2

Accounting Periods and Methods

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Introduction

A decedent's estate is created at the time of the decedent's death; however, the tax year begins on the day *after* the decedent's death. Any income received up to and including the date of death is reportable on the decedent's final income tax return. (See Key Issue 2B.)

The initial tax year of a trust generally begins upon the valid conveyance of property to the trust. (See Key Issue 1A for a detailed discussion of the creation of an estate or trust.) A new estate or trust adopts a tax year on or before the time prescribed by law for filing its first return (not including extensions). Trusts generally must adopt a calendar year, as discussed in Key Issue 2A. Conversely, estates can choose a fiscal year or calendar year, as discussed in Key Issue 2B.

The proper Form 1041 to file corresponds to the year in which the fiduciary's tax year begins. For example, if an estate's tax year begins June 1, 2014, and ends May 31, 2015, it would file Form 1041 on 2014 forms. Form 1041 is due by the 15th day of the fourth month following the close of the fiduciary's tax year.

If the tax year of the beneficiary differs from that of the estate or trust, the beneficiary is required to include his or her share of the fiduciary income in his gross income for the tax year of the estate or trust ending with or within his tax year. For example, if the tax year of an estate begins June 1, 2013, and ends May 31, 2014, a calendar-year beneficiary would report the income on his or her 2014 return (even though the income was reported on a 2013 Schedule K-1, as discussed previously).

Choosing an accounting method for tax purposes is important because it affects how and when income and deductions are recognized. An estate or trust may choose its own method of accounting, independent of the method used by the decedent or grantor, as long as the method clearly reflects income. See Key Issue 2C.

References

Rev. Procs. 2001-10, 2001-1 CB 272; 2002-28, 2002-1 CB 815; 2002-39, 2002-1 CB 1046; 2011-14, 2011-14 IRB 330; 2014-16, 2014-9 IRB 606, modified in part by Rev. Proc. 2014-54; 2014-17, 2014-12 IRB 661, modified in part by Rev. Proc. 2014-54; 2014-54, 2014-41 IRB 675; 2015-13, 2015-5 IRB 419; and 2015-14, 2015-5 IRB 450.
Rev. Rul. 90-55, 1990-2 CB 161.

KEY ISSUE 2A Permitted Year-ends for Trusts.

All trusts, except for those listed as follows, are required to use a calendar year (IRC Sec. 644).

1. Trusts that are exempt from tax under IRC Sec. 501(a).
2. Wholly charitable trusts described in IRC Sec. 4947(a)(1).
3. Qualified revocable trusts (QRT) that have elected to be treated as part of an estate [Reg. 1.645-1(h)(4)(ii)]. Note that when the Section 645 election ends, the tax year of the new trust must be a calendar year. (For a discussion of QRTs electing to be treated as part of the estate, see Key Issue 26E.)
4. Grantor trusts treated as wholly owned by the grantor under IRC Secs. 671–679 (Rev. Rul. 90-55).

Example 2A-1 Tax year for certain charitable trusts.

The Jarrell Hightower Charitable Trust is a charitable lead trust which provides that all income is to be distributed to certain charities during Jarrell's lifetime. Upon Jarrell's death, the trust principal is to be distributed to Jarrell's daughter, Jennifer.

This trust is not a wholly charitable trust as described in IRC Sec. 4947(a)(1). Instead, it is referred to as a split-interest trust (as are charitable remainder trusts). Therefore, it is required to use a calendar year for tax purposes. (See Chapter 25 for coverage of charitable trusts.)

If the trust is treated as owned by the grantor, the tax year of the trust is disregarded, and the grantor must report the gross income from the trust as if the trust does not exist. The grantor trust will normally use the same tax year as the grantor to facilitate the grantor's tax reporting process. See Key Issue 26K for reporting requirements of grantor trusts.

Example 2A-2 Tax year of a grantor trust.

Acme Corporation established a revocable trust for the benefit of certain key executives. The trust is treated as wholly owned by the corporation according to the grantor trust provisions of IRC Secs. 671–679. Acme has a June 30 fiscal year for its corporate tax year.

Acme, as the grantor of the trust, is treated as the owner of the entire principal and income of the trust. Thus, IRC Sec. 644, which imposes the calendar-year requirement for trusts, does not apply. The trust would report on a June 30 fiscal year, in accordance with the reporting rules for grantor trusts.

Unlike partnerships and S corporations, trusts are not allowed to make an election under IRC Sec. 444 to adopt a fiscal year.

Initial Short Tax Year

A fiduciary is not required to annualize income or prorate the personal exemption in the initial short year for a trust [IRC Sec. 443(c)].

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cash-basis taxpayer to recognize income when an item is credited to the taxpayer's account or made available without restriction, even if the item has not actually been received [Reg. 1.451-2(a)].

Expenses are generally deductible in the year of actual payment. However, prepaid expenses are deductible only in the year to which the expenses apply [Reg. 1.461-1(a)(1)]. Any expenses that relate to a future period must be capitalized and amortized over the period covered by the prepayment [Reg. 1.263(a)-4(d)(3)]. However, cash-method taxpayers are not required to capitalize prepaid expenses that create a benefit which expires on or before the earlier of: (1) 12 months after the first day on which the taxpayer realizes the benefit of the expense or (2) the end of the tax year after the year payment is made [Reg. 1.263(a)-4(f)(1)].

Although taxpayers with inventory generally cannot use the cash method, certain small businesses are allowed to use the cash method for the following exceptions:

1. *$1 Million Gross Receipts Exception.* Small businesses with average gross receipts of $1 million or less may use the cash method of accounting even if the taxpayer would otherwise be required to use the accrual method of accounting due to the presence of inventories (Rev. Proc. 2001-10).

2. *$10 Million or Less Gross Receipts Exception.* Certain taxpayers with average annual gross receipts of more than $1 million, but no more than $10 million, are allowed to use the cash method of accounting, regardless of whether they would otherwise be required to account for inventories (Rev. Proc. 2002-28). A taxpayer has average annual gross receipts of $10 million or less if, for each prior tax year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three-tax-year period ending with the applicable prior tax year does not exceed $10 million. However, the cash method is not available for a farming business or if the taxpayer's principal business activity for the preceding year is described by one of the following North American Industry Classification System (NAICS) codes: (1) mining (NAICS codes 211 and 212), (2) manufacturing (NAICS codes 31–33), (3) wholesale or retail trade (NAICS codes 42 and 44–45), and (4) information industries (NAICS codes 5111 and 5122). (See **www.census.gov/eos/www/naics** for more information on NAICS codes.)

Even if their principal business activity is described in an ineligible NAICS code, taxpayers that otherwise qualify can use the cash method if their principal business activity is:

1. providing services (including providing property incident to those services), or

2. fabricating or modifying tangible personal property upon demand in accordance with customer design or specifications.

Although the inventory accounting rules do not apply to qualifying small businesses taking advantage of the relief provision, merchandise on hand at the end of the year cannot be deducted. Instead, the cost of the merchandise is accounted for under the non-incidental materials and supplies rule of Reg. 1.162-3. This provision requires cash method taxpayers to expense the cost of these items only as they are consumed or used in the taxpayer's business or, if later, when the taxpayer pays for the items.

Any inventories of the qualifying small business must be accounted for under the rules of Reg. 1.162-3 (the inventory items are treated as materials and supplies that are not incidental). Such items on hand at year-end must be counted, and the cost is deducted in the latter of (1) the year the item is sold (or consumed in providing services to a customer) or (2) the year the item is paid for by the taxpayer.

Accrual Method. Under the accrual method, income generally is reported in the year earned, and expenses are deducted in the year incurred. The underlying principle behind the accrual method is to match income and expenses in the appropriate year. For this reason, the accrual method is generally required for purchases and sales of inventory [Reg. 1.446-1(c)(2)]. Income would not be clearly reflected if purchases were deducted in a different period from which sales of those items were recognized.

For income to be recognized or an expense to be deducted, all events to establish the right to receive that income or determine the existence and amount of a liability must have occurred, and the amounts must be able to be determined with reasonable accuracy [IRC Sec. 461(h)(4); Reg. 1.446-1(c)(1)(ii)]. For expenses, the all-events test is not satisfied until economic performance occurs. In other words, for liabilities arising from the performance of services or the receipt of goods, economic performance occurs as the goods and services are provided [Reg. 1.461-4(d)].

The 12-month rule for prepaid expense is also extended to accrual-based taxpayers if the qualifications of the economic performance rules are satisfied. This generally means that items cannot be deducted (or amortized) before the goods or services giving rise to the expense are furnished, even if the benefit derived from those expenses does not extend beyond 12 months (or, if earlier, beyond the close of the following tax year) [Reg. 1.263(a)-4(f)(6)].

Although most fiduciaries use the cash method of accounting, when they choose to use the accrual method of accounting or are required to use it (e.g., because they maintain inventories and are not eligible for the small business exceptions described previously), they must pay particular attention to the Section 461 economic performance rules and other rules unique to the accrual method.

Hybrid Method. A hybrid method is permitted when a combination of cash, accrual, and other methods is needed to clearly reflect income and expenses (e.g., accrual method is used for purchases and sales and the cash method for other items of income and expense).

Tangible Depreciable Property. In 2013, final regulations were released explaining how taxpayers can deduct or capitalize expenses for maintaining, fixing, or replacing tangible property. The rules expand a *de minimis* safe harbor for expensing certain costs and apply a routine maintenance safe harbor to buildings. The regulations generally apply to tax years beginning on or after January 1, 2014 [Reg. 1.263(a)-3(n)(1)].

In August of 2014, additional final regulations on the treatment of depreciable tangible property dispositions were issued. These regulations also generally apply to tax years beginning on or after January 1, 2014 [Reg. 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8]. When these rules require the capitalization of tangible property costs (rather than allowing current deductions for such costs), the capitalized amounts are generally depreciated for federal income tax purposes under the familiar MACRS depreciation rules.

The final regulations provide that assets may be grouped into one or more general asset accounts (GAAs). In general, each GAA must include assets that have the same depreciation method, recovery period and convention, and are placed in service in the same taxable year. However, special rules apply for establishing GAAs in certain circumstances. For example, assets eligible for the additional first year depreciation deduction (see Key Issue 8G) cannot be grouped with assets ineligible for the additional first year depreciation deduction. Also, assets eligible for the additional first year depreciation deduction may be grouped only with assets eligible for the same percentage of the additional first year depreciation [Reg. 1.168(i)-1(c)]. For more information on the new final tangible property regulations and the accounting method changes needed to comply with these regulations, see Chapters 3 and 14 of *PPC's 1120 Deskbook* and Rev. Procs. 2014-16, 2014-17, and 2014-54.

Changing Accounting Methods

A fiduciary generally elects a particular accounting method when an initial return is filed using that method. A different method of accounting may be used for each distinct business of the taxpayer [Reg. 1.446-1(d)].

A change of accounting method generally requires IRS consent, initiated by filing Form 3115 (Application for Change in Accounting Method). Certain situations allow for an automatic consent to change an accounting method; however, such situations are quite limited and not common for estates and trusts. To determine whether a situation warrants an automatic consent, see the instructions for Form 3115.

Preparation Pointer: When available, the automatic change procedures are generally much easier to follow and allow taxpayers to avoid the user fee that normally must be paid when Form 3115 is filed.

Currently, Rev. Proc. 2011-14 (or Rev. Proc. 2015-13 for Forms 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014) provides general guidance on the procedures for automatic and non-automatic accounting method changes. Rev. Proc. 2015-14 provides a comprehensive list of all automatic method changes.

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Note: Rev. Proc. 2015-13 was recently revised to allow for a more liberal transition rule than the one provided in the original version. The revision in section 15.02(1) allows taxpayers to choose whether to use Rev. Proc. 2015-13 or Rev. Proc. 2011-14 for automatic accounting method changes for their 2014 tax returns. Taxpayers who have already prepared a Form 3115 (Application for Change in Accounting Method) for their 2014 tax year using the procedures in Rev. Proc. 2011-14 will be permitted to use those procedures, rather than those in Rev. Proc. 2015-13.

Caution: Although Rev. Proc. 2011-14 and Rev. Proc. 2015-13 provide uniform procedures for making many of the automatic accounting method changes, it is a lengthy document that contains special rules in some instances. In addition, rules for taxpayers under examination are provided. Thus, for taxpayers eligible for an automatic method change, the revenue procedure should be carefully reviewed.

Automatic Changes for Tangible Property. As discussed previously in this key issue, final regulations under IRC Secs. 162 and 263(a) were released by the IRS in 2013, addressing the deduction and capitalization of amounts paid to acquire, produce, or improve tangible property and provide for several additional automatic accounting method changes. Effective for tax years beginning on or after January 1, 2014, an automatic accounting method change is available for changes related to repairs and maintenance and materials and supplies in Rev. Proc. 2014-16.

Regulations have also been released under IRC Secs. 167 and 168 dealing with depreciation and amortization of leasehold improvements and other fixed assets. Automatic accounting method changes related to the depreciation and disposition of fixed assets for tax years beginning on or after January 1, 2014, are available in Rev. Procs. 2014-17 and 2014-54.

For more detailed information on the changes in accounting method resulting from the final tangible property regulations), see Chapters 3 and 14 of *PPC's 1120 Deskbook*.

Accounting Method versus Error Correction. A change in accounting method should not be confused with the correction of an error, which is handled on an amended return. Examples of such errors include mathematical or posting errors, improper timing of income or expense recognition, and a correction of the recovery period of depreciable property.

Income in Respect of a Decedent

If the decedent used the cash basis of accounting, only the income items actually or constructively received prior to death are included on the final Form 1040. If the decedent used the accrual basis of accounting, the income items actually accrued through the date of death are reportable on the final individual return. However, amounts accrued only by reason of death are not included on the final Form 1040 [IRC Sec. 451(b)]. Such income, which the decedent had a right to receive but was not reported on his final return, is referred to as "income in respect of the decedent" (IRD). IRD is included in taxable income in the tax year received, regardless of the accounting method used by the estate or other recipient (IRC Sec. 691). It retains the same character in the hands of the recipient as it would have had in the hands of the decedent. A detailed discussion of IRD is covered in Key Issue 9A; deductions in respect of a decedent (DRD) are covered in Key Issue 12B.

Related-party Limitations

IRC Sec. 267(a) imposes two limitations affecting trusts related to another party. The first limitation disallows losses from the sale or exchange of property, directly or indirectly, between related parties [IRC Sec. 267(a)(1)]. The second limitation applies to related parties using different methods of accounting. In such situations, no deduction is allowed to a payor for amounts paid to a related payee until the payee includes the amount in gross income [IRC Sec. 267(a)(2)]. For example, a trust that uses the accrual method can only deduct expenses owed to a related party in the year in which the payment is included in the income of the related party. In effect, this rule requires the accrual-method-trust to use the cash method for reporting deductions with a related cash-method taxpayer and prevents related parties from obtaining a current deduction and deferred income recognition for the same item.

For purposes of the Section 267(a) limitations, related parties include [IRC Sec. 267(b)]:

1. a grantor and a fiduciary of any trust;

2. a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

3. a fiduciary of a trust and a beneficiary of the trust;

4. a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

5. a fiduciary of a trust and a corporation, if more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; and

6. an executor of an estate and a beneficiary of such estate (unless the sale or exchange is in satisfaction of a pecuniary bequest).

Multiple trusts with the same beneficiaries are not related, assuming the grantors are different.

Example 2C-1 Related-party restrictions.

The Hannah Jones Estate conducted an accrual-basis proprietorship during 2014 while the personal representative tried to find a buyer for the decedent's business. Karen Jones, Hannah's daughter, managed the business during this period. Karen was also a beneficiary of the estate. At December 31, 2014, the end of the estate's tax year, the estate accrued a $10,000 salary payable to Karen for the month of December. The salary was paid in January and represented 2015 income to Karen, who reports on the cash basis.

The estate cannot claim a deduction for the $10,000 accrued salary payable to Karen because Karen reports on the cash basis, and the estate and Karen are related parties under IRC Sec. 267(a). If Karen had included the salary in her 2014 income, the estate could have taken the deduction that year.

The determination of whether the parties are related is made at the close of the tax year for which the deduction would otherwise be allowed [IRC Sec. 267(a)(2)(B)]. Once a deduction has been deferred because of the related party rule, it is not allowed until the amount is includable in the gross income of the person to whom payment of the amount is made, even if the parties cease to be related at an earlier time [Temp. Reg. 1.267(a)-2T(b)].

Additional implications of the related-party rules are discussed in Key Issue 5J regarding capital asset transactions, Key Issue 7H for passive activity losses, and Key Issues 18B and 18C for property distributions.

discussion of the tax consequences and reporting of life insurance proceeds by an estate or trust, see Key Issue 3H.

Preparation Pointer: The IRS provides a worksheet to reconcile a decedent's information forms (e.g., 1099s, W-2, etc.) in Publication 559, "Survivors, Executors, and Administrators." It can assist the preparer with deciding which items are reported on the final Form 1040, and which are reported by the estate or beneficiary.

Some trusts and estates are subject to an additional tax, the net investment income tax (NIIT) if they have undistributed net investment income that exceeds a certain threshold. Key Issue 21B discusses when the NIIT applies, how the tax is calculated, and how it can be avoided or minimized.

References

Rev. Proc. 2015-14, 2015-5 IRB 450.
Rev. Ruls. 64-104, 1964-1 CB 223; 68-145, 1968-1 CB 203; 79-409, 1979-2 CB 208; 92-47, 1992-1 CB 198; 2000-2, 2000-1 CB 305; and 2006-26, 2006-22 IRB 939.

KEY ISSUE 3A Reporting Amounts Inconsistent with Form 1099 Reporting.

For many types of income, fiduciaries are instructed to attach a corresponding form from the Form 1040 series to Form 1041. However, Form 1040, Schedule B (Interest and Dividend Income), is not required. Therefore, preparers of fiduciary returns should focus on determining the correct amount and proper classification of income, which may not agree with Form 1099.

Decedent's Accounting Method Determines Who Reports Income

The method of accounting regularly used by a decedent before death determines the income to be included on the final Form 1040. Since most individuals use the cash method for reporting investment income, only those items actually or constructively received through the date of death are reported on the final return. When interest income accrues during the period that includes the date of death of a cash-basis taxpayer, the interest earned at the date of death but posted after death is income in respect of the decedent (IRD) and is reportable by the estate or other recipient when received (IRC Sec. 691). (See Key Issue 9C for discussion of when investment income is considered IRD.)

Example 3A-1 Interest accrued at date of death and constructively received before death.

Pop Werner, a cash-basis individual, invested $100,000 in a 4%, one-year certificate of deposit on October 1, 2014, with interest credited to his account on a monthly basis. Pop died on December 1, 2014. The CD matured, and the principal and interest were paid to his estate on October 1, 2015. The Form 1099-INT reported the entire $4,000 interest income in 2015 to Pop, using his social security number.

Since Pop was a cash-basis taxpayer, but was in constructive receipt of the interest income earned up to the date of his death, $667 of the $4,000 interest income should be reported on Pop's final Form 1040, whereas $3,333 is taxable to the estate in 2015.

Variation: If the interest earned on the certificate of deposit was not credited to Pop's account until the maturity date, none of the interest would be reported on Pop's final Form 1040 because he was not in constructive receipt of the interest before then. The entire $4,000 interest income would be reported on the estate's fiduciary income tax return. The $667 interest earned through Pop's date of death is income in respect of a decedent (IRD). See Key Issue 9A and Example 9A-1 for additional discussion on IRD.

Practice Tip: Executors and trustees typically request information from the bank regarding (a) the decedent's account value on his or her date of death [used when preparing the decedent's estate tax return (Form 706), if required] (b) the interest credited to the account from the beginning of the year to the date of the decedent's death (used to report the interest on the decedent's final Form 1040), and (c) interest from the date of the decedent's death to the end of the year (used to report the interest on the estate's fiduciary income tax return). The bank will often determine the pre- and post-death interest for reporting purposes.

Example 3A-2 Unredeemed bond coupons held at date of death.

Maude Laird died July 2. At the time of her death, she owned $5,000 of interest coupons on SBC bonds, payable June 30. The executor discovered the coupons during an inventory of Maude's safe deposit box and redeemed the coupons for cash.

Maude is considered to have constructively received the $5,000 of interest income before her death. Thus, the interest is reportable on her final Form 1040 and not on Form 1041, even though the estate received the cash. The IRD rules do not apply in this example.

If an individual dies after dividends are declared but before the date of record, the dividends will be included in the gross income of the estate because the estate will be the owner of record on the record date. If the individual dies after the date of record but before the dividends are received, the dividends will be included in the individual's gross estate for estate tax purposes and will be IRD to the estate (or other recipient) when received for income tax purposes.

Example 3A-3 Dividends received shortly after death.

Jack Horner died on August 5, 2014. At the time of his death, Jack owned 100 shares of Acme Corporation common stock. On July 15, Acme had declared a $15 per share dividend payable to shareholders of record on August 1, payable on August 10. The Form 1099-DIV from Acme for 2014 included the August 1 dividend under Jack's name and social security number.

Generally, dividends are constructively received when available for use by the decedent without restriction (i.e., on the date they are payable). Since Jack died after the time the dividend was declared but before the payment date, the dividend is not taxable on his final individual return. The executor may, however, consider reporting the dividend on Form 1040, Schedule B and then "backing" it out, to comply with the IRS matching program for Forms 1040.

Since Jack died after the date of record, the dividends are IRD. If Jack's estate is subject to estate tax, the estate is eligible for an income tax deduction under IRC Sec. 691(c) as discussed in Key Issue 12C.

Practice Tip: As soon as possible after an individual's death, the executor should apply for an employer identification number (EIN) for the estate. The application is made on Form SS-4 (Application for Employer Identification Number). The EIN should then be given to all payers of interest, dividends, and other types of income required to be reported on information returns. See Key Issue 1A for a discussion on EINs.

Short-term Capital Gain from Mutual Funds

Regulated investment companies (e.g., mutual funds) are required to report short-term capital gains as ordinary dividends. Trusts and estates should report such dividends as ordinary income and include them in distributable net income (DNI). However, the short-term capital gain portion of the dividends may not be includable in fiduciary accounting income, depending upon the terms of the governing instrument or applicable state law (Ltr. Ruls. 9811036 and 9811037). See Key Issues 16A and 16B for additional information about fiduciary accounting income and Key Issue 17C for coverage of DNI.

Nominee Reporting Not Required for Estates and Trusts

Anyone receiving a Form 1099 for amounts that belong to another taxpayer should generally file a Form 1099 showing the actual owner as the recipient and the nominee as the payer. The nominee, not the original payer, is responsible for filing the subsequent Forms 1099. However, nominee reporting is not required for interest and dividend income when the record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and taxpayer identification number of the actual owner and furnishes a Schedule K-1 to the actual owner [Regs. 1.6042-2(a)(1)(ii)(A) and 1.6049-4(c)(2)(i)].

Example 3A-4 Nominee reporting not required.

Assume the same facts as discussed in Example 3A-3. Even though a Form 1099 was mailed to the decedent's address and used the decedent's social security number, no further information reporting is

Practice Tip: For estates and complex trusts, tax savings can be achieved by preserving as much of the qualified dividends as possible (to the extent of DNI). As discussed in Key Issue 13F, it is tax-beneficial to allocate indirect expenses first to taxable income that is subject to higher tax rates (e.g., interest or rental income) to the extent possible, then to qualified dividends and long-term capital gains (if included in DNI), which are taxed at a maximum rate of 20%.

Extraordinary Dividends or Taxable Stock Dividends

When a simple trust [as defined in IRC Sec. 651(a) and Reg. 1.651(a)-1] receives extraordinary dividends (whether in cash or property) or taxable stock dividends, such dividends are excluded from distributable net income (DNI) if, for accounting purposes, the fiduciary allocates such amounts to principal under the terms of the governing instrument or applicable state law [IRC Sec. 643(a)(4)]. The significance of this rule is that the income is taxable to, yet not distributable by, the simple trust. The trust will be taxed on the dividends because the dividend amount is not included in the distribution deduction.

Example 3C-1 Taxable stock dividends received by a simple trust.

The Joe Jones Testamentary Trust received certain stock dividends taxable under IRC Sec. 305(b). The terms of the trust agreement provide that all income is to be distributed currently, and the instrument does not provide for any charitable contributions. Only fiduciary accounting income was distributed during the year. Therefore, the trust is a simple trust under IRC Sec. 651(a). Though the stock dividends are taxable for federal income tax purposes, the trustee properly allocated the dividends to principal in accordance with state law.

Although all income is required to be distributed currently, the trust will be subject to tax on the stock dividends. DNI, and thus the distribution deduction, does not include taxable stock dividends or extraordinary dividends received by a simple trust and properly allocated to principal.

When a complex trust or an estate receives extraordinary or taxable stock dividends, the dividends are included in DNI, even if allocated to principal by the fiduciary.

Neither the Code nor the regulations provide a definition of "extraordinary" dividends for DNI inclusion. "Extraordinary" in this context apparently refers to a corporate distribution other than an "ordinary" dividend that belongs to accounting income as defined by the governing instrument or applicable local law. See Key Issue 16B for additional discussion of fiduciary accounting income.

KEY ISSUE 3D Reporting Interest on U.S. Savings Bonds.

Interest income is included in net investment income when determining whether the net investment income tax (NIIT) applies. See Key Issue 21B for a discussion of this tax and when it applies.

Types of U.S. Savings Bonds

Series E and EE. Paper Series E and EE U.S. savings bonds are zero coupon investments issued at a discount. The interest is paid at maturity when the coupons are redeemed for their full face value. Electronic Series EE bonds are issued at their face value. The face value plus interest is paid at maturity. For each year prior to maturity, the bond's redemption value increases. This annual increase in value represents the interest accrual for each year. Series E bonds were last issued in 1980 and matured in 2010. Since then, U.S. savings bonds have been designated as Series EE.

The government extended the maturity date for some Series EE bonds. Interest continues to accrue on these bonds past the original maturity date until the final maturity date. This interest is reported using the same method as applied before the original maturity date.

Series H and HH. Series H and HH U.S. savings bonds were issued at face value and pay taxable interest in cash twice a year (taxable on receipt by cash-basis taxpayers). Series H bonds were issued until 1979 with a 30-year maturity. Since then, these coupon payment bonds have been designated as Series HH. Series HH bonds were acquired only by exchanging Series E or EE bonds. Exchanging a Series E or EE bond for a Series HH bond did not cause a cash-basis taxpayer to recognize the deferred interest income on a Series E or EE bond (IRC Sec. 1037). Instead, that income is recognized when the Series HH bond matures, which can be up to 20 years later [IRC Sec. 454(c)]. This exception to income recognition does not apply, however, to taxpayers who have elected to accrue the income on the Series E or EE bond (discussed later in this key issue). No new Series HH bonds have been issued after August 31, 2004, when the Treasury discontinued the exchange of Series E and EE bonds for Series H and HH bonds.

Series I. Series I bonds combine the features of deferring taxes on the interest until maturity with inflation protected growth. Series I bonds are 30-year instruments. They were first issued in September 1998 and contain a fixed interest rate and an inflation-adjusted rate. The bonds are issued at face value. Interest is added to the bond monthly, compounded semi-annually, and paid when the bond is redeemed. Series EE bonds cannot be exchanged for Series I bonds, and Series I bonds cannot be exchanged for Series HH bonds.

Alternatives for Reporting Interest Income

Cash Method. Cash-basis taxpayers generally report interest earned on Series EE and I bonds in the year of maturity (or in the year redeemed, if earlier).

Accrual Method Election. Alternatively, taxpayers can elect to report the interest on the accrual method (i.e., as earned) [IRC Sec. 454(a)]. This election also applies to Series H and HH bonds received in exchange for E or EE bonds, as well as the new Series I bonds (Ltr. Rul. 8217231). The taxpayer can make the election to accrue interest income in any year prior to selling or otherwise disposing of U.S. savings bonds. Once made, the election applies to all U.S. savings bonds owned currently (year of election) and subsequently acquired. In the year of election, the taxpayer reports all income accrued on the bonds from the date of acquisition. See the sample election statement at Election E209.

The election to convert to the accrual method for U.S. savings bond interest should be considered and weighed against the lost “time value of money” when:

1. Additional current income would be taxed at a lower rate than income in the bond’s year of maturity.

2. The tax rate is relatively low for the final return of a deceased taxpayer in relation to the tax rate of the estate or beneficiaries. (The tax implications of U.S. savings bonds owned at death are discussed later in this key issue.)

3. Additional current income may go untaxed (e.g., taxable income is below the filing limit).

4. A net operating loss or other carryforward item is expiring or otherwise could be used to offset the additional income.

5. Additional current income would be offset by expenses in the year of termination [the beneficiary may not be able to deduct the excess deductions (see Key Issue 24D) because they are reduced by 2% of AGI].

The election to accrue interest on U.S. savings bonds is irrevocable without IRS consent. However, taxpayers may obtain automatic consent to change back to the cash method for reporting interest income from U.S. savings bonds (Rev. Proc. 2015-14, Appendix Section 16.01). A sample revocation can be found at Election E211. The change back to the cash method cannot be made retroactively.

Practice Tip: Although not required, it is a good practice to identify U.S. government interest on Schedule K-1 to beneficiaries on “Other Information,” Line 14 (Code I). U.S. government interest may have state tax implications for beneficiaries.

Calculating the Annual Income Accrual

In the election year, the current reportable income is the end-of-the-year redemption value for all such bonds owned on the last day of the year, less their purchase price. In subsequent years, the annual income is the difference between the redemption value at the current year-end and the redemption value at the previous year-end. The

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Depreciation and Depletion

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Introduction

Depreciation expense is normally reported initially on Form 4562 (Depreciation and Amortization). However, estates and trusts are not required to attach Form 4562 to Form 1041 if the only depreciation is for assets, other than listed property, placed in service in prior years. Instead, the *fiduciary's share* of depreciation expense is entered on the appropriate lines of Schedules C (or C-EZ), E, or F (Form 1040), and the net amounts flow to page 1 of Form 1041. If the depreciation is not related to a specific business or activity, it is reported on line 15a "Other deductions not subject to the 2% floor." According to IRS instructions, all deductions in this category must be listed by type and amount on a separate schedule attached to Form 1041. As discussed in Key Issue 8A, depreciation and depletion that are apportioned to beneficiaries are *not* included on page 1 of Form 1041, but are reported directly to the beneficiaries on Schedule K-1.

Depletion expense is reported in a similar manner, except there is no form for depletion corresponding to Form 4562. If percentage or statutory depletion is claimed, special limitations apply, as discussed in Key Issue 8K.

Frequently, estates and trusts will have tax years of less than 12 months for their initial or final tax reporting periods. In such situations, the short-tax-year rules for depreciation may apply; see Key Issue 8L.

For a complete discussion about fiduciary accounting income and when such income is reduced by depletion and depreciation, see Key Issue 16A.

Depreciation on property placed in service after 1986 and accelerated depreciation of real property placed in service before 1987 usually will generate adjustments and tax preference items for alternative minimum tax purposes. Percentage depletion in excess of the property's basis is no longer a tax preference item for oil and gas properties. As discussed in Key Issue 22A, Schedule I of Form 1041 must be completed for every estate or trust that claims an income distribution deduction or if the fiduciary's share of alternative minimum taxable income exceeds $22,500.

All relevant depreciation tables, including summaries of tax depreciation rules, are included in the Depreciation Tables section. In addition, worksheets for computing depreciation, cost depletion, percentage depletion, and carryover are included at Worksheets W201, W202, and W203.

References

Rev. Procs. 89-15, 1989-1 CB 816; 2002-33, 2002-1 CB 963; 2007-16, 2007-4 IRB 358; 2011-14, 2011-4 IRB 330; 2011-41, 2001-35 IRB 188; 2014-16, 2014-9 IRB 606; 2014-17, 2014-12 IRB 661; 2014-54, 2014-41 IRB 675; and 2015-13, 2015-5 IRB 419.
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Carol, Sue, 30 BTA 443 (Tax Ct. 1934).

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Gutman, Edna C., 143 F.2d 201, 32 AFTR 942 (2nd Cir. 1944), *aff'g* 1 TC 365 (1942).
Lamkin, W.H., 533 F.2d 303, 38 AFTR 2d 76-5218 (5th Cir. 1976).
Nissen, Ida, Estate, 41 TC 522 (1964), *rev'd* 345 F.2d 230, 15 AFTR 2d 1009 (4th Cir. 1965).

KEY ISSUE 8A Apportioning Deductions among Fiduciary and Beneficiaries.

General Rules

Certain assets, sometimes referred to as wasting assets, lose value over a period of time because of exhaustion, wear and tear, and obsolescence. When such assets are used for the production of income or in a trade or business, taxpayers are allowed a deduction for depreciation or depletion. Theoretically, this deduction represents the decrease in economic value of the assets.

Selecting depreciation methods is one of the few post year-end tax planning decisions a fiduciary can make. While the fastest available method generally results in the lowest tax, this rule of thumb does not work when a taxpayer has expiring benefits (e.g., net operating losses) or is subject to the alternative minimum tax (AMT). Selecting the fastest depreciation method may increase the AMT adjustments and thus provide no net tax savings. When a fiduciary (or a beneficiary) is in an AMT position, electing a slower depreciation method and using the same method for both regular and AMT may provide a better tax result.

Elections E201, E202, E203, and E204 contain depreciation elections that can avoid or minimize the AMT adjustment. In addition, AMT related to depreciation and depletion is covered in Key Issue 22A.

Note: Personal property placed in service after December 31, 1998, has recovery periods for AMT that conform to MACRS. Thus, no adjustment is necessary [IRC Sec. 56(a)(1)(A)(i)].

The tax treatment of trust and estate depreciation and depletion is governed by IRC Sec. 642(e), which indicates that fiduciaries are allowed a depreciation or depletion deduction (on Form 1041) only to the extent the deduction is not allowed to the current income beneficiaries. IRC Sec. 642(e) refers to IRC Sec. 167(d) for the treatment of depreciation and to IRC Sec. 611(b) for the treatment of depletion.

See Key Issues 5F and 5G, respectively, for discussions of the basis of trust property and property acquired from a decedent. Unless the estate was created in 2010 and the executor elected to apply the modified carryover basis rules (see Key Issue 5G), the depreciable basis for property passing from the decedent to an estate is the stepped-up (or down) value on the decedent's date of death. Prior methods and accumulated depreciation are ignored, as further discussed in Key Issue 8I.

In 2013, final regulations were released explaining how taxpayers can deduct or capitalize expenses for maintaining, fixing, or replacing tangible property. The rules expand a *de minimis* safe harbor for expensing certain costs and apply a routine maintenance safe harbor to buildings. The regulations generally apply to tax years beginning on or after January 1, 2014 [Reg. 1.263(a)-3(n)(1)]. In August of 2014, additional final regulations on the treatment of depreciable tangible property dispositions were issued. These regulations also generally apply to tax years beginning on or after January 1, 2014 [Reg. 1.168(i)-1, 1.168(i)-7, and 1.168(i)-8]. When these rules require the capitalization of tangible property costs (rather than allowing current deductions for such costs), the capitalized amounts are generally depreciated for federal income tax purposes under the familiar MACRS depreciation rules.

The final regulations provide that assets may be grouped into one or more general asset accounts (GAAs). In general, each GAA must include assets that have the same depreciation method, recovery period and convention, and are placed in service in the same taxable year. However, special rules apply for establishing GAAs in certain circumstances. For example, assets eligible for the additional first year depreciation deduction (see Key Issue 8G) cannot be grouped with assets ineligible for the additional first year depreciation deduction. Also, assets eligible for the additional first year depreciation deduction may be grouped only with assets eligible for the same percentage of the additional first year depreciation [Reg. 1.168(i)-1(c)]. For more information on the new final tangible property regulations and the accounting method changes needed to comply with these tangible property regulations and the accounting methods changes needed to comply with these tangible property regulations, see Chapters 3 and 14 of *PPC's 1120 Deskbook* and Rev. Procs. 2014-16, 2014-17, and 2014-54.

Amortization

Estates and trusts may deduct amortization for intangible assets amortizable over 15 years under IRC Sec. 197, pollution control facilities under IRC Sec. 169, and for certain other property under Reg. 1.642(f)-1. The rules for allocating the deductions among fiduciaries and beneficiaries are the same for allocating depreciation and depletion deductions.

Apportionment Rules for Trusts

If property is held in trust, the allowable deductions for depreciation and depletion are apportioned among the current income beneficiaries and the trust on the basis of the trust accounting income allocable to each, *unless* the governing instrument (or local law if the instrument is silent) requires or permits the trustee to maintain a *reserve* and the reserve is, in fact, maintained [Regs. 1.167(h)-1(b), 1.611-1(c)(4), and 1.642(e)-1]. (However, if the instrument or local law determines who is entitled to the depreciation deductions, those persons may claim the deductions regardless of their respective shares of the trust income.) The purpose of a reserve is to preserve principal for the remainder beneficiaries, and it is accomplished by retaining a portion of current income at the trust level. For fiduciary accounting purposes, when a trustee maintains a reserve, a portion of income (cash) is transferred to principal (cash). Theoretically, at the end of the useful life of the asset, the trust will have accumulated enough in the reserve to replace the asset.

If the trust instrument is silent about setting aside a reserve for depreciation or depletion at the trust level, local law determines if a reserve is permitted or required. Local law means the statutes of the jurisdiction such as the state trust act, trustee powers act, income and principal act, as well as state and federal court decisions that construe the law of the particular state jurisdiction. Local law also provides the basis for interpreting the trust instrument if its wording is ambiguous concerning the establishment of reserves. In addition, the federal determination of ambiguity is made according to the standards of local law. See Key Issue 16A for a discussion of determining applicable local law.

When a trust instrument requires mortgage principal payments to be charged against income, and no depreciation reserve is maintained, tax depreciation is still apportioned based on the amount of fiduciary accounting income allocable to the beneficiary (see Example 16C-7). See Key Issue 16A for a discussion of the interaction of the governing instrument, state law, and federal tax concepts.

Example 8A-1 Tax depreciation deduction follows trust income.

Under the terms of the trust instrument and applicable local law, the fiduciary accounting income of the Jennifer Jones Trust is to be computed without regard to depreciation, depletion, or amortization. No reserves for these items are maintained by the trustee. All income is to be distributed to Margie Jones. In the current year, regular tax depreciation expense is $10,000.

Since the fiduciary accounting income distributable to Margie is not to be reduced by depreciation, no depreciation deduction is claimed on Form 1041. The $10,000 expense is reported to Margie directly on Schedule K-1.

If the trust document requires or permits the trustee to maintain a *reserve* (and the trustee actually does so), the tax deduction is first allocated to the trust to the extent income is set aside for the reserve, and any part of the income tax deduction in excess of the income set aside for the reserve is apportioned among the income beneficiaries and the trust on the basis of trust accounting income (in excess of the income set aside for the reserve) allocable to each [Reg. 1.167(h)-1(b)].

Trust accounting income is not reduced by depreciation or depletion expense unless there is a reserve required or permitted by the trust instrument (or required by local law if the instrument is silent), *and* the reserve is actually funded by the trustee. Also see Key Issue 16A for a complete discussion about trust accounting income and when such income is reduced by depreciation or depletion expense.

Example 8A-2 Reserve required by trust instrument.

Under the trust instrument, the trust accounting income of the Bill Witherspoon Children's Trust is to be distributed to Debbie Witherspoon. The trustee is directed to maintain a reserve for depreciation to the extent allowed under local law. The addition to the depreciation reserve in the current year is $20,000. Tax depreciation expense is also $20,000.

The $20,000 tax depreciation expense is deductible by the trust on Form 1041. The addition to the reserve is also a deduction in computing trust accounting income. Therefore, funding of the $20,000 reserve will decrease the cash distribution to Debbie by $20,000.

Caution: The instrument is often silent regarding depreciation or depletion reserves. Most local statutes will not convey the power to a trustee to establish reserves unless there is explicit wording in the trust instrument. Sometimes a direction to the trustee to preserve trust principal is sufficient to permit the establishment of reserves. Other jurisdictions require a more explicit statement in the instrument requiring or permitting reserves. Thus, the law

If the will had permitted discretionary distributions of estate income during administration, and the executor had made such distributions, the depreciation expense allowable for income tax purposes would have been apportioned among the estate and its heirs in proportion to the *income of the estate* allocable to each. The term *income* here means the amount of income determined under terms of the governing instrument or local law (i.e., fiduciary accounting income) [IRC Sec. 643(b)].

Note: Applicable depreciation or depletion expense in the year of the decedent's death must be allocated between the periods before and after the date of death. Using the decedent's basis, the expenses are calculated through the date of death and reported on the taxpayer's final Form 1040. After the date of death, depreciation is generally calculated using the stepped-up (or stepped-down) basis under IRC Sec. 1014. Under the general rules (step-up or step-down in basis), a new depreciation method may be used, and the depreciation is reported on the estate's initial Form 1041. However, for estates created in 2010 that elected to apply the modified carryover basis rules instead of federal estate tax, depreciation is calculated using the decedent's modified carryover basis under former IRC Sec. 1022, with special rules that apply if the executor allocated any basis increase to the property. (See Key Issue 8I for a discussion of depreciation on property acquired from a decedent.) Cost depletion is similarly affected by the change in basis, while percentage depletion is calculated based on the income earned after death. Depletion applicable to the period after the date of death is also reported on the estate's initial Form 1041.

For additional discussion of the basis of property acquired from a decedent, see Key Issue 5G.

Reporting Depreciation Recapture

When a trust or an estate sells a depreciable asset subject to Section 1245 or Section 1250 recapture, Form 4797 is completed to calculate the recapture amount. The ordinary income (i.e., recapture) portion is reported on the line provided for ordinary gains and losses in the "Income section" on page 1 of Form 1041. There is no provision in the Internal Revenue Code to report the depreciation recapture separately to the beneficiaries even though the related depreciation expense may have been reported separately to them. The ordinary income from depreciation recapture is simply a noncash component of distributable net income. See Key Issue 5N for additional discussion on calculating depreciation recapture.

Because bonus depreciation is an accelerated depreciation method, it is subject to recapture under IRC Secs. 1245 and 1250. See Key Issue 8G for more discussion of bonus depreciation.

Depreciation Corrections vs. Accounting Method Changes

Normally, corrections of errors, which should not be confused with accounting method changes, are handled on an amended return. However, if a method of computing depreciation (or of expensing or capitalizing costs) is considered an accounting method (see Key Issue 2C), changes can only be made by requesting a change in accounting method, rather than filing an amended return. A change to depreciation that is *not* an accounting method change generally can be made by amending the return.

The IRS has long held that a depreciation method must be used for two consecutive years before it is considered an accounting method. Under this rule, correcting a depreciation error occurring only for a single year required filing an amended return, rather than filing a change in accounting method. However, the IRS has waived the two-year rule, thus allowing taxpayers who wish to correct a depreciation method used only in the preceding year (that is, for only a single tax year) to do so by filing either an amended return or a Form 3115 (Rev. Proc. 2007-16). This simplifies filing for taxpayers changing a depreciation method they have used in the prior year and in years before that, since all the changes can be made on a single Form 3115.

Note: If the mistake has been made for only one year, an accounting method would not have been established, and it can be corrected on an amended return.

Once a method is adopted, taxpayers must receive IRS permission to change it, generally by filing Form 3115. (See the discussion of changing accounting methods in Key Issue 2C). Permission to change is required even if the taxpayer's accounting method is erroneous (for example, depreciating an asset over the wrong recovery period).

Tangible Property Dispositions. Rev. Proc. 2007-16 permits automatic accounting method changes with regard to depreciation on certain disposed property when the taxpayer did not claim the full amount of depreciation allowed or allowable. This means that taxpayers do not permanently lose the benefit of previously understated depreciation deductions. Rev. Proc. 2011-14 (as modified by Rev. Proc. 2012-20), or Rev. Proc. 2015-13 for Forms 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014, provides the guidelines for obtaining automatic consent, but it generally requires attaching a completed Form 3115 (Application for Change in

Accounting Method) to the return for the year of change and also filing a copy with the IRS Ogden Office. Rev. Procs. 2011-14 and 2015-13 contains comprehensive guidance on automatic changes in accounting methods.

Note: Rev. Proc. 2015-13 was recently revised to allow taxpayers to choose whether to use Rev. Proc. 2015-13 or Rev. Proc. 2011-14 for automatic accounting method changes for their 2014 tax returns.

See Key Issue 2C for information on changes in accounting methods. For detailed information on the accounting method changes required to comply with the final tangible property regulations, as discussed in Key Issue 8A, see Chapters 3 and 14 of *PPC's 1120 Deskbook* and Rev. Procs. 2014-16, 2014-17, and 2014-54.

KEY ISSUE 8B Allocating Deductions from Another Pass-through Entity.

Depreciation from Another Estate or Trust

If a trust or estate is a beneficiary of another trust or estate, the depreciation expense or cost recovery deduction is first allocated to the recipient trust or estate by the fiduciary entity owning the property. The recipient trust or estate then divides the deduction according to the rules explained in Key Issue 8A.

Example 8B-1 Depreciation allocated from another fiduciary.

After a review of the trust documents, the preparer of the current year Form 1041 for Trusts Alpha and Beta determines that half the net income of Trust Alpha is to be paid to Trust Beta. In turn, Trust Beta must pay 25% of its income to individual beneficiary Charlie. Both trust instruments are silent as to depreciation reserves, and no reserves have been set aside by either trustee.

The current year tax depreciation expense for Trust Alpha's real property is $100,000. Of this total, $50,000 is allocated to Trust Beta under the general rule discussed in Example 8A-1 (depreciation expense allocated according to trust income). Thus, $12,500 (one-fourth of the $50,000) is allocable to the individual beneficiary, Charlie, under the same rule. If Trust Beta itself owns depreciable properties, 25% of the depreciation on those directly owned properties will also be allocated to Charlie.

Depreciation from Partnership or S Corporation Property

Partnerships. If an estate or trust holds a partnership or limited liability company (LLC) interest, an issue will arise as to how the depreciation, depletion, and amortization incurred by the partnership or LLC should be allocated to the estate or trust. According to Rev. Rul. 74-71 and IRC Sec. 702(a)(7), an estate or trust must separately take into account its distributive share of the partnership depreciation, depletion, or amortization deduction when its resulting tax liability is determined differently than if the item were not taken into account separately. Because of the unique manner in which depreciation, depletion, and amortization are allocated between the estate or trust and its income beneficiaries, the income tax liability of the estate or trust, as the recipient partner, could be different if depreciation were not stated separately. However, if the estate or trust made no distributions, the requirement to separately state depreciation, depletion, or amortization should not be necessary since no fiduciary accounting income (and thus, depreciation deduction) would be allocable to the beneficiaries.

In practice, most partnerships do not separately state depreciation due to the administrative burden. The only partners with potentially different income tax liabilities would be estates or trusts, and the partnership may not realize that some of its partners are estates or trusts. Although a fiduciary could fulfill this requirement for separately stated depreciation by requesting the specific information from the partnership after receiving the Schedule K-1 from the partnership, it may be difficult to obtain this information in sufficient time to prepare the Schedule K-1 from the estate or trust.

Example 8B-2 Depreciation allocated from a partnership.

The Ryan Family Children's Trust (Trust) holds an interest in the Farm Partnership. This year the Schedule K-1 from Farm Partnership reported income to the trust of $10,000 and an alternative minimum tax (AMT) depreciation preference of $1,000. The Trust distributed all income for the year. It does not maintain a depreciation reserve.

Since all income was distributed to the beneficiaries, the depreciation should be reported directly on Schedule K-1 (Form 1041) to the beneficiaries. However, this information typically is not separately stated on the Schedule K-1 from the partnership. In the authors' opinion, the AMT depreciation preference can be distributee who receives income from an estate will not be allocated a prorata portion of the tax depreciation, depletion, or amortization deductions unless such beneficiary is also either an heir, legatee, or devisee of the specific property generating the deductions. Therefore, the estate in *Estate of Ida Nissen* was allocated the deduction since the recipients of estate income were discretionary beneficiaries and not heirs, legatees, or devisees of the property giving rise to the deduction. Instead, they were beneficiaries of legatees (i.e., the residuary trusts).

A different conclusion was reached by the Fifth Circuit Court of Appeals when an executor made distributions of income during estate administration to income beneficiaries of a testamentary trust to which the estate assets were to be distributed (*Lamkin*). (The testamentary trust had not yet been funded.) The court concluded that if the trust beneficiaries had received the income from the future trust, rather than from the estate, the depreciation deduction would have been allocated prorata to the trust beneficiaries. It further reasoned that the income distribution was constructively made from the estate to the trust, and then by the trust to the income beneficiaries. Thus, the income beneficiaries were entitled to the depreciation deductions from the estate property.

The distinction between the results in *Lamkin* and *Estate of Ida Nissen* is that in *Estate of Ida Nissen*, the will authorized income distributions during estate administration, whereas in *Lamkin*, it did not. The distributees in *Estate of Ida Nissen* received income distributions from the estate according to their status under the will as discretionary income distributees, rather than as future trust beneficiaries. Thus, the distributees in *Estate of Ida Nissen* were not considered heirs, devisees, or legatees of the specific property giving rise to the depreciation deduction accruing to that property. In fact, the distributees in *Estate of Ida Nissen* could have received income generated by assets other than that which was distributed.

Example 8F-1 Distributions to discretionary distributees.

Margret Mayberry died while living in the Fifth Circuit in 2014. Her will directed that the residue of her estate form the principal of a trust but did not specifically authorize the distribution of income during the estate administration. Although the trust was not funded until 2015, the executor distributed its inception-to-date income in December 2014 to Susan, the sole trust beneficiary. Included in the income was $5,000 of net rental income. The rental property tax depreciation for the period ending December 31, 2014, was $3,000.

Because the will did not provide for the distribution of income during the period of administration, the executor's distribution to Susan, as the future income beneficiary of the trust, must be based on her status in relation to the trust. In other words, the income distribution was constructively made from the estate to the trust, and then by the trust to Susan. Thus, the depreciation from the estate property can be allocated to Susan, as beneficiary of the future trust.

KEY ISSUE 8G Bonus Depreciation and Special Incentives.

Bonus Depreciation

An additional first-year depreciation deduction (also called bonus depriciation) is allowed for qualified property placed in service after December 31, 2007, and before January 1, 2015 (before January 1, 2016, for certain long-production period property) [IRC Sec. 168(k)]. The bonus depreciation is determined without any proration based on when during the tax year the property was placed in service, so even property placed in service on the last day of the tax year is eligible for the full applicable amount. Regular first-year depreciation is then claimed after reducing basis for bonus depreciation, if applicable.

The bonus depreciation allowance rate is typically 50%. However, property acquired and placed in service after September 8, 2010, and before January 1, 2012 (2013 in the case of long-production property and certain noncommercial aircraft) was eligible for a 100% bonus depreciation rate [IRC Sec. 168(k)(5)].

To be eligible for bonus depreciation, the property must meet three broad criteria:

1. The asset must be qualified property (which includes machinery, equipment, and other tangible personal property; most purchased software costs; and qualified leasehold improvements costs).

2. The original use of the asset generally must begin with the taxpayer after December 31, 2007 (September 8, 2010, for 100% bonus depreciation). Used assets generally do not qualify.

3. The property must have been acquired and placed in service within the applicable time period, generally after December 31, 2007 (September 8, 2010, for 100% bonus depreciation) and before January 1, 2015.

Qualified Property. *Qualified property* must be property that is [IRC Sec. 168(k)(2)(A)]—

1. eligible Section 168 recovery property with a recovery period of 20 years or less,

2. depreciable computer software other than software amortizable under IRC Sec. 197,

3. water utility property defined in IRC Sec. 168(e)(5), or

4. qualified leasehold improvement property.

Electing out of Bonus Depreciation. A taxpayer can elect out of the first-year bonus depreciation for any class of property [IRC Sec. 168(k)(2)(D)(iii)]. See Election E205. (For more information, see Key Issue 14C in *PPC's 1040 Deskbook*.)

Ineligible Property. Qualified property does not include any property subject to the alternative depreciation system (ADS) under IRC Sec. 168(g), other than where the taxpayer has voluntarily elected ADS [IRC Sec. 168(k)(2)(D)]. This precludes the bonus depreciation deduction for property used predominantly outside the U.S., property used by a tax-exempt entity, and tax-exempt bond-financed property. This rule also applies when ADS depreciation is required because of other Code provisions (Rev. Proc. 2002-33). Similarly, bonus depreciation cannot be claimed for listed property used 50% or less for business [see IRC Sec. 280F(b)(1)].

As discussed in Key Issue 8A, an election may be made to group assets subject to the Section 168(a) general depreciation system or the Section 168(g) alternative depreciation system into general asset accounts (GAAs). If the election is made, the property may only be grouped into a GAA with property on which the same percentage applies. Property not eligible for bonus depreciation or property on which the taxpayer elected out of bonus depreciation must be grouped into a separate GAA. For more information on depreciating assets in GAAs, see Chapter 14 of *PPC's 1120 Deskbook*.

Impact on AMT Depreciation. Bonus depreciation is allowed for both regular tax and AMT [Committee Report for the 2010 Tax Relief Act and IRC Sec. 168(k)(2)(G)]. In addition, depreciation claimed for any remaining adjusted basis of the property (for bonus depreciation) is also allowed for both regular tax and AMT. Thus, regular tax and AMT depreciation are the same throughout the entire recovery period of the property.

KEY ISSUE 8H Section 179 Election Not Available to Estates and Trusts.

Taxpayers may generally elect to treat up to $25,000 (for 2014) of the cost of tangible personal property purchased for use in the active conduct of a trade or business as deductible in the tax year in which the property is placed in service [IRC Sec. 179(b)(1)(B)]. Without this election, the cost of the property would be capitalized and recovered through depreciation.

However, IRC Sec. 179 specifically does not apply to estates and trusts [IRC Sec. 179(d)(4)]. Therefore, the fiduciary must capitalize and depreciate all tangible personal property placed in service by the estate or trust with no immediate write-off available.

Note: The existence of a grantor trust is generally ignored as a separate entity for income tax purposes since its tax attributes are ascribed to and reported by the grantor. Although there is no authority explicitly on point, it appears that an individual should be allowed to take a Section 179 expense deduction in connection with assets legally owned by his or her grantor trust (e.g., a revocable trust), provided the other Section 179 requirements are satisfied.

See Key Issue 8B for a discussion of allocating Section 179 expense from a partnership or S corporation. See the Depreciation Tables for ACRS, MACRS, and ADS tables used to compute depreciation for property acquired since 1981 at D101–D304.

IRC Section	Reference
6651(c)(1)	1K
6651(f)	T307; 1K
6652(c)(2)	T307
6654(d)(1)	23C, 23D
6654(d)(2)	23C, 23E
6654(e)(1)	23B, 23C
6654(e)(2)	23C
6654(i)(1)	4D, 23B
6654(i)(2)	4D, 23B
6654(l)	6C, 23B, 23E
6654(l)(2)	23B
6654(l)(4)	23C,23E
6657	T307
6662	C101, T307; 1L, 1M
6662(c)	1L
6662(d)	1L
6662(d)(2)	1L, 1M
6662(h)(1)	1L
6662(i)(1)	1L
6662(j)(3)	1L
6663	T307
6664(a)	1L
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6664(c)	1L
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6676	T307; 1L
6677	T307; 27I
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6694	C101; 1M
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7701(a)(14)	27G
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7701(a)(36)	C101

INTERNAL REVENUE SERVICE RELEASES FINDING LIST

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IRS Release	Reference
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2000-3	12A

NOTICES

IRS Release	Reference
87-32	E105; 23E, 23F, 23G
89-48	1B
95-18	21E
97-24	4A
97-34	T306; 27F, 27H, 27I
98-6	E107; 1B, 26F
98-20	25B
98-66	E107; 1B, 26F
99-17	25B
99-42	23C
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2001-62	1B
2004-83	1B
2005-20	14B
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2009-5	C107; 1M
2010-53	E102
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REVENUE PROCEDURES

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88-22	D101
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91-15	C201; 4A
92-64	26F
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64-104	3D
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66-87	26G
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67-74	5F, 17E, 18C, 18E
67-167	5P
67-241	26G
67-242	12C
68-49	17G, 18C
68-145	E210; 3D, 9C
68-392	17D
68-430	5J
68-667	11H
69-297	9F
69-300	1B
69-486	18C

IRS Release	Reference	IRS Release	Reference	IRS Release	Reference
70-50	6D	76-23	24A	90-55	2A
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74-71	8B	81-244	23J	95-14	6C
74-175	5D, 12B, 14B	83-25	26F	2000-2	3F
74-530	8C	83-75	11C	2003-123	11C
74-613	5P	85-13	26H	2004-5	11A
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References to the Deskbook (the larger binder) are to key issues.
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ELECTION E205

Electing out of Bonus Depreciation

Qualifying property acquired and placed in service after December 31, 2007 and before September 9, 2010 was eligible for additional first-year bonus depreciation of 50% of the property's original basis. Qualified property acquired and placed in service after September 8, 2010 and before January 1, 2012 was eligible for additional first-year bonus depreciation of 100% of the property's original basis. Currently, 50% first-year bonus depreciation applies for qualified property acquired and placed in service after December 31, 2011 and before January 1, 2015. The placed in service dates are generally extended one year for certain qualifying property having longer production periods. Original use of the property must begin with the taxpayer (i.e., only new property qualifies). Qualified property is generally property with a recovery period of 20 years or less, depreciable computer software, water utility property, and qualified leasehold property. Bonus depreciation is allowed for both regular tax and AMT.

A taxpayer may elect not to deduct the additional first-year bonus depreciation for any class of property placed in service during the tax year. The term "class of property" refers to (1) 3, 5, 7, 10, 15, and 20-year recovery period classes; (2) water utility property; (3) depreciable computer software; and (4) qualified leasehold improvement property. The election to not claim the bonus depreciation must be made for all additions within an entire class placed in service for the tax year. Once made, the election is irrevocable without IRS consent.

Caution: The availability of bonus depreciation expires for property placed in service after December 31, 2014. As of the date of this publication, this provision has not been extended past 2014. Practitioners should monitor for legislation extending the provision for 2015 and possibly beyond.

Who Can Elect

Any taxpayer. The election is made separately by each person owning qualified property (i.e., by the taxpayer actually owning the property).

When to Elect

By the due date, including extensions, of the return for the tax year the property is placed in service. If the return was timely filed without the election, an amended return may be filed within six months of the original due date (not including extensions). "Filed pursuant to Section 301.9100-2" should be written on the amended return. Once made, the election may be revoked only with the written consent of the IRS (i.e., a private letter ruling must be requested).

How to Elect

By attaching a statement to the return.

Authorities and References

IRC Sec. 168(k)(2)(D)(iii); Reg. 1.168(k)-1(e). See Key Issue 8G.

Sample Election

ELECTION COMPLETELY OUT OF 50% BONUS DEPRECIATION

Taxpayer elects under IRC Sec. 168(k)(2)(D)(iii) to not claim the additional 50% first-year bonus depreciation deduction for the following classes of property placed in service during the tax year ended [Year-end] : [List for which Election Is Made] .

ELECTION E206

Bond Premium Amortization

A taxpayer can elect to deduct amortization of bond premium for taxable bonds. (Premium amortization is mandatory for tax-exempt bonds.) If the election is made for any such bond, it applies to all bonds held at the beginning of that year and to all bonds thereafter acquired. The election is binding for subsequent years unless the IRS grants permission to revoke. Taxpayers can receive automatic consent to revoke the election, using a cut-off basis and without a Section 481(a) adjustment, under Section 5.01 of Rev. Proc. 2015-14.

Bond premium amortization for bonds acquired after 1987 is a reduction to interest income. Amortization on bonds acquired after October 22, 1986 and before 1988 is treated as investment interest expense or, if elected, as a reduction of interest income; the amortization for bonds acquired before October 23, 1986 is treated as a miscellaneous itemized deduction not subject to the 2% of AGI floor for noncorporate taxpayers and, apparently, is deductible without limitations by corporate taxpayers.

Bond premium amortization is generally advantageous since it reduces taxable income while the bond is held. Without the election, a capital loss is recognized for the premium amount when the bond matures since the premium increases the bond's basis over par value. When the bond is sold before maturity, the increased basis affects the gain or loss from the sale. The only real drawback is the recordkeeping associated with computing and tracking the amortization.

Who Can Elect

Any taxpayer, other than a dealer in bonds, holding taxable bonds acquired at a premium.

When to Elect

With the timely filed return for the first tax year the election is to be effective. Presumably, this is the due date including extensions, although the regulations do not specifically state this. Automatic consent to revoke must be made by the due date, including extensions for the year in which the revocation is effective.

How to Elect

Making the Election. By claiming the amortization deduction on the return and attaching a statement to the return for the first tax year the election is to be effective.

Revoking a Prior Election. Revoking a prior election is a change in accounting method(s) but automatic consent to revoke can be filed in accordance with Rev. Proc. 2015-14. Form 3115 is attached to the tax return for the year of change, and a copy is filed with the IRS National Office. The taxpayer must enter designated automatic accounting method change number "16" on the appropriate line on the Form 3115 and attach a statement.

Authorities and References

IRC Sec. 171(c); Reg. 1.171-4; Rev. Proc. 2015-14, 2015-5 IRB, Sec. 5.01, designated automatic accounting method change number "16." See Key Issue 3E.

Sample Election

ELECTION TO AMORTIZE BOND PREMIUM

Taxpayer hereby elects to amortize bond premium pursuant to IRC Sec. 171(c) and Treasury Regulation 1.171-4(a).

Sample Election

REVOCATION OF ELECTION TO AMORTIZE BOND PREMIUM
(Designated Automatic Accounting Method Change No. 16)

Pursuant to Revenue Procedure 2015-14, taxpayer hereby requests revocation of a prior IRC Sec. 171 election to amortize bond premium for the following reason(s) [Insert reason(s) for the revocation.] .

Taxpayer has used [Insert method used.] method to make the Section 171(c) election.

Taxpayer made the Section 171(c) election on [Insert date of election.] .

ELECTION E207

Bond Market Discount Accrued Using the "Constant Interest Rate" Method

A bondholder must determine the accrued market discount before the disposition of the bond if there is (1) a partial principal payment of the bond or (2) direct interest expense with respect to the bond. This determination must also be made when an election to include accrued bond market discount in current income under IRC Sec. 1278(b) is in effect. (See Election E208.)

Accrued bond market discount generally is calculated using the ratable accrual method. However, a taxpayer may elect to accrue the market discount under the original issue discount (OID) "constant interest rate" rules instead. The election is effective as of the date the bond is acquired.

This election generally will result in less accrued market discount in the early years of holding the bond versus that resulting from the ratable accrual method. However, the complexity of the calculation generally will deter the use of this election since the ratable method calculation is relatively simple and straightforward.

The election is made for either a specific bond or for a class or group of bonds. Once made, the election is irrevocable.

Who Can Elect

Any taxpayer holding a market discount bond.

When to Elect

By the due date, including extensions, of the return for the first tax year in which the taxpayer is required to determine the accrued market discount.

How to Elect

By attaching a statement to the return.

Authorities and References

IRC Sec. 1276(b)(2); Rev. Proc. 92-67, 1992-2 CB 429. See Key Issue 3E.

Sample Election

ELECTION TO ACCRUE MARKET DISCOUNT UNDER THE CONSTANT INTEREST RATE METHOD PURSUANT TO IRC SEC. 1276(b)(2)

Taxpayer hereby elects under Rev. Proc. 92-67 to accrue market discount under the constant interest rate method on the following bonds: [List individual bonds or classes of bonds.] .

The taxpayer was not required to determine accrued market discount for any of the above bonds for any tax year before [Tax Year for which Election Is First Effective] .

ELECTION E208

Including Accrued Bond Market Discount in Current Income

This election allows taxpayers to include market discount in income in the year accrued. This accelerates income recognition that otherwise would occur in the year the bond matures, is redeemed, or is disposed of. Making the election prevents the application of IRC Sec. 1277, which can limit deductions for interest expense in excess of the accrued (but unrecognized) market discount.

The basis of the bonds is increased by the amount of market discount included in gross income under this election.

The election applies to all market discount bonds acquired during the year of the election as well as in any subsequent year. However, if a taxpayer wishes to revoke this election, Section 32.01 of Rev. Proc. 2015-14 allows for automatic IRS consent to the change in accounting method, using a cut-off basis and without a Section 481(a) adjustment.

If this election is made, taxpayers should also consider the election to compute the annual discount accrual using the constant interest rate method (see Election E207).

Who Can Elect

Any taxpayer holding a market discount bond.

When to Elect

By the due date for a timely filed return for the tax year in which the election is desired. Presumably, the due date includes extensions, although Rev. Proc. 92-67 does not specifically state this. Automatic consent to revoke must be made by the due date, including extensions for the year in which the revocation is effective.

How to Elect

Making the election. By attaching a statement to the timely filed tax return.

Revoking the election. Automatic consent to revoke is made by attaching a statement to Form 3115, filed with the return, and a copy of Form 3115 is filed with the IRS National Office. The taxpayer must enter designated automatic accounting change number "73" on the appropriate line on the Form 3115.

Authorities and References

IRC Sec. 1278(b); Rev. Proc. 92-67, 1992-2 CB 429 (section 7 has been modified and superseded by Rev. Proc. 2015-14, 2015-5 IRB, Sec. 32.01, designated automatic accounting method change number "73"). See Key Issue 3E.

Sample Election

ELECTION TO INCLUDE ACCRUED BOND MARKET DISCOUNT IN INCOME CURRENTLY PURSUANT TO IRC SEC. 1278(b)

Taxpayer hereby elects under the automatic consent procedure outlined in Rev. Proc. 92-67 to include accrued market discount in gross income. Taxpayer has used [Insert method used (i.e., the ratable accrual or constant interest rate).] method to determine the market discount attributable to the tax year covered by this return.

Taxpayer agrees to have the election apply to all market discount bonds, regardless of their issue date, that are acquired on or after the first day of the current tax year.

Sample Election

REVOCATION OF ELECTION TO INCLUDE ACCRUED BOND MARKET DISCOUNT IN CURRENT INCOME (Designated Automatic Accounting Method Change No. 73)

Pursuant to Revenue Procedure 2015-14, taxpayer hereby requests revocation of prior election to include accrued bond market discount in current-year income for the following reason(s) ___[Reason(s) for the Revocation.]____.

Taxpayer has used ____[Method Used.]_____ method to make the Section 1278(b) election.

Taxpayer made the Section 1278(b) election on ______[Date of Election.]_____.

Taxpayer will not make a constant interest rate election for any bond that has been subject to the Section 1278(b) election being revoked and for which a constant interest rate election was not effective in the year of acquisition.

ELECTION E209

Accruing Interest on U.S. Savings Bonds

A taxpayer may elect to include in income each year a ratable portion of the excess of the redemption price over the purchase price of U.S. Series EE and I savings bonds. If this election is not made, all income is reported in the year the bond is redeemed, disposed of, or finally matures, whichever is earlier.

Making the election puts the taxpayer on the accrual basis for reporting the income from U.S. savings bonds. This may be advisable for minor children or elderly individuals whose income reported on such basis is not enough to create a tax liability, while recognition of the full amount of income at bond maturity would result in tax. On the other hand, parents who intend to redeem the bonds pursuant to IRC Sec. 135 to pay for the child's qualified higher education expenses might benefit more by not making the election.

The election applies to Series EE and I U.S. savings bonds. It also applies to a retained investment in a matured Series E or EE U.S. savings bond and to nontransferable obligations of the federal government (e.g., Series H or HH bonds) for which a Series E or EE bond was exchanged.

The election is considered an accounting method and applies to all Series EE or I U.S. savings bonds owned in the year of election and any that are subsequently acquired.

In the year of election, the taxpayer must report the cumulative increase in the redemption price from the date of acquisition to year-end for all bonds held at year-end. This includes bonds acquired in prior years. Redemption prices for each year are shown on the U.S. Public Debt Internet site at **www.treasurydirect.gov**.

The election to accrue interest income on U.S. savings bonds cannot be revoked without IRS consent. However, the IRS has provided taxpayers an expeditious means of revoking the election. (See Election E211.)

Who Can Elect

Any cash basis taxpayer.

When to Elect

With the tax return for the year in which the taxpayer desires the election to be effective. Presumably, this is the due date including extensions, although the regulations do not specifically state this. The election can be made on an amended return filed by the due date for the original return.

How to Elect

By filing a statement with the return.

Authorities and References

IRC Sec. 454; Reg. 1.454-1(a). See Key Issue 3D.

Sample Election

ELECTION TO ACCRUE INTEREST ON U.S. SAVINGS BONDS

Taxpayer hereby elects under IRC Sec. 454 to currently recognize as income the increment in the periodic redemption price over original purchase price of U.S. savings bonds described in Reg. 1.454-1(a)(1) that were owned as of January 1, [Year] or that are acquired after that date.

ELECTION E210

Accruing Interest on U.S. Savings Bonds upon Owner's Death

If U.S. savings bonds are transferred after the owner's death, the owner (decedent) used the cash method, did not report the interest each year [i.e., had not made the Section 454 election to accrue interest (see IRC Sec. 454)], and had purchased the bonds entirely with his or her own funds, the person responsible for filing the decedent's final income tax return may, on behalf of the decedent, elect to include all interest earned up to the date of death on the decedent's final income tax return. The estate or beneficiary receiving the bonds then reports only interest earned after the date of death (Rev. Rul. 68-145).

The election applies to Series EE and I U.S. savings bonds. It also applies to a retained investment in a matured Series E or EE U.S. savings bond and to nontransferable obligations of the federal government (e.g., Series H or HH bonds) for which a Series E or EE bond was exchanged.

The election is also available to accrued interest on U.S. savings bonds owned by a grantor trust created by a decedent before death (Rev. Rul. 79-409).

The election to accrue interest income on U.S. savings bonds cannot be revoked without IRS consent. However, the IRS has provided taxpayers an expeditious means of revoking the election. (See Election E211.)

Who Can Elect

The executor, administrator, or other person responsible for filing the decedent's final income tax return.

When to Elect

With the decedent's final tax return. Presumably, this is the due date including extensions, although the regulations do not specifically state this. The election can be made on an amended return filed by the due date for the original return.

How to Elect

By filing a statement with the return.

Authorities and References

IRC Sec. 454(a); Reg. 1.454-1; Rev. Ruls. 68-145, 1968-1 CB 203; 79-409, 1979-2 CB 208. See Key Issue 3D for additional information.

Sample Election

ELECTION TO ACCRUE INTEREST ON U.S. SAVINGS BONDS

On behalf of the decedent taxpayer, an election is hereby made under IRC Sec. 454(a) to currently recognize as income all previously unreported interest income on U.S. savings bonds described in Reg. 1.454-1(a)(1) that were owned as of [Date of Death]. The decedent owner, who had purchased the bonds with [his or her] own funds, used the cash method of accounting, and had not previously elected under IRC Sec. 454(a) to include the annual interest income in gross income.

ELECTION E211

Revoking Income Accrual Election on U.S. Savings Bonds

The election to accrue interest income on U.S. Series EE or I bonds under IRC Sec. 454 may be revoked only with IRS consent. However, the IRS has provided taxpayers with an expeditious method of revoking the election without incurring a user fee. Upon filing the revocation statement in the specified format, the taxpayer receives automatic IRS consent to the method change.

After revoking the previous election to accrue interest income on U.S. Savings bonds [see Reg. 1.454-1(a)], the taxpayer reports income on a bond in the year the bond matures, is redeemed, or is disposed of, whichever is earliest. The revocation has no effect on the interest income previously recognized. It is effective for any unrecognized interest on all Series EE or I bonds held at the beginning of the year in which this election is made and all subsequent acquisitions of Series EE or Series I bonds.

Who Can Elect

Taxpayers who previously elected to accrue interest income on U.S. savings bonds.

When to Elect

By the due date, including extensions, of the return for the tax year in which the revocation is desired.

How to Elect

By filing an election statement with the taxpayer's return.

Authorities and References

IRC Sec. 454; Rev. Proc. 2015-14, 2015-5 IRB, Sec. 16.01 designated automatic accounting method change number "131."

Sample Election

CHANGE IN METHOD OF ACCOUNTING UNDER SECTION 16.01
OF REV. PROC. 2015-14
Designated Automatic Accounting Method Change No. 131

Taxpayer Name: ______________________ EIN or SSN: ______________________

The taxpayer agrees to report all interest on obligations acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest.

The taxpayer agrees to report all interest on obligations acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of any interest income previously reported in prior tax years.

The Series EE or I U.S. savings bonds for which this change in accounting method is requested include:

______________________ ______________________

______________________ ______________________

______________________ ______________________

Year of change: [Insert beginning date.] [Insert ending date.]
(Beginning Date) (Ending Date)