¶ 18.01 Introduction

Not every person creates or is the beneficiary of a trust, but everyone does ultimately die. Thus, the income taxation of estates should be an important concern, both for individuals who wish to arrange their affairs so as to minimize taxes and for professionals who need to render effective assistance in this planning.

This chapter examines the special income tax considerations raised in estate administration, when an individual dies with or without a valid will. Included in this discussion are the filing requirements imposed on the personal representative of an estate,[1] as well as the tax problems and related tax planning options and opportunities that are available in the administration of a decedent's estate.[2]

Since 1993, when estate income tax brackets were greatly compressed, astute tax planning during estate administration has become more important. An estate now reaches the highest tax bracket, 39.6 percent, at only $8,650 of taxable income.[3] Therefore, a fiduciary who fails to distribute estate income currently or who distributes it currently in a manner that does not qualify for a distributions deduction, and the attorney or accountant who fails to advise the fiduciary to make substantial distributions, may face serious criticism (or lawsuits) from beneficiaries whose personal tax rate on such income would have been lower than the rate paid by the estate.

¶ 18.01[1] “Estate” Defined

Neither the Internal Revenue Code (the Code) nor the Treasury Regulations specifically define a decedent's “estate” for income tax purposes. One of the better definitions was provided by the U.S. Court of Appeals for the First Circuit, which said that an estate includes:

[p]roperty of all kinds held, under the provisions of the will, by any legal representative appointed by the probate court, by whatever name he may be called, whose duty it is to keep safely such property, and finally to distribute it under the direction of the probate court.[4]

This language is supported by the income tax regulations that state that a decedent's estate requires both property of a decedent and a fiduciary to administer it, although the existence of a will is irrelevant.[5]

The Internal Revenue Service (IRS) has also examined the meaning of an “estate” in several rulings. In **Revenue Ruling 64-307**,[6] for example, the IRS said that a decedent can have only one estate, even if there are multiple wills and multiple estate administrations. In the ruling, a decedent left property situated in two countries, the disposition of which was controlled by two separate wills. One will was written under U.S. law and it disposed of all of the decedent's U.S. assets, while the second will was written under the law of a foreign country and disposed of all of the decedent's foreign assets. Each will was probated in its own country, and different persons were named executors.

The U.S. executor argued that the deceased had two separate and independent estates for income tax purposes, in order to multiply the number of personal exemptions and lower rate brackets. The IRS ruled, however, that “where there are ancillary and domiciliary executors, there is only one taxable entity and the domiciliary executor must report all income and is liable for payment of the tax.” The IRS said that the same principles applied when a U.S. decedent's estate was administered in both the state of domicile and another state in which the deceased owned real property.[7]

¶ 18.01[2] Income Taxation of Estates Generally

An estate, like a trust, is a separate taxable entity, but it is entitled to deduct amounts properly paid or distributed to a beneficiary, and amounts permanently set aside for charitable beneficiaries.[8] The income tax liability of an estate is computed much like that of an individual, with an initial determination of gross income and taxable income, followed by the application of the appropriate income tax rates and the reduction of the tax by any available credits.[9] The key distinctions between the computation of the tax liability of an estate and that of an individual are:

1. Estates receive a “personal exemption” of only $600;[10]

2. The rules for computing estate charitable deductions differ from those for individuals (and, to a significant degree, those for trusts);[11]

3. Deductions for depreciation, depletion, amortization, and net operating losses are subject to special allocation rules to divide them between the estate and its beneficiaries;[12]

4. The estate cannot deduct most administration expenses from its gross income if those same items are also deducted on the decedent's federal estate tax return;[13]

5. The estate must recognize gain on some distributions of appreciated property to beneficiaries;[14] and

6. The estate can deduct amounts properly paid or distributed to its beneficiaries, up to its distributable net income (DNI) for the year.[15]