

## Estate Administrators: Estate Income Tax Timing is Everything

A Decedent's Estate is a living legal entity that pays income tax, but how much it pays is controllable through planning.

Although some larger and more complex estates can take as many as three years to settle, most small estates are settled within 16 months, and in all the confusion that surrounds assuming the role of Estate Administrator, one of the most frequent and crucial responsibilities is Income Tax.

Although inheritances are not taxable, the Administrator is responsible for both settling the decedent's final income tax as well as registering the Estate as an Income Tax Entity with IRS. This is because at the moment of death, all of the decedent's assets automatically transfer to a new legal entity known as The Estate. This means, in addition to Surrogate Responsibilities, the administrator is responsible for obtaining a Tax Identification Number from IRS and notifying the decedent's banks and investment fiduciaries of the name and TIN of the Estate so that the assets can be properly accounted for, tax wise.

As it is not uncommon for securities and other assets to be liquidated so that final expenses can be paid and distributions made to beneficiaries, and despite the fact that the tax basis of "inherited" assets is the fair market value at the time of death, there is often income generated within the estate prior to the time that cash is distributed to beneficiaries. As a result, if not properly planned, that first year's Form 1041 filing can result in a somewhat hefty tax bill, and to make matters worse, if the administrator does not plan the timing of payment of estate invoices for items such as fiduciary, legal and tax advisory fees, those hefty expenses can end up not being deducted against the estates taxable income.

An example of just how this could result is as follows. Assume that the assets of the Estate will not pass entirely to the surviving spouse and designated beneficiaries, but rather to several beneficiaries either named in a will or determined through probate. The administrator is so overwhelmed that the decedent's most recent tax preparer is not contacted, nor is any tax advisor contacted for that matter, until the calendar year following the decedent's passing when it is realized that a final income tax return Form 1040 needs to be filed for the decedent. But what about investment income or capital gains realized afterwards by the Estate? Let's assume that at the urging of the banks or the attorney that a tax ID number was timely applied for, and now the Estate needs to report the income on Form 1041, but the largest expenses, the Fiduciary fees and expenses and the professional fees, including the accountant, were not yet paid in the year that the income was realized, resulting in overstated taxable income.

These expenses, known as Internal Revenue Code Section 69(e) expenses (or Miscellaneous deductions), were suspended for individuals under the 2017 Tax Act, but they remained available to reduce the taxable income of estates. But if the deductions are missed on the year in which the Estate realized the most taxable income, that could result in a significant overpayment of Estate Income Tax in the first year, and a significant taxable loss in year two, for the estate, while possibly finding that income tax is due of the final return of the decedent.

Although tax law allows final estate “69(e)” non-business expenses such as professional fees to be passed to the beneficiaries on the final Form K-1, that Miscellaneous deduction is virtually useless as since 2017 it is no longer deductible by individuals on Schedule A of Form 1040.

This is where planning takes its proper place, and why fiduciaries should contact the tax accountant without delay, not to mention that it should be one with experience in dealing with Estate Income Tax.

Beside setting things up and advising in advance what to expect including calculating a Pro Forma Final Decedent’s Personal Income Tax Return, decisions can be made regarding the type of Tax Accounting Method to use for the estate, projecting what the total expenses of administering the estate will be, how long the estate will last (less than one year, two years or possibly three), and most of all properly match the estate administrative estate expense deductions against the income of liquidating the estate assets thereby minimizing the income tax to the estate as well as the beneficiaries.

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