



The §645 Election: The Benefits are Many and the Detriments are Few

ESTATES & TRUSTS: Use the election when trust distributes to charity or to preserve an S corporation selection.

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IRC §645 provides an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes. When the election is made by the executor and trustee, tax advantages available to an estate are available to the trust.

Advantages of Making the Election

Ability to elect a fiscal year: Unlike trusts, which are required to adopt a calendar year end, estates can elect a fiscal year end. This makes it possible to shift income from one year to another, but keep in mind that income could be doubled in the final year.

The charitable set-aside deduction under IRC §652(c)(2) would be available to the trust. Trusts generally can only deduct the amounts that are paid to charities in the current or following year. Estates can take a charitable deduction for income "set-aside" to be distributed to the charity at a later date.

Example 1-4: Client dies and her will provided that her entire residual estate would be given to her favorite charitable organization. The estate earned \$50,000 of interest income during the year and no distributions were made to the charity that year. Pursuant to the will, this amount was set aside for future distribution to the charitable beneficiary of her estate. The estate will be allowed a contribution deduction for the amounts of income set aside for future distribution (IRC §642(c)(2)) and will pay no tax on that income.

Example 1-5: Client dies and her trust provided that the residue of her trust would be given to her favorite charitable organization. The trust earned \$50,000 of interest income during the year and no distributions were made to the charity that year or the following year.

No §645 election was made to treat the trust as part of the estate for income tax purposes. The trust will not get a charitable set-aside deduction, even though the entire residue of the trust is to go to the charity when it is eventually distributed.

The only way the trust can get a charitable deduction in the current year is to make distributions in the current year or the following year to the charity.

Active participation requirement: For estates, the active participation requirement under the passive loss rules is waived for two years. Thus, an estate may deduct \$25,000 of passive rental real estate losses against nonpassive income. For trusts, the rental real estate exemption for active participation is not allowed.

Holding stock: An estate may hold S corporation stock for an unlimited time during administration while a revocable trust may hold the S corporation stock for only two years after the date of death of the grantor.

Multiple exemptions: Estates have a bigger exemption, \$600 versus \$100 or \$300 for trusts, but if the election is made, only the \$600 exemption will be utilized. On the other hand, if the estate and trust each file their own return, two exemptions will be utilized.

Loss deductions: Estates may deduct losses for pecuniary (fixed amount) bequests of in-kind (non-cash) property that has depreciated because an estate and its beneficiaries are not considered related parties. A trust and its beneficiaries are considered related parties, so losses cannot be taken for such distributions for trusts.

Qualified Revocable Trusts (QRT)

An eligible revocable trust is a grantor trust under IRC §676 (power to revoke retained by grantor) at the grantor's death. The power to revoke must be held by the grantor, although it may need approval by a nonadverse person or the grantor's spouse. A testamentary trust cannot be a QRT (it would not be revocable at the grantor's death), nor can a trust that is the distributee of a QRT that previously made a §645 election.

How the Election is Made

The §645 election must be made on Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, by the due date, including extensions, of the estate's initial income tax return. Or, if there is no personal representative, for the first taxable year of the trust filing as an estate. If a trust does not meet the income tax filing requirements for an initial short year, but wants to make the §645 election, it still must make the election by the due date including extensions, for the short initial year.

Tax identification numbers (TINs) must be obtained for both the electing QRT and the related estate. If there is no executor, a TIN is only required for the QRT.

It is possible to have more than one QRT. If that is the case, each trustee must make the election and sign the Form 8855.

This election is effective for two years after the date of death (if no federal estate tax return is required); otherwise, it is effective until six months after the final determination of estate tax liability.

How is the Income for the Estate and Trust Reported on the Return?

The trust's and the estate's items of income, deductions, and credits are included on the combined Form 1041 for the electing trust and related estate under the TIN for the related estate.

The separate share rule generally will apply when a qualified revocable trust is treated as part of the decedent's estate. Under the separate share rule, the estate's portion of income and deductions and the trust's portion of income and deductions would be treated as separate shares, and distributable net income would be calculated separately for each.

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Example 1-6: Trustee of the family trust and the executor of the estate make a §645 election. For the current year, the trust has \$50,000 of interest income and \$5,000 of administrative expenses.

The trust made distributions of \$45,000 to the surviving spouse. The estate has \$10,000 of dividend income and \$2,000 of administrative expenses. No distributions were made from the estate property.

Distributable net income (DNI) must be calculated separately for the trust and estate. In this case, the trust would have DNI of \$45,000 and the estate would have DNI of \$8,000.

The surviving spouse would receive a K-1 reporting \$45,000 of interest income, while the estate would end up paying tax on \$8,000 of dividend income at the estate level.

If the DNI calculation was combined, the result would be DNI of \$53,000, but the K-1 to the beneficiary would report part of the income as interest income and part as dividend income.

Recommendation

Even though the §645 election, once made, is irrevocable, (Treas. Regs. §1.645-a(e)(1)) it should almost always be made for a qualified revocable trust when the grantor dies. Imagine the malpractice involved with not getting a charitable income tax deduction, or blowing an S corporation election because the §645 election was not in place.

The only downsides are the loss of the trust's personal exemption (a separately filed income tax return for the trust would get a \$100 or \$300 exemption, while the combined filing results in only a \$600 exemption for the estate) and the loss of the use of the lower income tax brackets for the trust when the estate and trust are combined. There may be other reasons (i.e. litigation between the estate and trust) for not making the election, but the reasons for making the election are strong.

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Footnotes:

- 1 IRC §642(c)(2)
- 2 Treas. Regs. §1.645-a(e)(1)

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