not actually paid. A simple trust is therefore entitled to an income distribution deduction under Section 651 of the Internal Revenue Code when no actual distribution of income is made to a beneficiary.

## Electing to Treat a Decedent's Revocable Trust as Part of an Estate

Section 645 of the Internal Revenue Code permits an executor of an estate and a trustee of a qualified revocable trust to elect to treat both entities as part of a decedent's estate. Combining the tax returns of an estate and a qualified revocable trust is usually more efficient and cost effective, and it permits the qualified revocable trust to engage in tax planning through the use of a fiscal tax year rather than a calendar tax year, which could be advantageous by deferring income tax for beneficiaries. A Section 645 election must be made no later than the due date of the estate's income tax return for the first taxable year of the estate, and once made, the election is irrevocable. The combined tax return may only be used until the earlier of two years after the date of the decedent's death if no estate tax return is required to be filed, or if an estate tax return is required to be filed, six months after the date of the final determination of estate tax liability.

## **65-Day Rule**

The most powerful deduction for estates and trusts to shift some or all of the income tax liability from the estate or trust to the beneficiary is the income distribution deduction. In estates and complex trusts, the income distribution deduction is only available if a distribution is actually made to the beneficiary during the estate's or complex trust's tax year.

Unfortunately, a fiduciary may not always know how much to distribute to the beneficiary to minimize the estate's or complex trust's tax liability until after the end of the tax year. The fiduciary may have also simply forgotten to make the necessary distributions to minimize taxes, or the estate or complex trust may be terminating early in the next tax year and the fiduciary wants to avoid filing an additional income tax return. Section 663(b) of the Internal Revenue Code is a fiduciary's savior because it permits distributions made within the first 65 days of any tax year of an estate or complex trust that are properly paid or credited to be considered paid or credited on the last day of the preceding tax year. A fiduciary must make the 65-day election on a timely filed return, and if no return is required to be filed, on a statement filed with the internal revenue office with which a return would be filed if a return was required. A 65-day election is irrevocable after the last day prescribed for making the election.

## **Electing to Treat Estimated Tax Payments as Paid by Beneficiary**

Beneficiaries are often unaware of the taxable nature of distributions that they are receiving from a trust, and they may not pay sufficient estimated tax payments throughout the year to account for taxable income from a trust. Section 643(g) of the Internal Revenue Code permits a trustee of a trust to make estimated tax payments and then elect to treat any portion of the estimated tax payment as having been paid by the beneficiary of the trust. If such an election is made, the payment made is treated as having been paid or credited to the beneficiary on the last day of the tax year and treated as payment of estimated tax made by the beneficiary on Jan. 15 following the tax year. A trustee must make the election on or before the 65th day after the close of the tax year of the trust. The 643(g) election also applies to estates in an estate's final tax year.

## **Charitable Deductions**

If amounts are paid during the tax year to a charitable beneficiary pursuant to the terms of the governing instrument, the estate or trust is entitled to a charitable deduction under Section 642(c) of the Internal Revenue Code. Unlike charitable deductions for individuals, there is no limitation on the charitable deduction for estates and trusts. If a charitable contribution is paid after the close of the tax year and on or before the last day of the following tax year, then the fiduciary may elect to treat the amount paid in the second tax year as having been paid in the first tax year. This election can be especially helpful if the fiduciary was unable to pay the charitable contribution in the first year but the estate or trust had taxable income that needed to be offset by the charitable distribution. The 642(c) election must be made on a timely filed income tax return for the estate or trust.

## **Property Distributed In-Kind**

When a fiduciary distributes property to a beneficiary, the fiduciary may either distribute the property in cash or in-kind. In-kind distributions can have a significant impact on the beneficiary, estate, or trust if the fiduciary is not considering the various tax consequences.

For purposes of determining the amount of a distribution of in-kind property to a beneficiary, the amount of the distribution is equal to the lesser of the basis of the property in the hands of the estate or trust, or the fair market value of the property distributed. The basis of the property in the hands of the estate or trust is equal to the adjusted basis of the property in the hands of the estate or trust immediately before the distribution, adjusted for any gain

or loss recognized by the estate or trust on the distribution. Unless the fiduciary is distributing property in-kind in satisfaction of a pecuniary bequest, the estate or trust would not ordinarily recognize gain on the distribution. The basis of the property received by the beneficiary would then be the adjusted basis of the property in the hands of the estate or trust immediately before the distribution, adjusted for any gain or loss recognized to the estate or trust on the distribution. For example, if the trustee distributed stock with a basis of \$100 and a fair market value of \$150, the amount of the in-kind distribution to the beneficiary would be equal to \$100, and the basis in the hands of the beneficiary would be equal to \$100. When the beneficiary ultimately sold the stock, the beneficiary's gain would be calculated based upon the \$100 basis.

Section 643(e)(3) of the Internal Revenue Code permits the fiduciary to elect to recognize gain or loss on the in-kind distribution to the beneficiary, in which case, the amount of the distribution would be equal to the fair market value of the asset. A 643(e)(3) election may be especially useful if the estate or trust has harvested losses from prior years that could offset gains in the current tax year. The election must apply to all in-kind distributions made by the fiduciary in the tax year, and the election, once made, is irrevocable. In the example above, the amount of the distribution would now be \$150, and the basis in the hands of the beneficiary would be \$150. The trust would be responsible for paying the tax on the \$50 gain, and the beneficiary would have the benefit of a stepped-up basis to the fair market value on the date of distribution.

When making the 643(e)(3) election, the fiduciary must be cognizant of the loss disallowance rules of Section 267 of the Internal Revenue Code. While Section 267(b)(13) does not disallow a loss in the case of a sale or exchange in satisfaction of a pecuniary bequest from an estate, Section 267(b)(6) disallows a loss between a fiduciary of a trust and a beneficiary of such trust. A trustee should be aware that a 643(e)(3) election to recognize a loss could result in a loss disallowance under Section 267(b)(6).

Fiduciaries have many tools at their disposal to engage in income tax planning for an estate or trust that can benefit beneficiaries. By considering various election opportunities early in the year, fiduciaries may be able to successfully minimize or shift income tax liabilities.

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