

**CALIFORNIA LAWYERS ASSOCIATION  
TAXATION SECTION  
2024 WASHINGTON, D.C. DELEGATION PAPER**

**ADDRESSING THE NEEDLESS DIFFERENCES IN ELECTIONS AVAILABLE TO  
TRUSTS AFTER THE ENACTMENT OF THE IRC SECTION 645 ELECTION  
(IRC §§645)**

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<sup>2</sup> Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law; no such participant has been specifically engaged by a client to participate in this paper.

## EXECUTIVE SUMMARY<sup>3</sup>

IRC section 645 was enacted in 1997 because of the increasing use of revocable trusts as will substitutes to avoid probate in many states. IRC section 645 was added by the Taxpayer Relief Act of 1997, as section 646 and redesignated as section 645 by the IRS Restructuring and Reform Act of 1998. Section 645 sets forth the statutory requirements for making the election to treat certain trusts as part of an estate. According to the legislative history, the 645 election is intended to minimize the tax differences between estates and trusts that essentially serve the same estate administration function during a reasonable period of administration. H.R. Rep. No. 105-148, at 379 (1997). The Internal Revenue Service issued final regulations for section 645 on December 4, 2002.

Section 645 provides in pertinent part that if both the executor of an estate and trustee of a qualified revocable trust elect the treatment provided in section 645, such trust shall be treated and taxed as part of such estate (and not a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable period. A section 645 election can be used to combine the qualified revocable trust and estate into one entity for tax purposes, allowing only one Form 1041 to be filed. If the 645 election is made, trust income and deductible expenses will be reported by the estate on the estate's income tax return, and the trust will be treated as part of the estate, even though the trust, rather than the estate, continues to hold the assets.

Today, most estate plans utilize a "pour-over" last will and testament and a revocable living trust as the cornerstone of the estate plan, rather than just a comprehensive last will and testament. Because of this, there are seldom probate estates, hence in most instances the 645 election is not available unless an estate is opened. In many cases the only reason to open an estate is to allow the trust estate to qualify for the 645 election. There is however no need to have differences in elections between estates and trusts and the specific utilization of IRC section 645. By making a 645 election, the electing trust gets to take advantage of elections that are available to estates, but generally not to trusts. This paper will seek to address how it is more efficient and sound tax policy to allow trusts and estates to use the same elections and allow a trust without a corresponding estate to avail itself of a 645 election.

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## DISCUSSION

### I. CURRENT LAW

IRC section 645 allows a qualified revocable trust to be treated as part of a decedent's estate for federal income tax purposes, rather than as a separate entity, under certain circumstances. If both the executor of an estate and the trustee of a "qualified revocable trust" elect the treatment provided in this section, such trust shall be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date." [IRC section 645.] The election applies from the date of death until the "applicable date", which is defined in IRC section 645(b)(2) as the date two years after the date of death, if no estate tax return is required, or six months after the final determination of estate tax, if an estate tax return must be filed. [IRC section 645(b)(2).] To make this election, as described more fully below, the executor and trustee must timely file Form 8855 election to treat a qualified revocable trust as part of an estate qualified with the IRS. This enables the trust to be taxes as part of the estate during the election time period and the trust income and deductible expenses will be reported by the estate on the estate's income tax return, and the trust will be treated as part of the estate. This election can reduce administrative burden and streamline the tax process for both the estate and trust. Most importantly, this election can also significantly increase the time available to make many elections described herein, particularly in a taxable estate for estate tax purposes.

The final determination of estate tax liability is defined as the earliest of:

1. Six months after the issuance of an estate tax closing letter, unless a claim for refund is filed within twelve (12) months after the issuance of the letter,
2. A final disposition of a claim for refund that resolves the estate tax liability, unless a suit is instituted within six months after a final disposition of the claim,
3. A settlement agreement with the IRS that determines the estate tax liability,
4. Court orders, judgments, decrees, or decisions that resolve the estate tax liability, unless a notice of appeal or a petition for certiorari is filed within ninety (90) days after the issuance of the court order, judgment, decree, or decision, or
5. The expiration of the statute of limitation, as provided in IRC section 6501.

A qualified revocable trust is defined in IRC section 645(b)(1), as any trust that on the date of the decedent's death is treated as owned by the decedent under IRC section 676 by reason of a power of the deceased grantor to revoke or reacquire the trust

assets held by the decedent. If an executor has been appointed for the decedent's estate, an IRC section 645 election may be made by the executor of the decedent's estate and the trustees of each qualified revocable trust joining in the election. If no executor has been appointed for the decedent's estate, an election to treat one or more of the decedent's qualified revocable trusts as an estate may be made by the trustees of each qualified revocable trust joining in the election. [Reg. Sec. 1.645-1(c)(2)(i)].

The executor and trustee (or the trustee if an executor is not appointed) must make the Sec. 645 election no later than the filing due date, including extensions, of the Form 1041 for the first tax year of the related estate, or for the first tax year of the QRT if it is making the election. The due date for filing the election applies even if there is insufficient income to file a Form 1041 for that first tax year (Sec. 645(b) (2); Regs. Sec. 1.645-1(c)).

Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, is used to request an automatic 5½-month extension of time to file Form 1041. If a QRT's trustee is making the Sec. 645 election and needs an extension, the name and EIN of the electing trust will appear at the top of Form 7004, and form code 04 (estate other than a bankruptcy estate) will apply.

A 645 election allows a qualified revocable trust to take advantage of federal income tax rules that apply to estates, but not to trusts. For example, estates unlike trusts, are not required to use a calendar year end, and may use a fiscal year end to defer the recognition of income to the estate and its beneficiaries [see IRC section 441, (b)(1) and 644(a)]. An estate is not required to pay estimated tax for the first two years of its existence [see IRC section 6654(l)(2)(A)]. An estate is entitled to a higher exemption deduction [see IRC section 642(b)]. Additionally, a trust treated as an estate may be able to pass certain losses and deductions through to its beneficiaries at its termination as an estate, even though it may continue in the form of a trust [see IRC section 2053]. Medical expenses incurred by the decedent that are paid by his or her estate in the one-year period after his or her death may be deducted on the decedent's final income tax return, but this deduction is not available if the medical expenses are paid by the trust. We take a look at some of these tax advantages in more detail below.

There are very few downsides to making the 645 election. The only downsides are the loss of the trust's personal exemption (a separately filed income tax return for the trust would get a \$100 or \$300 exemption, while the combined filing results in only a \$600 exemption for the estate) and the loss of the use of the lower income tax brackets for the trust when the estate and trust are combined. There may be other reasons (i.e. litigation between the estate and trust) for not making the election, but the reasons for making the election are typically very compelling.

At the end of the election period, the electing trust's share is deemed to be distributed to a new successor trust (if there is one). If the electing trust continues in existence after the election period terminates and an executor was appointed, the trustee will file Form 1041 under the name and EIN of the electing trust, using a calendar year. If an executor was not appointed, the trustee must obtain a new EIN for the electing trust and file Form 1041 under the trust's new EIN (Treas. Regs. Section 1.645-1(h)(2)(ii)).

## **A. Benefits of Using a §645 Election.**

**1. Availability of a Fiscal Tax Year.** IRC section 644 requires trusts to adopt a calendar tax year. The taxable year of any trust shall be the calendar year. [IRC section 644(a).] However, pursuant to IRC section 441(b)(1), estates may select a fiscal year or a calendar tax year for federal income tax purposes. The 645 Election allows the electing trust to report income in the same tax year as the estate's income, which may be a fiscal year or a calendar year, depending on what the estate elected.

### **2. Increased Personal Exemption Amount.**

Estates have a larger exemption than either simple trusts or complex trusts. IRC section 642(b)(2) allows trusts to use either a one hundred or a three hundred exemption deduction to reduce their taxable income, while estates are permitted a six hundred dollar exemption deduction under IRC section 642(b)(1). By making a 645 election, the trust can now have the increased exemption of six hundred dollars. [Treas. Reg. 1.645-1(e)(2)(ii).]

**3. Extended Payment Deadlines.** Pursuant to IRC section 6654(l)(2)(A), an estate is not required to pay estimated tax until the tax year ending two years following the decedent's death. Estates are also not subject to underpayment penalties during this time. The same is not true for trusts. However, trusts that utilize the IRC section 645 election are not required to make estimated tax payments during their first two years of existence [Treas. Reg. 1.645-1(e)(4)].

**4. Entitlement to a C Charitable Deduction.** Trusts generally can only deduct the amounts that are paid to charities in the current or following years and no charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. [IRC section 681(a)]. Pursuant to IRC section 642(c)(2), estates can take a charitable deduction for income "set-aside" to be distributed to a charity at a later date. The 645 Election allows the electing trust to claim an income tax charitable deduction for amounts set aside for charitable purposes, as well as amounts paid to charities, pursuant to the terms of the governing instrument for the electing trust under IRC section 642(c). [Treas. Reg. 1.645-1(e)(2)(iv).]

### **5. Extended S Corporation Stock Holding Periods.**

An estate is allowed to own S corporation stock for a longer period than a trust. Pursuant to IRC section 1361(c)(2)(A)(ii), trusts can hold S corporation stock for the two-year period beginning at the date of death, and then it must either dispose of the stock or make a Qualified Subchapter S Trust ("QSST") or Electing Small Business Trust ("ESBT") election, if applicable, in order to prevent the termination of the corporation's S-election. Estates can hold the stock for as long as it takes to administer the estate subject only to the prolonged administration rules of Treas. Reg. 1.641(b)-3(a). The 645 election allows a trust to hold S corporation stock beyond the two-year deadline without the necessity of making a QSST or ESBT election if the estate is still being administered beyond that time period. In essence, an estate is an eligible S corporation shareholder for which neither a QSST nor an ESBT election is required. When the 645 election period expires for an estate or electing trust that held S corporation stock, the receiving trust (if there is one) is treated as a testamentary trust that can continue to qualify as an eligible shareholder for another two years before making a QSST or an ESBT election (IRC section 1361(c)(2)(A)(iii)).

Generally, a trust must make either a Qualified Subchapter S S Corporation stock Trust ("QSST") election or an Electing Small Business Trust ("ESBT") election to be an eligible S corporation shareholder under IRC section 1361(c)(2). The election must be made within two years of the decedent's death.

IRC Section 1361(d)(1) provides that a QSST whose beneficiary makes an election under IRC Section 1362(d)(2) will be treated as a trust described in IRC Section 1361(c)(2)(A)(i), and the QSST's beneficiary will be treated as the owner (for purposes of IRC Section 678(a)) of that portion of the QSST's S corporation stock to which the election under IRC Section 1361(d)(2) applies. Under IRC Section 1361(d)(2)(A), a beneficiary of a QSST may elect to have IRC Section 1361(d) apply. Under IRC Section 1361(d)(2)(D), this election will be effective up to fifteen days and two months before the date of the election. IRC Section 1361(d)(3) provides that for purposes of IRC Section 1361(d), the term "qualified subchapter S trust" means a trust (A) the terms of which require that – (i) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current beneficiary may be distributed only to such beneficiary; (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust; and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to that beneficiary; and (B) all of the income (within the meaning of §643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States.

IRC section 1361(c)(2)(v) provides that a trustee may elect to have the trust treated as the owner of S corporation for income tax purposes. IRC Section 1361(e)(1)(A) provides that an “electing small business trust” means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in §170(c)(2)-(5), or (IV) an organization described in §170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under §1361(e) applies to such trust.

A domestic estate, on the other hand, is an eligible S corporation shareholder by default under IRC section 1361(b)(1)(B). The IRC section 645 election allows an electing trust to be an eligible S corporation shareholder without making a QSST or an ESBT election, until the election terminates.

Note, if the trustee fails to make the necessary elections in a timely fashion to qualify a trust as a QSST or ESBT, to hold S corporation stock, then the only remedy available to prevent loss of “S” corporation status, is to apply for a Private Letter Ruling under IRC Section 1362(f) which is an expensive and time consuming process.

**6. Active Participation:** The Code waives the active participation requirement under Sec. 469 for estates for two years following the decedent’s death. The election also waives the active participation requirement for an electing trust.

**7. Foreign Trusts and Estates:** A QRT is not required to be a domestic trust; it may be a foreign trust. If a foreign revocable trust makes a Sec. 645 election and the related estate is a domestic estate, the foreign trust reports its income with the domestic estate on a Form 1041. Form 1040-NR, U.S. Nonresident Alien Income Tax Return, will not be required for the foreign trust during the election period. If a foreign revocable trust makes a Sec. 645 election and the related estate is a foreign estate, the foreign trust reports its income with the foreign estate income on a single combined Form 1040-NR. Note that the information reporting requirements pursuant to Sec. 6048 will continue to apply to a foreign trust even if a Sec. 645 election was made.

## **B. Complexity of Making the Election.**

While there are many benefits of making the 645 election, the election itself is very complex as to having a sophisticated enough trustee and/or knowledgeable tax advisors to recognize that such an election should be analyzed. Just to wade through the requirements to properly make the election is also complex and the rules below summarize the complexity, such that any misstep will mean a valid 645 election was not made.

The executor or trustee makes the 645 election by completing and filing Form 8855. Once made, the election is irrevocable (Secs. 645(a) and (c)).

If an executor is appointed by a court, the executor completes Part I of Form 8855, and the trustee, who may be (but is not required to be) the same person as the executor, completes Part III.

If no executor is appointed by the court, the trustee makes the election on Form 8855 and completes Part I and Part III.

If more than one QRT joins in the election, the trustees of each QRT must appoint one QRT as the filing trust whose trustee completes Part I of Form 8855 and is responsible for filing Form 1041 for the combined electing QRTs.

If an executor is appointed after the trustee of an electing trust makes a 645 election, a revised Form 8855 is required to be filed within ninety (90) days of the appointment if the executor agrees with the trustee's election. If there is no agreement between the executor and trustee, the election period terminates on the day before the appointment of an executor who was not appointed until after the trustee made the 645 election.

If an executor is not appointed and there is only one QRT making the Sec. 645 election, that QRT's trustee will file Form 1041 and use the QRT's employer identification number (EIN) on the income tax return. The trustee checks the box for the decedent's estate in line A. The trustee also checks the box at line G and enters the QRT's EIN on line G as well.

If multiple QRTs join in the election, the trustee of the appointed filing trust will file the income tax return using that trust's EIN. The trustee then enters the EIN for the electing trust with the highest total asset value on line G of Form 1041. In addition, the trustee of the appointed filing trust attaches a statement to Form 1041 providing the name and EIN of each electing trust and the name and address of each trustee.

If an executor is appointed, the executor files the income tax return on behalf of the related estate and uses the estate's EIN. Line G of Form 1041 includes the EIN of the electing trust with the highest total asset value. The executor must also submit a statement as described above if multiple QRTs join in the election.



### III. PROPOSED CHANGES

There is no reason that estates should receive more beneficial elections and more time for making elections than a revocable trust. In order to gain the more favorable rules for estates, a fiduciary could open a shell probate estate and treat the estate and trust as merged for tax purposes. The Trustee can then avail himself or herself of the benefits of a 645 election. After the IRS enacted IRC section 645, there is no need to have differences in elections between estates and trusts. As shown above, by making a 645 election, the electing trust is able to take advantage of the same elections that are available to estates, but generally not to trusts. It is more efficient to allow trusts and estates to be permitted to use the same elections without the artifice of having an estate so the trust may use that estate to gain tax advantages. This procedure is also complex and often missed, hence disadvantaging trust estates that are administered without the advice of tax counsel or other tax professionals and disadvantaging beneficiaries. Thus, the following elections should be allowed and available to both trusts and estates.

**A. Availability of a Fiscal Tax Year.** Allow trusts to select a fiscal year or a calendar tax year as is available with estates.

**B. Increased Personal Exemption Amount.** Allow trusts to have a six hundred dollar exemption deduction to reduce their taxable income.

**C. Extended Payment Deadlines.** Allow trusts to avoid the requirement to pay estimated tax payments during their first two years of existence and clarify that trusts are not subject to underpayment penalties during this time period.

**D. Entitlement to a C Charitable Deduction.** Allow trusts to claim an income tax charitable deduction for amounts set aside for charitable purposes, as well as amounts paid to charities, pursuant to the terms of the governing instrument for the electing trust under IRC section 642(c).

**E. S Corporation Stock/S Corporation Shareholder.** Allow a trust to hold S corporation stock through the period of administration. And, make trusts an eligible S corporation shareholder by default.

**F. Active Participation:** Allow the waiver of the active participation requirement under Section 469 for two years following the decedent's death.

**G. Foreign Trusts and Estates:** Allow the foreign trust to report its income with the foreign estate income on a single combined Form 1040-NR.

The above changes will allow for a more streamlined administration in a trust and avoid pitfalls that occur when a trust does not avail itself of a 645 election. There should be no difference in tax elections and timing between a trust and estate and treating an estate and trust administration equally with regard to benefits and elections allows for better tax policy.

### **III. CONCLUSION**

IRC section 645 was enacted in 1997 because of the increasing use of revocable trusts as will substitutes to avoid probate in many states. As most people today have a trust to avoid probate, there is no reason to have different elections apply for a trust administration versus an estate administration. It is more efficient to have the same elections apply to trusts and estates since most taxpayers these days have a trust to avoid probate. In a trust administration, a 645 election can be made to allow a trust administration to take advantage of the more favorable elections available to estates, if the trustee is aware that such an election should be analyzed and most often should be made. Due to many trust administration being conducted by unsophisticated trustees, this places a disadvantage on many trust estates. If the trust estate had been a probate estate instead, the advantages would automatically apply. This appears to be an unwarranted distinction. Hence the authors propose that estates and trusts be treated the same in regards to beneficial elections, including those discussed herein.