Revocable trusts are an increasingly popular substitute for wills, and for good reason: In many jurisdictions, funding a revocable trust during life can result in substantial time and cost savings after death by avoiding the state law probate system. A funded revocable trust can also be useful in incapacity planning during the grantor’s life. Even an unfunded revocable trust that operates only as a receptacle for the pour-over of an estate provides certain advantages after the grantor’s death, including keeping the details of the grantor’s testamentary dispositions private. This article addresses the recurring tax and reporting issues that arise when the grantor of a revocable trust dies.

Background on Revocable Trusts

In a revocable trust, the grantor retains the right to revoke or amend the trust during his lifetime. In community property jurisdictions, it is fairly common to see married couples creating joint revocable trusts rather than each creating a separate revocable trust. Certain additional nuances introduced by joint revocable trusts do not arise where a revocable trust has a single grantor, particularly to what extent the trust remains revocable by the surviving spouse after the death of the first spouse; but for most purposes, the issues noted in this article apply equally well to the portion of a joint revocable trust that becomes irrevocable at the death of the first spouse.

For maximum convenience, the grantor generally serves as the sole trustee while he has the capacity to do so; alternatively, the grantor may have one or more cotrustees, or may not even be a trustee at all. The grantor no longer individually owns assets transferred to a revocable trust during the grantor’s life, so at the grantor’s death, those assets do not need to pass through the grantor’s probate estate. Revocable trusts are “tax-transparent”—that is, 1) the assets of the trust are includible in the grantor’s estate for estate tax purposes (IRC section 2038); 2) transfers to the trust during the grantor’s life are incomplete gifts for gift tax purposes (Treasury Regulations section 25.2511-2(c)) and therefore do not give rise to gift tax or to a gift tax return filing obligation; and 3) the trust is a grantor trust for income tax purposes during the grantor’s life (IRC section 676), so all items of income, gain, and loss are reportable on the grantor’s income tax return. Note that revocable trusts will be grantor trusts even if they are foreign trusts under IRC section 7701(a)(30) and (31), notwithstanding that it is generally rather difficult to qualify foreign trusts for grantor trust treatment [see IRC section 672(t)].

Taxpayer Identification Number Issues

Although a revocable trust can have a separate employer identification number (EIN) as its taxpayer identification number (TIN), this is not mandatory. Grantor trusts are permitted to use the grantor’s Social Security number (SSN) as their TIN [Treasury Regulations section 1.671-4(b)(2)(A)]. This is particularly convenient, as it obviates the need for filing any Form 1041 for the trust [Treasury Regulations section 1.671-4(b)(1)]. Where a grantor trust has a separate EIN, it can file a rather pro forma “grantor trust return,” but even a pro-forma return is still a filing obligation.

But what happens when the grantor dies? A revocable trust becomes irrevocable at the grantor’s death, but one sometimes hears that the administration of the assets of the trust nonetheless continues seamlessly, in contrast to assets in the decedent’s individual name, which generally cannot be administered at all until a probate court appoints an executor or similar fiduciary. Matters are rarely so simple, however, either from a tax perspective or a non-tax perspective. From a substantive (i.e., non-tax) perspective, while it is true that assets held through a formerly revocable trust do not need to go through probate after the grantor’s death, a successor trustee frequently needs to take over the administration of the trust; in that case, the successor formally accepts the role of trustee and effectively communicates the change in trustee to the financial firms holding the trust’s assets. From a tax perspective, if the trust has been using the grantor’s SSN as its TIN, it will need to obtain its own EIN because the grantor’s SSN dies with the grantor.

Obtaining an EIN is straightforward, but it is now more time-consuming than under the old system, in which the IRS would issue new EINs over the phone. Whereas now, only internation-
al taxpayers can obtain an EIN by phone, and domestic taxpayers must apply online, by fax, or by mail (see the instructions for Form SS-4).

The more tedious aspect of the process stems from the fact that most financial firms will require new accounts to be opened whenever an account’s TIN changes, which simplifies their tax reporting. Specifically, opening a new account allows the financial firm to report taxes under the grantor’s SSN for the period prior to death, and under the separate EIN for the period after death. If no new account were opened, and the separate EIN were simply applied to the existing account, the tax reporting for the whole year would be done—inaccurately—under the separate EIN.

Opening new accounts frequently takes time, generates considerable paperwork, and can result in investment performance history being lost. It might seem that finding a way around the requirement to open a new account would be beneficial. In theory, the need for obtaining a separate EIN for the trust after the grantor’s death (and therefore the need for opening new accounts) can be eliminated if the revocable trust does not use the grantor’s SSN as its TIN during the grantor’s life, but rather has its own EIN even prior to the grantor’s death. The financial firm can then report taxes under that EIN for the whole year of the grantor’s death without doing anything inaccurate.

Without a new EIN and a new account, though, how can a CPA know what income is allocable to the period before death when the trust was a grantor trust and what income is allocable to the period after death when the trust is not a grantor trust? In this case, both a thorough review of all of the account statements and reconciliation with the 1099s will be required. Given that additional work, and the disadvantage of having to file Form 1041 during the grantor’s life if the revocable trust has a separate EIN, it is better to use the grantor’s SSN during the grantor’s life, and open new accounts at the grantor’s death at the cost of greater simplicity.

A situation might arise where a grantor trust did have a separate EIN while the grantor was alive: Should that number be used after the grantor’s death so that new accounts do not need to be opened? Or should a new EIN be obtained to simplify the process of preparing income tax returns for the year of death? The solution may depend upon the number of accounts involved, and how much income was earned prior to death. At a minimum, consider obtaining a new EIN and opening new accounts to avoid the problem of manually allocating income between pre-death and post-death periods.

**Section 645 Election**

The trust ceases to be a grantor trust once the grantor of a revocable trust dies. Depending on its provisions and administration, the trust then becomes a complex trust or a simple trust, but either way it becomes a separate taxpayer with its own reporting obligations, just as the estate of the deceased grantor is a separate taxpayer with its own reporting obligations. Consider making an IRC section 645 election to reduce the number of separate returns required. Section 645 permits the trustee of a formerly revocable trust and the executor of the grantor’s estate to jointly elect to treat the trust as part of the estate for income tax purposes [IRC section 645(a)]. The election can remain in place for two years from the date of death, if no federal estate tax return is required, or for six months after the final determination of the estate tax liability if a federal estate tax return is required to be filed [IRC section 645(b)(2)]. To make the election, Form 8855 must be filed for the estate’s first income tax return by its due date, including extensions [IRC section 645(c)].

Another benefit of the IRC section 645 election is that unlike a trust, an estate can elect a fiscal year (IRC section 644). The longest permitted fiscal year is generally the one that commences with the first of the month in which death occurred. Consequently, the formerly revocable trust can usually push off its obligation to pay tax by making this election. This is particularly true because all estates, but not all revocable trusts, are exempt from paying estimated taxes for two years from the date of death [IRC section 6654(i)(2)]. Furthermore, for any decedent whose estate would be a foreign estate [IRC section 7701(a)(3)(A)], electing to treat the formerly revocable trust as part of the estate has two highly significant potential benefits: First, foreign estates and their beneficiaries are not subject to U.S. income tax on their foreign source income (IRC section 641(b), 643(a)(6)). Second, foreign estates, unlike foreign trusts, are not subject to the throwback rules applicable to undistributed net income [IRC section 665(a)].

**Preparing Form 706**

When preparing the federal estate tax return (Form 706), or any state estate tax return that is based upon the federal return, assets held by a revocable trust should be reported differently than assets the decedent owned in his or her own name. While individually owned assets are listed on different schedules depending on the nature of the asset (i.e., real estate on Schedule A, stocks and bonds on Schedule B), all assets owned by a revocable trust are reported on Schedule G, regardless of the type of asset. On Part 4 of the return itself, only question 13(a)—which asks whether any trusts created by the decedent during his lifetime existed at the time of his death—and question 12—which asks whether the decedent made any transfer described in sections 2035, 2036, 2037, or 2038—need to be answered in the affirmative. These questions can easily be missed, because so many of the other questions are answered in the negative.

**The Trust Legacy**

Revocable trusts have long been the primary testamentary document in certain jurisdictions where probate is notoriously difficult or expensive to navigate, but revocable trusts are becoming commonplace even in states where estate planners have traditionally relied only on wills. Using a will or a revocable trust as the primary testamentary document is a decision each individual must make with his estate planning attorney, based on non-tax considerations such as privacy and cost. Because thorny tax issues can arise after a grantor’s death, CPAs who know how best to handle those issues can provide reassuring advice to individuals who might be unprepared to deal with them.

*Ian Weinstock, JD, is a partner at Kostelanetz & Fink LLP.*