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5 Tax Issues Executors Should Know to Avoid Trouble in Probate

Serving as executor or administrator of an estate is not easy. If it's for the estate of a loved one, an individual executor manages grief in addition to many legal requirements. In addition to probate court rules, there are many tax issues to address. Here are some of the most common:

1. **Decedent's Final Return.** The IRS is one creditor you don't want to mess with, as they can hold an executor personally liable for unpaid taxes. When someone dies, their tax year ends as of their date of death. The executor is responsible for filing the final federal and state returns and ensuring that any tax due is paid. These returns are due April 15 of the year after the date of death. If someone dies before filing a return for the prior year, the executor must make sure that the return is filed and any taxes paid.

2. **Step-Up in Basis.** Appreciated assets such as stock or real estate get a "step-up" in basis when the owner dies. The new cost basis is equal to the fair market value of the asset on the date of death. This means that if the assets are sold shortly after the owner's death, there will be little to no capital gains tax due. An executor should obtain accurate date of death valuations for stocks (generally average of high and low), mutual funds (generally closing value) and real estate (appraised value). This information should be passed along to the beneficiaries receiving the assets. This could protect the executor from being sued by beneficiaries who paid more income tax upon the sale of the asset than was actually due.

3. **When is an Estate Income Tax Return Required?** Estates are separate tax-paying entities; a return must be filed if there is more than $600 of gross income earned during the taxable year of the estate (not necessarily a calendar year) or if there is a non-resident alien beneficiary. Income items including final wages received after death, interest, dividends, and capital gains must be reported. Federal estate income tax rates are very high, reaching the top rate of 37% at just over $12,500 of income, and the 3.8% net investment income tax also applies to most income. However, the estate can take a deduction for income distributed to a beneficiary, who then must report the income on his or her own return. Failure to properly prepare and file a fiduciary income tax return can be costly for the estate and/or beneficiaries, as well as expose the executor to liability. Only experienced tax advisors should prepare the returns.

4. **IRAs and 401(k)s.** IRAs, 401(k)s, and other retirement plans that are payable to an estate require special care to ensure that income taxes are minimized. Again, an executor can be held responsible for not handling these accounts properly. In most cases, it does not make sense to designate the estate as beneficiary of a retirement account. However, it is done on occasion, or the estate may be the default beneficiary when the named beneficiary predeceased the account owner. There are very complex rules governing the required payment from a retirement account to an estate, and failure to seek advice from a knowledgeable professional could result in higher income tax bills for the estate, and ultimately, the beneficiaries.

5. **How Estate Expenses Can Save Taxes.** Expenses incurred during estate administration, such as attorneys' fees, accountant fees, court costs, and bank fees, are deductible against the income of the estate. For the final year of the estate (which may also be the first year), if these expenses exceed the income, the loss can be "carried out" to beneficiaries via the income tax return for the estate, enabling them to lower their own taxes. Any capital losses are treated the same. So, it often pays to file a return even if there is little to no income.

Conclusion

This overview addresses just a few of the matters that an executor must consider. Others may include investment management and diversification, safe-keeping of property, federal estate taxes and spousal portability of the estate tax exemption, and court requirements. Experienced probate counsel can give an executor peace of mind, expedite the estate administration, and may very well enable the estate to minimize taxes.