Qualified Funeral Trusts

Notice 98–6

PURPOSE

Section 1309 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (the Act) added § 685 of the Internal Revenue Code to permit certain trusts to elect Qualified Funeral Trust (QFT) status. This notice provides guidance on QFT eligibility requirements, election procedures, and simplified reporting requirements.

BACKGROUND

A pre-need funeral trust arises from an arrangement where funeral merchandise or services are purchased from a seller to benefit a specified beneficiary before the beneficiary's death. A pre-need cemetery merchandise trust arises from an arrangement where cemetery merchandise or services are purchased from a seller to benefit a specified beneficiary before the beneficiary's death. The purchaser enters into a contract with the seller of the funeral or cemetery merchandise or services whereby the purchaser selects the merchandise and services to be provided upon the death of the beneficiary, and agrees to pay for them before the beneficiary's death. Under state law, such amounts (or a portion thereof) are required to be held in trust during the beneficiary's lifetime and are paid to the seller upon the beneficiary's death.

Rev. Rul. 87–127, 1987–2 C.B. 156, addresses the taxation of pre-need funeral trusts. The ruling provides four situations under which funeral trusts are formed and concludes that in all four situations the trust is a grantor trust and the purchaser is treated for federal tax purposes as the owner of the trust. Any amount that a seller receives from the trust (as payment for services or merchandise) is includible in the gross income of the seller.

Section 685 permits the trustees of certain pre-need trusts to elect QFT status on behalf of the trusts. If the election is made, a trust is not treated as a grantor trust and the purchaser would not be subject to tax on trust income. The trustee is liable for the tax on the taxable income of the trust as determined in accordance with the income tax rate schedule generally applicable to estates and trusts. However, the personal exemption deduction under § 642(b) is unavailable.

QFT ELIGIBILITY REQUIREMENTS

Section 685(b) defines a QFT as any trust (other than a foreign trust) if—(1) the trust arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services, (2) the sole purpose of the trust is to hold, invest and reinvest funds in the trust and to use the funds solely to make payments for those services or property for the benefit of the beneficiaries of the trust, (3) the only beneficiaries of the trust are individuals with respect to whom those services or property are to be provided at their death under contracts described in item (1), (4) the only contributions to the trust are contributions by or for the benefit of those beneficiaries, (5) the trustee elects the application of this subsection, and (6) the trust would, but for this election, be treated as owned under subpart E (the grantor trust provisions) by the purchasers of the contracts.

Pre-need cemetery merchandise trusts are substantially similar to pre-need funeral trusts and therefore the analysis in Rev. Rul. 87–127 applies to them. Pre-need funeral trusts and pre-need cemetery merchandise trusts that meet one of the situations under Rev. Rul. 87–127 are grantor trusts and the purchasers of the contracts giving rise to the trusts are the owners of the trusts. Accordingly, these trusts may elect to be treated as QFTs if they meet the other QFT requirements under § 685.

A QFT cannot accept aggregate contributions by or for the benefit of an individual in excess of $7,000 (contribution limit). Section 685(c)(1). Section 685(c)(2) provides that for purposes of § 685(c)(1), all trusts having trustees that are related persons shall be treated as 1 trust. Persons are related if (A) the relationship between the persons is described in §§ 267 or 707(b), (B) the persons are treated as a single employer under subsection (a) or (b) of § 52, or (C) the Secretary determines that treating the persons as related is necessary to prevent avoidance of the purposes of this section. The $7,000 contribution limit is adjusted annually for inflation for any contracts entered into after calendar year 1998. Section 685(c)(3).

A trust is deemed to exceed the contribution limit under § 685(c) if the trust is determined, over the anticipated life of the trust, to receive projected contributions (based upon existing contributions, the applicable state law trust contribution requirements, and any expected contributions in excess of the state law requirements) that exceed the contribution limit. The determination is made at the inception of the trust and is made again when the amount of the projected contributions used in the previous determination changes. For example, a trust that is determined at its inception to exceed the contribution limit during the life of the trust will be deemed to exceed the contribution limit at inception. However, a trust that is determined at its inception not to exceed the contribution limit but exceeds the contribution limit in a future year, due to a change in projected contributions, will be deemed to exceed the contribution limit at the time of the change in projected contributions. A trust loses its QFT status at the time that it is deemed to exceed the contribution limit.

If a QFT has multiple beneficiaries, the contribution limit will apply separately to each beneficiary. A QFT that has multiple beneficiaries will be taxed as if each beneficiary's interest in the QFT is a separate trust. Each beneficiary's share of the total contributions to a trust and share of the trust's income is determined in accordance with the beneficiary's interest in the trust; a beneficiary's interest in a trust may be determined under any reasonable method.

QFT ELECTION PROCEDURES

A trustee may elect QFT status for trusts that meet the requirements of QFTs under § 685 for taxable years ending after August 5, 1997. Therefore, trusts existing prior to August 5, 1997, and trusts created after August 4, 1997, may elect QFT status. The filing of Form 1041–QFT is treated as the election. The election must be filed no later than the due date, with extensions, for filing the trust income tax return for the year of election. The election applies to each trust reported in the QFT return.

A trustee need not elect QFT status for the trust's first eligible year; even if no election is made for the first eligible year, a QFT election may be made for subsequent tax years. A QFT election, once made, cannot be revoked without the consent of the Commissioner.

Under both § 685 and Rev. Rul. 87–127, amounts received by the seller from a trust are treated as payments for services and merchandise and are includible in the gross income of the seller in the taxable year received or properly accrued under the seller's method of accounting. In the case where a seller was not reporting income in accordance with Rev. Rul. 87–127, for example, where a seller improperly reported investment income in the taxable year it was earned by the trust rather than the purchaser reporting such income, a duplication of income may result from an election under § 685. The Service is continuing to study this issue.

SIMPLIFIED QFT REPORTING REQUIREMENTS

A trustee of a QFT is required to file a trust return on behalf of the QFT. The proper form to file is Form 1041–QFT. A trustee may file one aggregate Form 1041–QFT for all of its QFTs and should follow the instructions associated with that form.

REQUESTS FOR COMMENTS

The Treasury and the Service invite comments from the public on issues that may arise in implementing § 685. Send written comments to the following address:

Internal Revenue Service
CC:DOM:CORP (NT 98-6;
CC:DOM:P&SI:1)
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Alternatively, send written comments electronically via the Internet to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.htm1. Please identify the comments as relating to this Notice.

DRAFTING INFORMATION

The principal author of this notice is Daniel J. Coburn of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Coburn at (202) 622-3050 (not a toll-free call).