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Guide to Federal Estate and Trust Tax Return Requirements

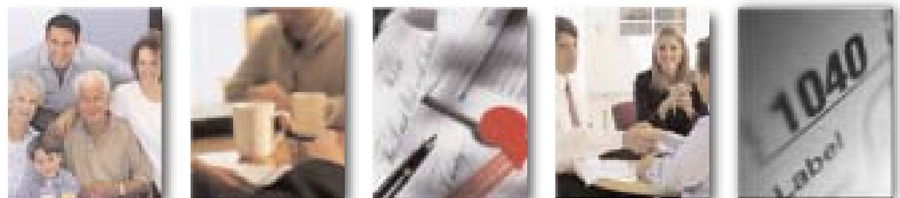

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Table of Contents

Guide to Federal Estate and Trust Tax Return Requirements

What Tax Returns Are Required to Be Prepared and Filed? 1

Form 706 2

Form 1040 4

Form 1041 6

How Does This Affect the Beneficiary? 7

Conclusion 9

You have been named as personal representative or trustee by a relative or close friend. You understand that this very important appointment requires you to carry out the wishes of that relative or friend and that it also carries certain duties and responsibilities. One of those responsibilities is to make sure all of the appropriate tax returns are prepared and filed, and taxes are paid. Or, you may be a beneficiary named in a will or trust, and you will be receiving various assets or cash from the decedent. As a recipient of those assets, there will be an impact on your personal income tax return.

The purpose of this booklet is to educate you as to the various federal returns which may be required and the impact decisions made during the estate settlement and trust administration process will have on those returns as well as on the beneficiaries and their returns. Please keep in mind that, although most administrations are similar, different tax returns may be required depending upon the assets involved, the disposition of the assets, and the circumstances of various family members or other beneficiaries.

WHAT TAX RETURNS ARE REQUIRED TO BE PREPARED AND FILED?

The most complicated return that you may be required to have prepared and filed for a decedent is the Federal Estate Tax Return, or Form 706. A similar return is usually required to be filed with the state in which the decedent resided at his or her time of death. In addition, if the decedent owned certain types of property in states other than his or her state of residence, a similar return may also be required to be filed with the state where that asset is located. This return is only required if the total value of the decedent's gross estate is equal to or greater than the applicable exclusion amount (commonly known as the "unified credit amount").

The applicable exclusion amounts are as follows:

Year	Amount
2006	$2,000,000
2007	$2,000,000
2008	$2,000,000
2009	$3,500,000
2010	Estate Tax Repealed
2011	$1,000,000 [1]

1 The pre-2001 federal tax rules will be automatically reinstated in 2011 unless Congress and the president take further action. Thus, taxpayers may face an even larger estate tax burden after 2010.

The return most commonly required to be prepared and filed for a decedent is the final individual income tax return, or Form 1040. As with Form 706, an income tax return must be filed with the IRS as well as the state in which the decedent resided at his or her time of death and possibly other states if income was generated there.

During the period of administration, income will continue to be generated by the assets that were owned by the decedent at his or her time of death. Whether this income is generated by assets held in a revocable trust (that becomes irrevocable at death) or as part of the probate estate, it will need to be reported and income tax paid. Depending on circumstances, this income will need to be reported on one or more fiduciary income tax returns, or Form 1041. Each of these returns will be explained in greater detail.

FORM 706

What is Form 706?

Form 706 is the "death tax" return that has been in the news so much during the last several years. The purpose of this return is to tax the value of assets owned by the decedent as of the decedent's date of death.

Are only assets in the decedent's individual name included on Form 706?

No. The Internal Revenue Service (IRS) in the Internal Revenue Code requires that Form 706 include all assets owned or controlled by the decedent.

Thus, assets owned in any of the following forms of ownership must be listed on Form 706:

- Individual Name – Any asset with just the decedent's name as owner is required to be listed on Form 706. These assets are subject to probate.
- Joint Name – Any asset held in the name of the decedent and another person, whether that person is the decedent's spouse or someone else, is required to be listed on Form 706. If the asset is held jointly between the decedent and his or her spouse, it is assumed that each of them owns half of that asset; thus, only half of the value of that asset will be counted for taxing purposes on Form 706. If the asset is held jointly between the decedent and a person other than his or her spouse, it is necessary to determine how much of the value of that asset each of them contributed. For example, if it is a joint bank account, did the decedent and the other person each contribute an equal share, or did the decedent contribute all of the funds and simply add the other person to the account for convenience purposes in order to write checks for the decedent? If the other person did contribute a portion of the value of that asset, say 25 percent, it will be necessary to show proof that that person contributed that portion. In this case, only 75 percent of the value of the asset would be considered as contributed by the decedent and counted for taxing purposes on Form 706.
- Trust Name – If the decedent transferred assets into his or her revocable trust prior to death, these assets must still be listed on Form 706. The reason for this is because the decedent still had control of these assets during his or her lifetime (i.e., they could be sold, gifted, or used up by the decedent). The full value of these assets are shown on Form 706. However, assets which have been transferred to most irrevocable trusts are not included on Form 706, and thus are not counted for taxing purposes. The reason these assets are not included on Form 706 is because the decedent gave up control by giving them to a trust which has someone other than the decedent acting as trustee (thus, the decedent has given up control and ownership of that asset), and the decedent cannot revoke or amend the trust (thus, the term "irrevocable"). Please note, however, that although the assets of the irrevocable trust are not included on Form 706 for taxing purposes, the existence of the irrevocable trust must still be disclosed on Form 706.
- Beneficiary Designated – This would include any asset that designates a beneficiary to receive the asset upon the decedent's death, such as a life insurance policy, IRA, annuity, or pension. Although this type of asset is not subject to probate, the entire value of the beneficiary designated asset is shown on Form 706.

Why is it important to accurately value the assets shown on Form 706?

It is important to accurately value the assets, even if Form 706 is not required, because each asset receives a new basis upon the decedent's death. This is commonly known as a "step up in basis." Showing the correct basis for an asset is important for determining gain or loss on sale for accounting and income tax purposes. If you sell an asset for $500 and its basis is $100, your gain is $400. However, if the decedent originally bought stock worth $100, but on his or her date of death it is now worth $500, the basis becomes the date of death value which is $500. Now if the stock is sold for $500, there is no gain.

Normally the basis is the asset's value as of the date of death of the decedent. However, the IRS does allow the fiduciary to look at the value of the assets six months after date of death to determine whether the values have increased or decreased. This is called the alternate value date. If the asset has been sold, exchanged, distributed, or otherwise disposed of during this six-month period, then that value will be considered the alternate value. If the total value of the assets as of the alternate value date is less than the total value of the assets as of the date of death, *and* the estate tax is thereby *reduced*, then the estate tax is calculated on alternate value date amounts. The alternate value date amounts then become the basis of the assets. You may not pick and choose which assets are shown at date-of-death value and which are shown at alternate-value-date value in order to take advantage of some assets which have fallen in value versus others which have increased in value. It is an all or nothing situation.

So if I receive stock or another asset from the decedent's estate, there will never be any gain on it?

It depends. If you receive the $500 stock discussed above as an "in-kind" distribution from the decedent's estate or trust, and then sell it for $550, you will have a $50 gain for which you will be responsible for paying tax. If you sell the $500 stock for $400, you will have a $100 loss that you can show on your own personal income tax return.

What is an "in-kind" distribution?

An in-kind distribution means that you are taking your inheritance in the form of one of the assets held by the decedent's estate or trust, rather than the trustee having sold that asset and then distributing cash to you.

Is there tax due when filing Form 706?

It depends. If the decedent has a surviving spouse, there normally is no tax due as a result of the unified credit and the unlimited marital deduction. The unlimited marital deduction provides that you may pass an unlimited amount of assets to your spouse without paying any tax on that gift. Thus, in a typical estate plan for a married couple, an amount equal to the unified credit amount is allocated to a family trust tax free, and the remainder of the decedent's assets are allocated to a tax-free marital trust for the benefit of his or her spouse because of the unlimited marital deduction. The amount going into the family trust will never be taxed for estate tax purposes again. However, the amount remaining in the marital trust at the spouse's death will have estate taxes assessed on it when the spouse dies. In essence, the allocation of assets to the marital trust is simply postponing the tax on those assets, rather than avoiding the tax entirely. If the decedent is unmarried, the amount over the unified credit amount, excluding amounts going to charity, will be taxed. The unified credit amount, whether it passes into a trust or is distributed outright to the beneficiaries, is not taxed.

How much is the estate tax?

The 2005 estate tax rates started at 45 percent for estates or trusts valued at more than $1,500,000 and then progress upwards to approximately 47 percent for estates or trusts valued at more than $2,000,000.

Who is responsible for paying the estate tax?

The fiduciary (personal representative, executor, or trustee) for the decedent's estate or trust, or the person "in control" of the assets, is responsible for paying this tax. Normally the funds come from the estate or trust; however, the fiduciary may be held personally liable for any taxes due.

If the estate or trust does not have cash available, it will be necessary to sell or liquidate other assets to raise the cash needed to pay the tax. Therefore, it is important to do some preplanning to have an orderly and tax-advantageous plan to sell or liquidate assets such as stocks, bonds, or other assets prior to the tax due date.

When must the estate tax be paid?

Form 706 must be filed nine months from the date of death of the decedent. The tax is due at that time. Although a six-month extension past that date to file the return is available, any estate tax payable is due on the nine-month due date.

What happens once Form 706 is filed with the IRS?

There is a waiting period of approximately six to eight months until the IRS issues a clearance letter approving Form 706 as filed. During that time, the IRS will review Form 706 to determine whether they agree with the values shown for the assets or other tax positions reflected on the return. Once that clearance letter is received, a copy of it is sent to the state in which the state version of Form 706 was filed in order to obtain the state's clearance letter. After that, the estate or trust assets are distributed based upon the terms of the will or trust.

Does the IRS always issue a clearance letter after reviewing Form 706?

Since this is the last opportunity for the IRS to collect any taxes from the decedent, the IRS will sometimes disagree with the values shown on Form 706. If that is the case, they may request additional information substantiating the values or deductions shown on the return. If that is not satisfactory, they may then request a meeting with your accountant and/or attorney to discuss Form 706. Ultimately, an agreement will be reached on the appropriate values, and the IRS will issue a clearance letter.

FORM 1040

What is Form 1040?

Form 1040 is the income tax return that the decedent was required to file during his or her lifetime. This will be the final Form 1040 which must be filed on behalf of the decedent.

What is reported on Form 1040?

The decedent's income and deductions are reported on this final Form 1040. However, the period covered by this Form 1040 is from January 1 of the year in which the decedent died until his or her date of death. For example, a decedent passed away on August 1, 2005. Form 1040 would include the income the decedent earned, and the deductions available to him or her, for the period January 1, 2005 through August 1, 2005. Income and deductions occurring after the decedent's date of death will be shown on Form 1041, as discussed in greater detail in this booklet.

It should be noted that some deductions may not be shown on Form 1040, but may be of more significant tax benefit if shown on Form 706. Please see the discussion regarding this particular issue further in this booklet.

The decedent may have created a revocable trust during his or her lifetime and transferred assets into that trust. During his or her lifetime, the revocable trust is treated as a "shadow" of the person, and all income earned on assets owned by the revocable trust is treated as income earned by the person and, thus, shown on his or her Form 1040. Deductions

are treated in the same manner. Again, only the income and deductions of the revocable trust occurring during the portion of the year the decedent was alive will be shown on the decedent's final Form 1040; income and deductions occurring after the date of death are shown on a different tax return.

What about the income and deductions occurring after date of death?

Income and deductions occurring after the date of death now belong to an entity other than the decedent, specifically either his or her probate estate or trust. If a decedent owned assets in his or her name individually at the date of death, those assets are subject to probate and are often referred to as the "probate estate." In addition, the decedent may have created a revocable trust during his or her lifetime and funded the trust with assets which he or she owned. Upon the decedent's death, the revocable trust becomes irrevocable, meaning it may not be revoked or changed in any way. Accordingly, income and deductions occurring after the decedent's date of death are reported on the income tax return for the probate estate or trust (namely, Form 1041, which is discussed further in this booklet).

Is there any reason not to show deductions on Form 1040?

Yes. This is an example of why it is important to coordinate the preparation of all of these different tax returns. The main purpose of taking deductions is to decrease tax due. Thus, obtaining the most "bang for the buck" is important, and one would not want to waste deductions by putting them on a return where they will not be the most effective. In a situation where there is a surviving spouse, Form 706 is usually nontaxable. For this reason, it would make better sense to show the decedent's final medical expenses on the final Form 1040 where they may reduce any income tax due, rather than show them on Form 706 where there is no tax due anyway. In a situation where there is no surviving spouse, Form 706 is usually taxable. Therefore, as many deductions as possible should be shown on Form 706, since the tax rates for Form 706 are usually higher than the tax rates for the decedent.

Is there a change in filing status after the decedent is deceased?

No. If the decedent had been filing a joint return with his or her spouse prior to death, then the final Form 1040 may still be filed as a joint return. The return would just not include any income earned on the decedent's assets after his or her death (except for assets held jointly with the spouse, since they automatically pass to the spouse upon the decedent's death).

Is there tax due when filing the final Form 1040?

It depends. Whether tax is due, or whether a refund may be expected, is determined by the amount of income and/or deductions which are shown on the decedent's final Form 1040 and the amount of tax paid for that year.

How much is the income tax?

The income tax rates for the decedent's final Form 1040 would be the same as if he or she were alive. So if the decedent was in a 27 percent bracket prior to death, it is probable that the same 27 percent bracket would apply to the final Form 1040.

Who is responsible for paying the income tax?

Any income tax due is considered a debt of the decedent. Thus, his or her probate estate or trust would be responsible for paying the tax.

When must the income tax be paid?

The final Form 1040 is due on April 15 following the year of the decedent's death, and any tax due would be payable at that time. Although a four-month extension past that date to file the return is available, any income tax payable is due on April 15.

FORM 1041

What is Form 1041?

If a decedent owned assets in his or her name individually at date of death, those assets are subject to probate, and are often referred to as the probate estate. In addition, the decedent may have created a revocable trust during his or her lifetime and funded the trust with assets which he or she owned. Upon the decedent's death, the revocable trust becomes irrevocable, meaning it may not be revoked or changed in any way. Both the probate estate and the trust are now considered an "entity" or "person" and must file an income tax return known as Form 1041.

What is reported on Form 1041?

The income and deductions of the probate estate or trust are reported on Form 1041. As stated above, this would be income and deductions occurring after the decedent's date of death. Form 1041 must be filed for each year that the probate estate or trust is in existence.

Is there tax due when filing Form 1041?

It depends. Whether tax is due is determined by the amount of income and/or deductions which are shown on Form 1041. Another determining factor is whether distributions have been made to the beneficiaries.

Why would making a distribution to a beneficiary determine the amount of tax due on Form 1041?

When a distribution is made to a beneficiary, it "carries out" the income earned by the probate estate or trust. The benefit of carrying out the income to the beneficiary is that it is then taxed at the beneficiary's income tax rate, rather than at the probate estate or trust tax rate. Usually the beneficiary's tax rate is lower than the tax rate of the probate estate or trust. The beneficiary is given a form called a K-1 (beneficiary's share of income, deductions, credits, etc.) which lists the amount that the beneficiary should show on his or her personal income tax return.

How much is the tax for Form 1041?

The 2005 tax rates for a probate estate or trust started at 15 percent for taxable income of up to $2,000 and then progress upwards to 35 percent for taxable income of $9,750 or more.

Thus, there is usually a tax savings when the income is carried out to the beneficiaries, since they usually have a lower tax rate than that of probate estates and trusts.

Who is responsible for paying the tax?

As previously noted, if a distribution is made to a beneficiary to carry out the income, the amount is shown on the beneficiary's personal income tax return (Form 1040), and thus the beneficiary is responsible for paying the tax. Although this sounds unfair, as previously noted, it in effect lowers the amount of tax paid by taxing the income at the beneficiary's lower personal tax rate rather than at the probate estate or trust's higher tax rate. In addition, the beneficiary will have received the distribution and, thus, have assets available to use to pay the tax.

If no distribution has been made to the beneficiary which would allow the income to be carried out to the beneficiary, the income is then retained at the probate estate or trust level. In this instance, the probate estate or trust is responsible for paying the tax. If the probate estate or trust does not have cash available, it will be necessary to sell or liquidate other assets to raise the cash needed to pay the tax.

When must the tax be paid?

It depends on whether the probate estate or trust is using a calendar or fiscal year. If the probate estate or trust is using a calendar year, Form 1041 is due April 15 of the year following the year of death. The first year tax return would be a short year. Using the example from above, the first Form 1041 would cover the period from decedent's date of death on August 1, 2005 through December 31, 2005. After that, each Form 1041 would cover January through December (except for the final Form 1041, which would only cover January through the month the trust terminates).

A probate estate has the option to file based on a calendar year, as noted above, or on a fiscal year based on the decedent's date of death. If a fiscal year is used, Form 1041 is due on the fifteenth day of the fourth month after the end of the fiscal year. For example, a fiscal year for our decedent would be August 1 through July 31, and Form 1041 filing due date would be November 15.

A trust is normally required to file based on a calendar year. However, the Internal Revenue Service allows the trust to elect to file on a fiscal year for the first two years following the decedent's date of death. The Internal Revenue Service also allows the probate estate and trust to file one combined Form 1041 using a fiscal year. In addition to allowing cost savings (having to pay for the preparation of the one combined probate estate/trust return versus two separate returns for the probate estate and for the trust), the option of using a fiscal year allows some tax planning benefits if chosen.

State Taxes

In addition to federal taxes, there may also be taxes payable at the state level. This may include income tax, as well as estate tax. It should also be noted that previously most states imposed an estate tax equal to the state death tax credit defined in the Internal Revenue Code. This was commonly known as the "pickup" tax and equaled the amount of credit granted by federal law. However, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the federal exemptions, which thus reduced the amount of pickup tax going to the states. As a result, depending on how a particular state's statute was written, even though the credit was no longer given on the federal estate tax, the estate of a decedent might still have to pay that amount of tax to the state. In effect, these states were automatically "decoupled" from the federal law. Thus, a resident of a decoupled state may now be required to pay estate tax to the state even if they don't owe any estate tax to the federal government.

HOW DOES THIS AFFECT THE BENEFICIARY?

Most beneficiaries assume that when they receive an inheritance, they will receive the full amount of the inheritance, and that will be that. They don't expect there to be any income tax consequences to them personally. However, as already noted above, the beneficiary may be responsible for paying income taxes for assets received as an inheritance. There may also be some income tax benefits to the beneficiary. Let's consider some specific assets and how receiving them as an inheritance impacts the beneficiary personally.

Real Estate

Real estate receives a step up in basis. If the real estate was not in joint name, the entire interest in the property receives a step up. For example, if the decedent originally purchased the property for $50,000, and at the time of the decedent's death it was valued at $100,000, the basis of the real estate passing to the beneficiary is $100,000. The beneficiary could sell the property for $100,000 and not have any gain on that sale. However, if the beneficiary sells the property for anything over $100,000, he or she will have a gain (i.e., if it sells at $125,000, the beneficiary then has a gain of $25,000).

If the real estate was in joint name with a spouse, the property is considered to consist of two halves. One-half would have a basis of $25,000 (one-half of the original purchase price of $50,000), and one-half would have a basis of $50,000 (one-half of the date of death value of $100,000). Thus, the beneficiary who is the surviving joint tenant would have to calculate the gain based on these two halves. A sale price of $100,000 would be divided in half to equal two shares of $50,000 each. There would be no gain on the date-of-death half (sale price $50,000 – date-of-death basis $50,000 = 0), but the original basis half would have gain of $25,000 (sale price $50,000 – original basis $25,000 = $25,000).

Stocks and Bonds

The same issue regarding gain exists for stocks and bonds. The beneficiary's basis in the stock or bond will be the value as of date of death. If the beneficiary sells the stock or bond for a price greater than the basis, he or she will have to report the gain. On the other hand, if a beneficiary sells the stock or bond for less than the basis, he or she may report a loss on their personal income tax return. This is a much more common scenario in a stock market with falling values than had previously occurred during the rising stock market of the 1980s and 1990s.

United States Savings Bonds

Depending on the type of savings bond, interest accrues until the bond is cashed and, thus, is not taxed until that time. The income tax has been deferred. This often surprises the beneficiary, who was not anticipating having to pay any, much less all, of the income tax due on the savings bond. One way to handle this issue is to elect to show this interest income on the decedent's final income tax return and pay the income tax due. This is appropriate if the decedent's tax bracket is lower than the beneficiary's tax bracket and would thus lower the amount of tax paid, as well as provide an estate tax deduction. Another option is for the beneficiary to not cash all of the savings bonds at once, but rather to develop a plan to cash them in over a period of years, thus spreading the impact of the income tax into the future in smaller amounts.

Retirement Plans, IRAs, and 401(k) Plans

These plans also deal with deferred income tax. Again, it is the beneficiary who will be responsible for paying the tax due. If the beneficiary is the spouse of the decedent, he or she may often do a rollover into their own plan and, thus, avoid having to pay any income tax at that time. Other beneficiaries may want to consider taking the payments in installments rather than in a lump sum, if that option is available to them.

Trust Income and Principal Distributions

Income distributions from a trust will need to be shown on the beneficiary's personal Form 1040 and may cause the beneficiary to have to pay tax on the distribution, depending on the beneficiary's tax situation. As previously noted, the benefit of having the income taxed at the beneficiary's tax rate is that it is lower than the trust's tax rate.

Principal distributions from a trust will not generate any income tax on the beneficiary's personal Form 1040. This is in essence the "bequest" which the beneficiary is receiving.

If a trust directs that income is required to be paid to beneficiaries, the trustee should actually make such distributions. When this provision is included in a trust agreement, the income is taxed to the beneficiaries, even if they have not received any distribution from the trust.

Form K-1

The beneficiary will receive Form K-1 (beneficiary's share of income, deductions, credits, etc.) from the estate or trust. This form shows the amount of taxable distributions which the beneficiary has received from the estate or trust which the beneficiary must show on his or her personal Form 1040. The beneficiary should wait to receive Form K-1 before preparing his or her Form 1040 to avoid the necessity of redoing their income tax return to include this information.

CONCLUSION

We hope this booklet has helped notify you of some of the tax aspects involved in the estate settlement and trust administration process. Clearly, there are a wide range of issues and situations to address, depending on the particular estate or trust involved, as well as the beneficiary's personal tax situation. Plante & Moran is available to help you sort through the complexities of estate and trust taxation. If you have any questions, please contact us for additional information or a personal consultation.

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