

Why Make the IRC 645 Election

Take-Away: A timely IRC 645 election after a decedent's death can add flexibility and possibly help a trust to save income taxes.

Background: We just passed the date for the election under the Tax Code for distributions made in the first 65 days of the new calendar year to be treated as if those distributions had been made in the prior calendar year. [IRC 663(b).] The benefit of such an election is to shift income from the trust to the trust beneficiaries who are normally in a lower marginal income tax bracket.

There is yet another important tax election that can be made regarding a decedent's trust that provides perhaps even more tax-related benefits, which is an election that is made under IRC 645.

IRC 645: An election under IRC 645 permits a qualified revocable trust (QRT) to be treated as part of the settlor's estate for federal income tax reporting purposes. This exposes the trust's income to many opportunities and options that are available only to a decedent's estate.

QRT: The term *qualified revocable trust* is a trust that on the date of the decedent's death was treated as owned by the decedent by reason of his/her power to revoke or reacquire the trust's assets. [IRC 676.] With this definition, if the decedent could only revoke his/her trust with the approval of an adverse party, or if that power was held by a nonadverse party, that trust will not qualify as a QRT. [Regulation 1.645-1(b)(1).] If the settlor had more than one QRT an IRC 645 election may be applied to all of those trusts.

Election: The Personal Representative and the trustee of the QRT must join in making the election. Form 8855 is used to make the election, with the Personal Representative filling in Part 1, and the QRT trustee filling in Part 3 of that Form. If there are multiple QRTs, the respective trustees must join in making the election, but they must appoint one QRT trustee as the 'filing trustee' who is responsible to file Form 1041 for the combined QRTs.

Irrevocable Election: Once the IRC 645 election is made it is irrevocable. [IRC 645 (a) and (c).]

Timing: Sometimes the trustee of the QRT will make the election, well before the subsequent appointment of a Personal Representative (PR.). In that case, an amended Form 8855 is required to be filed if the PR agrees with that election. If there is a disagreement, the 645 election period terminates on the day before the PR was appointed.

Election Due Date: The election must be made no later than the filing due date, including extensions, of the Form 1041 for the first tax years of the related decedent's estate, or for the first tax year of the QRT if the trustee is making the election. Note that even if there is insufficient income to file a Form 1041 for that first tax year, the election must still be timely filed. [IRC 645(b)(2).]

Effect of Election: If an effective IRC 645 election is made, then the related estate and the electing trust(s) are treated as separate shares for purposes of computing distributable new income and applying distribution provisions. [Regulation 1.645-1(e)(2)(iii) and 1.663(c)-4(a).]

Trust Identification Number: Each QRT must obtain a new EIN following the decedent's death, whether or not an IRC 645 election is made. [Regulation 301.6109-1(a).]

Termination: The election is terminated on the day that both the electing trust and the related estate distribute all of their assets, if earlier than the two-year period described earlier.

Benefits of a 645 Election: As a generalization, an IRC 645 election allows a QRT to use tax rules that apply to decedent's estates, but not to trusts. A snapshot of those rules follows:

The obvious first is that the election eliminates the need to file separate tax returns. The electing QRT must report its income with the estate's income on a single, combined, tax return.

Fiscal Year: A trust is normally limited to filing its income tax returns on a calendar-year basis. If the combined return using IRC 645 elects a fiscal year-end, that can allow some income shifting from one year to another.

Estimated Taxes: With a 645 election the trust qualified for the estimated tax payment exemption. These estimated tax payments are not required for a period of up to two years following the decedent's death.

S Corporation Shareholder: If a QRT holds subchapter S stock, it must make a Subchapter S trust (QSST) election or an electing small business trust (ESBT) election to be an eligible S corporation shareholder. In contrast, the decedent's estate is an eligible S corporation shareholder, without having to make either a QSST or an ESBT election within two years after the decedent's death.

Charitable Deduction: A charitable set-aside election permits an electing trust to claim an income tax charitable deduction for amounts set aside for charitable purposes, as well as amounts actually paid to charities. [IRC 642(c).]

Active Participation Rule: The Tax Code generally imposes restrictions on the allowance of passive activity losses and credits, like rental activities. [IRC 469(c)(2).] However, it waives the active participation requirement for estates for up to two years. An IRC 645 election automatically waives the active participation requirement for an electing QRT.

Foreign Trusts: A QRT is not required to be a domestic trust, i.e., it can be a foreign trust. Thus, if a foreign QRT makes a 645 election with a related domestic estate, the foreign trust will report its income with the domestic estate on a Form 1041, thus avoiding the need to file a Form 1041-NR tax return for the election period.

Reforestation Deduction: An estate can amortize reforestation expenses permitted under IRC 195(b)(1)(B)(iii), which can extend to the electing trust.

Conclusion: Trusts and decedent's estates are taxed differently, with a lot more flexibility accorded to the taxation of estates. Making a timely 645 election provides that additional flexibility to the decedent's revocable grantor trust, all of which can help save taxes.

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