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Income Taxes During Estate Administration

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INCOME TAXES DURING ESTATE ADMINISTRATION

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One of the many problems which face a fiduciary administering a decedent's estate is the necessity of preparing and filing Federal and Colorado income tax returns. This article will discuss various aspects of the problem in the hope that it will help attorney in recognizing and dealing with income tax problems. The scope of the article is so broad that no exhaustive discussion of any particular aspect will be undertaken, but every effort will be made to hit the high spots.

It seems to the writer that a fiduciary has three primary concerns with respect to income tax, and this article will accordingly deal separately with each of them in turn: the decedent's final return, the returns of the estate, and problems of personal liability of the executor.

THE DECEDENT'S FINAL RETURN

For the sake of brevity we shall consider decedents who were on a calendar year basis at the time of death and who used a cash basis of accounting for income tax purposes. Most decedents will fall into this class.

The decedent's final return will cover the period from the end of his last taxable year up to and including the date of death. This fractional year return is considered a fiscal year return, even though decedent had been on a calendar year.[1] The fiduciary must prepare a Federal and Colorado decedent's final return if the gross income of the decedent exceeds $600.00 for the period covered by the return. The return is due on or before the 15th day of the third month (fourth month for Colorado) following the close of the twelve month period which began with the first day of a decedent's fractional year.

A fiduciary may find that he must prepare not only a decedent's final return, but also a return for the decedent's last full calendar year, in the event the decedent had not done so himself before his death. This is not uncommon where a decedent dies between January 1 and March 15 of any year. The Federal law permits a joint return to be filed by a decedent and a surviving spouse in the year of death, and the period of the return is considered to be the period of the surviving spouse's taxable year. In Colorado, separate returns must be filed in the year of death.

A fiduciary may have to file a decedent's final Federal return in order to obtain a refund to which the estate may be entitled, as where more has been withheld from wages and more has been

[1] Therefore where the rates of tax are changed by Statute to become effective in the middle of a calendar year, one may not use the calendar year rates, but one must pro-rate taxes over the respective time before the change in rates and after the change.

paid on estimated tax than the return shows the decedent owes. In such a case, certified copies of letters testamentary or of administration should be attached to the final return; otherwise the refund will be delayed. Always be alert to discover the right to refunds.

Liability for payment of estimated taxes ceases with death as to future installments, so bills from the Collector's Office, based on estimated forms filed by decedent, may be ignored.

INCOME TO BE INCLUDED

Present Federal law in this respect was radically changed by the Revenue Act of 1942 which adopted Section 126 of the Internal Revenue Code concerning "income and deductions in respect of a decedent." Colorado has not adopted any part of the changes, so we find some fairly important differences in the treatment of income and deductions. The former Federal and present Colorado law is that items of accrued income must be shown on decedent's final return although not received by decedent in the taxable period covered by the return and even though decedent was on the cash basis. Present Federal law requires that accrued items shall be reported when received by those entitled to receive them (generally the estate).

1. *Salaries:* On Federal, show only checks or cash actually received by decedent while he was alive. On Colorado, be sure to pick up not only checks and cash actually received, but also any additional payments to which decedent was entitled, such as salary from last pay day to death, and any bonuses to which he might be entitled.

2. *Interest:* On a decedent's final Federal return you show only interest actually or constructively received by the decedent while he was alive. All bond coupons which matured during the period of the return would be shown. Colorado requires a more troublesome procedure, namely that interest be accrued on a day to day basis, so that if you have bond coupons you have to figure interest from the date the last coupon was paid to the date of death, and show on decedent's final return both the amount of the cashed or cashable coupons and the amount of such accruals. Naturally in Colorado you only show the difference between the value of the later maturing coupons and the amount you have accrued on the decedent's final return when you report the bond income on the estate's first income tax return. On the Federal Estate income tax return you would show the full amount of the later maturing coupon. U. S. Government savings bonds which are held by decedent with another as co-owner, or payable on death to another person can be ignored by the fiduciary, for it is the duty of the survivor to report the increase in value when the bonds are cashed.[2]

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[2] Except when decedent had been reporting the increment on the bond each year. In such case the survivor only reports the difference between the value at death and at time of cashing.

4. *Dividends:* On Federal return show only dividends received or constructively received by decedent. On Colorado pick up not only dividends received, but also dividends which were payable to stockholders of record on a date prior to or on the day of death.

5. *Partnership Income:* An article could be written on this subject alone, and it is a complicated one. Assuming the partnership ends with the death of the partner, which is generally the case, the income of the partnership for the partnership year or years ending with the dissolution, as properly computed in accordance with partnership method of accounting, is included to the extent of the deceased partner's share on his final return. There would seem to be no distinction between the Federal and Colorado rules in this situation. There is a possibility that Colorado might require a decedent's share of items of accrued partnership income to be shown on decedent's final return, even though under the partnership's method of accounting such items were not accruable at death.

6. *Installment Contracts:* Under Federal and State law it is possible to report capital gain over a period of years if certain conditions are met with respect to payments. It should be noted that the law requires a fiduciary either to pick up all the unreported capital gain on the decedent's final return, or to post a bond with a designated official conditioned on the reporting of the income element of the installments received by the persons entitled to receive them.

DEDUCTIONS OF A DECEDENT

The usual deductions that are allowed on a personal income tax return are allowed to a decedent; however, under Federal law only items actually paid out during decedent's lifetime can be deducted, while under Colorado law not only can such items be deducted, but you may also deduct any accrued item, such as interest and taxes. In fact in Colorado such items as have accrued as deductions *must* be taken on decedent's final return, or they are lost to the decedent and to the estate. A good example of such a deduction would be a real estate tax where a Colorado decedent dies after March 1, the date when such taxes become a lien. This tax will probably be paid a year or so later by the person entitled to the real estate, but it is a deduction on decedent's final state (but not Federal) return.

THE ESTATE INCOME TAX RETURN

The estate is considered a separate and distinct taxable entity from the decedent. The period of the first estate return begins one day after death, and a fiduciary may choose his own taxable year, provided that it does not cover a period more than twelve months in time, and provided that it ends on the last day of a month. Once having picked his taxable year, a fiduciary must stick to it thereafter and file twelve month returns, unless he gets permission from the Commissioner to change his taxable year. A return must be filed if the estate's income for the taxable year exceeds $600.00 for both Federal and Colorado income tax purposes. Returns are filed on Federal form 1041 and Colorado form 104:1.

INCOME TO BE SHOWN ON ESTATE INCOME TAX RETURN

1. *General:* The easiest way to state the law on this point is to say that one picks up on the estate's first income tax return all items of taxable income received by the estate except those which, under the rules previously stated in this article, should be shown on the decedent's final return.

2. *Basis and Date of Acquisition on Sale of Capital Assets:* Under Colorado law you have one simple rule. The cost or basis is the fair market value on the date of death (usually as evidenced by an inheritance tax return), and the date of acquisition is the date of death. Under Federal law the rule is less simple. The date of acquisition is always date of death, but the cost or basis may be either the fair market value at the date of death, or the fair market value on one year after the date of death. Where there is no estate tax return filed, or where the optional valuation date is not used where an estate return is filed, then you use the value on date of death; but when you have an estate tax return and have used the optional valuation date, then you use the value on one year after death. In a situation where the optional valuation date was used for estate tax purposes, but an asset is disposed of within a year of death, then there can be no income tax gain or loss because the estate tax law adopts the sale price as the value to be used with respect to the asset disposed of on the estate tax return. It should be noted that where an estate asset is distributed in kind to satisfy a specific bequest of cash, the law considers this to be the equivalent of a sale by the fiduciary, and gain or loss must be recognized, measured by the difference between the cost basis and the value of the assets distributed in kind; this does not apply to distributions in kind to residuary legatees.

DEDUCTIONS OF THE ESTATE INCOME TAX RETURN

1. Administration expenses, including administrator's or executor's fees and attorney's fees, may be deducted on the estate income tax return for the year in which paid, *provided* that they are not taken as a deduction on an estate tax return, and further provided that there is attached in duplicate to the estate income tax return on which the deductions are claimed a statement to the effect that the items have not been claimed as deductions for estate tax purposes and waiving the right to have the items claimed as estate tax deductions. A recent ruling [3] states that some administration expenses may be taken on income tax returns and others on estate tax returns, provided the same deduction is not taken twice, and provided the requirements concerning the statement and waiver are met. In small estates it is often possible to spread out the payment of administration expenses so as to reduce the estate net income below the $600.00 point for all the taxable years,

[3] I.T. 4048, 1951-9-13579.

and this should be borne in mind when advising fiduciaries. Colorado regluations flatly disallow a deduction for administration expenses.[4]

2. *Taxes, Interest, etc.* These items may be taken when paid, provided that they were not taken on decedent's final return under the rules stated earlier in this article. If such items were accrued debts at decedent's death, they may also be taken on the estate and inheritance tax returns, and you will in effect be getting a double deduction with respect to them.

3. *Deductions of Estate Tax:* If an item has to be included as income on an estate income tax return, which also had to be included as an asset for estate tax purposes, then you are allowed a deduction on the estate income tax return of the amount of estate tax attributable to the inclusion of that particular item on the estate tax return. The computation of the deduction is fairly complicated, but the regulations contain examples. There are no Colorado income tax regulations on this subject.

4. *Payments to Beneficiaries:* Amounts of income properly paid to beneficiaries may be deducted from the estate's income tax return. Federal authorities take the position that no court order is necessary to support such deductions, on the theory that if such payments are made it will be presumed that they are properly made in view of the fact that administrators and executors are court officials and are subject to the control of the court. The position of the Colorado authorities is less clear in this respect, and it is the author's understanding that it is best to obtain a court order directing the income payment if the fiduciary wishes to have such payments considered as income tax deductions. Of course in any situation where the estate deducts amounts as payments to beneficiaries, then such payments must be reported as income by the beneficiaries.

THE FEDERAL 65 DAY RULE

This rule is one of the hardest to understand and to apply in all Federal income tax practice. In general, the rule may be said to be that if a distribution of income of an estate for a particular year is properly distributed to a beneficiary within 65 days after the end of that particular year, then such distribution is a deduction on the estate income tax return for that particular year and must be included on the personal return of the beneficiary for his taxable year in which the estate's taxable year terminates. For example, assume an estate and beneficiary both on calendar years, and a distribution of income on February 1 of the year following of $1,000.00. Then the estate will deduct this $1,000.00 from its return for the period ended December 31, previously, and the beneficiary will report the $1,000.00 on his personal return for the year ending the previous December 31. The thing to remember about this rule is that if you close an estate within 65 days after the end of the estate's taxable year, you will be required to deduct

[4] Art. 6(a) (2).

distributions to beneficiaries that ordinarily will have not been deductible, but would have been taxable to the estate. Other provisions of Section 162 of the Internal Revenue Code should be carefully studied in connection with the Federal Estate income tax years where you make partial or final distributions to beneficiaries.

The Colorado income tax law presents no such problems. The estate is regarded as a separate entity up to the moment of closing, and you compute your tax regardless of what is going to happen to the income after the estate is closed, without taking any deductions for distributions of income to beneficiaries unless there has been a court order for the distribution of income prior to the order of final distribution.

It is interesting to note that there is considerable sentiment in favor of modifying the Federal 65 day rule, and bills have been introduced in Congress to accomplish this purpose.

PROBLEMS OF PERSONAL LIABILITY

An executor may be personally liable under both Federal and Colorado income tax law for debts owed to the taxing authorities by either the decedent or the estate. Under Federal Law [5] he is liable to the extent of payments which he may make of any debts due by the decedent or estate, while under Colorado law there is apparently no limit to the extent of liability. This liability will extend to debts incurred for taxes owing by the decedent during his lifetime as well as those incurred during administration.

A. *Federal Law*

Two steps should be taken to minimize the risk involved by these provisions of the law.

1. *Give notice of fiduciary relationship* under Section 312 of the Internal Revenue Code. After you have done this, the Commissioner must direct all notices of deficiency to the fiduciary and there is no chance that deficiencies will be assessed against the decedent without the fiduciary's knowledge.

2. *Reduce the period of limitation* against assessments of deficiency by applying for prompt assessments of tax on returns filed by decedent and by the estate under Section 275 (b) of the Internal Revenue Code. Such requests must be made after the returns are filed and the code provides that the Commissioner has only eighteen months from the date of the request in which to assess a deficiency. Of course, if the regular three year statute of limitations will run out prior to the eighteen month period, there is no need to request prompt assessment for any taxable year on which the three years statute will have operated by the end of 18 months.

When there is serious doubt in the fiduciary's mind as to the correctness of returns which have not been protected by limitations, he would do well to hold out a reserve from his final distribution.

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[5] Section 3467 Revised Statutes of the United States.

B. *Colorado Law*

Chapter 84 A, Section 44, of the Colorado income tax law provides that a fiduciary may apply to the Director of Revenue for a so-called closing agreement to settle all questions of tax liability of the decedent or the estate. The Director must take action within six months of the application, or the fiduciary will be discharged from personal liability. The better practice is to apply for a closing agreement at the time of filing the decedent's final income tax return to cover returns filed by the decedent in his lifetime and to apply for closing agreements on the estate's income tax return at time of filing the final estate income tax return. Under present regulation [6] the right to ask for two closing agreements might be questioned, but such a request would appear to be justified under the law, and is desirable from the point of view of closing estates more rapidly. The fiduciary's primary concern is with the decedent's lifetime returns, not with the returns which he has himself prepared. If he has had clearance on returns filed by the decedent by the expiration of six months from the date of his request for a closing agreement, he will for all practical purposes be ready to close the estate without fear of hidden tax traps.

SHOULD A LAWYER'S OFFICE BE A DEAD STORAGE WAREHOUSE?

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Office space costs as much as $2.25 or more per square foot in large cities, and with expanding business every foot of space in a lawyer's office counts. Should we not give our clients their files when we are through with their cases?

Our office now has a record of 9,250 cases handled under this system during the past 12 years, and we have never regretted our move to return all files to the clients when their cases are completed. Here is how it works:

We have a large 5″x8″ white card with a record of the case on it. It contains such data as Court number (if there is one), name of client and who referred the client to us, work to be done, estimated fee, estimated time required, and then the final fee that was actually charged and collected, and the total number of hours consumed. A review of these cards from time to time will tell us how much per hour we were able to charge our clients and thus assist us in determining future fees to be charged in like cases. This card has sufficient space to record things we are doing for the client. When our work is completed, we make a note on the card as to the disposition made of the case and then deliver the entire file to the client after taking his receipt. We itemize the important documents such as deeds, releases, abstracts, etc., and

[6] Article 37.