

TIPS AND TRICKS FOR FIDUCIARY TAX RETURNS

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The Best Advice I Can Give You...

Is to hire a competent, experienced CPA.
Don't worry about what it costs. It's worth it to avoid IRS problems that can end up costing far more than just accounting fees.

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Types of Fiduciary Tax Returns

- ESTATE TAX RETURNS – FORM 706
 - Due within 9 months of Date of Death
 - Required when the value of the estate exceeds the exemption amount (\$12.92m for 2023)

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FEDERAL ESTATE TAX RETURN

- You might also consider filing one when:
 - There is a surviving spouse, so you can port the first spouse's unused exemption to the surviving spouse.
 - The value of the estate is close to the exemption amount. If the IRS determines the estate is over the exemption amount, at least you won't get a failure-to-file penalty.
 - You want the comfort of an estate tax closing letter so you know it won't come back up as an issue again later.

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Federal Estate Tax

- Sunset is around the corner!
 - **The estate tax exemption this year is \$12.92m per person, adjusted for inflation each year.**
 - **At the end of 2025, it is scheduled to go down to \$5m per person.**
 - **Fingers crossed that Congress can get its act together to address this early and without much drama. (lol)**
 - **In 2020, the estate tax applied to only 0.1% of the people who died that year.**
 - **If the exemption reduces to \$5m, the estate tax will apply to a higher percentage of the population, especially if real estate values remain high.**

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Portability of the DSUE Amount

- As mentioned earlier, it may be a good idea to file an estate tax return when the first spouse dies, even if no estate tax is due, so you can elect portability of the Deceased Spouse Unused Exclusion (DSUE) amount.
- If I die in 2023 and my estate is worth \$2m, my husband can file an estate tax return for me to preserve the remaining \$10.92m of my unused estate tax exemption, so his estate can use it down the road when he dies.
- IRS recently issued Rev. Proc. 2022-32 which gives a simplified method for certain estates to obtain an extension of time to file a return by the 5th anniversary of the decedent's death to elect portability of the DSUE amount.

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Types of Fiduciary Tax Returns

- **INCOME TAX RETURN – FORM 1041**
 - **REPORTS INCOME TAX FOR AN ESTATE OR AN IRREVOCABLE TRUST**
 - **If the estate/trust generates more than \$600 in annual gross income, you are required to file Form 1041.**
 - **The reporting period may be on a calendar year ending December 31st, or on a fiscal year period. The fiscal year period ends on the last day of the month before the Decedent's date of death and is due to be filed four and a half months after the close of the tax year.**

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Ordinary Income Tax Brackets of Trust and Individual Beneficiaries

If Taxable Income Is Between		Individual	Trust
		MFJ	
647,850	Over	37%	37%
431,900	647,850	35%	37%
340,100	431,900	32%	37%
178,150	340,100	24%	37%
83,550	178,150	22%	37%
20,550	83,550	12%	37%
13,450	20,550	10%	37%
9,850	13,450	10%	35%
2,750	9,850	10%	24%
-	\$2,750	10%	10%

Source: IRS

Bloomberg

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Allowable Deductions:

- **Administration fees and expenses, such as attorney, accountant and tax preparer fees, administration costs that would not have been incurred if the property were not held in the Estate and so on.**
- **Other allowable deductions may include appraisal fees, or fiduciary fees that are established under the *reasonableness* standard.**

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Deductions Not Allowed

- The key is to know what is not deductible on the **Fiduciary Income Tax Return**, so determining which of the following deductions would be best utilized on the **other tax returns** discussed above.
- Those deductions not allowed on Form 1041's include:
 - Funeral expenses;
 - Medical and Dental expenses of the Decedent;
 - Personal Interest (credit cards, etc.); and
 - Expenses attributable to tax-exempt income, such as brokerage commissions for tax-exempt bonds.

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Income Distribution Deduction

- **Trusts and Estates are allowed an income distribution deduction for distributions made to beneficiaries during the administration.**
- **The beneficiary, and not the Trust or Estate, pays the income tax on their distributive share of income, which is reported on a Schedule K-1 (Form 1041).**

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Other Possible Deductions

- The **645-Election** is for treating the Trust as part of the Estate, thereby filing **only one** Fiduciary Income Tax Return for Trusts and Estates, rather than one for each entity. This saves time and money for the fiduciary and the beneficiaries of an Estate or Trust.
- The **65-Day Rule** election: If a distribution is made within the first 65 days of the end of the tax period, for instance on a calendar year with the year-end being December 31st, i.e., distributing by March 5th, the distribution is treated as a deduction in the prior tax year.

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What if you need an extension?

- **Form 1041 has an automatic extension of time to file, which is 5 ½ months and is completed by filing Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns.**
- **If there is any income tax liability owing, at least 90% of estimated taxes must be paid before the original filing deadline, or late payment interest and penalties will be applied.**

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What if you need an extension?

- **Apply for an automatic 6-month extension of time to file Form 706.**
- **Apply for a discretionary (additional) extension of time to file Form 706 (Part II of Form 4768).**
- **Apply for a discretionary (for cause) extension of time to file Form 706.**
- **Interest must be paid on any estate and GST taxes that aren't paid in full by the original due date of the tax return, regardless of whether an extension of time to file and/or pay has been obtained.**

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Case Law Update

- **Stanojevich v. Commissioner, U.S. Tax Court, April 10, 2023**
 - **Trustee filed a tax return determined to be frivolous by the IRS.**
 - **IRS imposed a § 6702(a) penalty on the Trustee personally, rather than the trust.**
 - **Tax Court held that the Trustee was liable for the penalties.**
 - **The fact that Congress has directly placed on a trustee the duties and responsibilities associated with the filing of the trust's income tax return supports the conclusion that Congress considered it appropriate also to impose § 6702(a) liability on a trustee who files a frivolous income tax return on behalf of the trust.**

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Hoensheid v. Commissioner

- U.S. Tax Court, March 15, 2023
- Held that an Estate was not entitled to a charitable contribution deduction pursuant to § 170 because they did not have reasonable cause for their failure to procure a qualified appraisal.
- IRS's determination to disallow the charitable deduction was upheld by the tax court.
- Without an appraisal prepared by a qualified appraiser, the IRS can't effectively verify whether a reported charitable contribution has been properly valued.

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Estate of MacElhenny v. Commissioner

- U.S. Tax Court, March 15, 2023
- Decedent defaulted on two loans and judgments were entered against him.
- Decedent's children purchased the judgments from the banks at highly discounted prices, and then sought to deduct the judgments on the Decedent's estate tax return under § 2053(a)(3).
- The deduction was disallowed by the IRS, which was upheld by the tax court.
- Treas. Reg. § 20.2053-1(d)(4) requires that the debt actually be paid by the estate, which did not occur here.

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Estate of Spizzirri v. Commissioner

- U.S. Tax Court, February 28, 2023
- Decedent's estate argued that payments the Decedent made during his lifetime to his daughter, stepdaughter, and seven other women, were payments for care and companionship. Tax Court ruled in favor of the IRS holding that these payments were gifts, subject to gift tax.
- The Estate did not call any of the women to give testimony as to the nature of the payments. The Decedent did not issue any 1099's or W-2's, and did not report these payments on his income tax return.

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Demuth v. Commissioner (In re E/O Demuth)

- U.S. Tax Court, July 12, 2022
- Tax Court held that checks written by the Decedent's son/POA as gifts made before the Decedent died, but paid after his death, were includible in the decedent's gross estate.
- Under Pennsylvania law, these checks were not completed gifts prior to the decedent's death because they were not accepted, certified or final payment made before he died.

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Larson v. Commissioner (In re E/O Levine)

- U.S. Tax Court, February 28, 2022
- The Tax Court held that a decedent's estate did not include the cash surrender value of life insurance policies owned by an insurance trust. The decedent had no right to terminate the policies, and under § 2036, she did not retain any right to possession or enjoyment of the life insurance policies transferred to the insurance trust.
- The decedent had irrevocably surrendered her interest in the insurance trust and had no right to change, modify, amend or revoke its terms.

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Estate of Grossman v. Commissioner

- U.S. Tax Court, May 27, 2021
- Commissioner argued that the decedent was never properly divorced from his first wife, so only transfers to her would qualify for the marital exemption.
- The Tax Court ruled in favor of the Estate, holding that the decedent had obtained a *get*, a Jewish religious divorce, which would be honored by the courts in New York (the decedent's state of residence). Thus, his later marriage was legal, and that wife was his legal surviving spouse, eligible for the marital exemption.
- Court commented that no one raised this as an issue until the IRS did, and the first wife had filed her tax returns as single for many years (even prior to the *get*).

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Estate of Warne v. Commissioner

- U.S. Tax Court, February 18, 2021
- This one involves valuation issues – discounts for properties in a family trust.
- Valuation issues are “easy pickings” for IRS auditors. It’s imperative to have appraisals that are solid. This is another area where you don’t want to be cheap. Spend the money and get really good appraisals.
- Discounts on valuations include things like lack of marketability, lack of control, and built-in capital gains. These discounts can result in huge tax savings in the right circumstances.
