Tax Issues in Washington Probate Administration

I. Income tax considerations

A. The decedent's final individual income tax return

A new, separate legal entity is created upon an individual's death. A final, individual income tax return (Form 1040) is required to be filed for the year of death and would include income from January 1 through the individual's date of death. This final income tax return would include all items of income and deduction through the date of death. If the taxpayer had a spouse, this final return may either be filed separately or as a joint return with the surviving spouse. If a probate estate is not opened, this return may be signed by the surviving spouse alone. However, if there is a personal representative appointed for the estate (other than the surviving spouse), then this individual is required to sign the final return for the decedent.

Any unused carryovers reported on a decedent's final return expire upon their death. Thus, if the taxpayer had capital loss carryovers, net operating loss carryovers, or passive loss carryovers these would disappear upon their death. In Washington, if there is a surviving spouse, then only ½ of the carryover amounts would expire and the surviving spouse would retain their share of the carryover amounts.
The individual filing requirements are the same for a deceased taxpayer as a living taxpayer. Thus in 2021, filing is only required for a single taxpayer that has income of more than $12,550 if they are under 65; or $14,250 if they are 65 or older. Likewise, an individual that files using the married filing separately status is allowed to have income of $12,550 if they are under 65; or $13,900 if they are 65 or older. Similarly, a joint return with a spouse is only required if their income exceeds $25,100, or exceeds $26,450 if one of them is over 65, or exceeds $27,800 if both of them are over 65.
Even if a taxpayer is not required to file a tax return, if the taxpayer has estimated payments or other credits on their account – or if there was withholding taken on their current year income, it may be beneficial to file a return in order to claim a refund of these amounts.

Hint: In many instances it may be beneficial to file a power of attorney form with the IRS for the decedent's year of death. In the event the taxpayer's records may be incomplete – you can request both a wage and earnings transcript (to find what income/deduction items have been reported under the taxpayer's social security number for the year of death) as well as transcript of account (to show the account history at the IRS including payments made on the account during the year of death, as well as any prepaid tax amounts carried forward from the prior year.) In fact, if you are unsure whether the decedent is current with their income tax obligations, you can request a transcript for the last 3 years activity to determine if there are any prior year returns which need to be filed. It is also possible to request a copy of prior returns from the IRS. There's a fee of $43 for each copy requested and these are available for the current tax year and up to seven prior years by completing a Form 4506 request.

B. The estate's income tax return

The estate's tax year begins the day after the decedent's date of death. The estate can choose either a calendar year end or a fiscal year end not more than one year after the date of death. Thus, if an individual dies in December, the estate could select a fiscal year end between December 31 of the year of death and November 30 of the following year. The selection of fiscal year is done at the time that the initial estate return is filed. Although the Form SS-4 asks for the fiscal year end at the time the tax identification number is applied for – the date indicated on the SS-4 is not a binding election.

If an estate can be wrapped up within 12 months, making a fiscal year election for the estate allows for the filing of a single tax return that is both the first and the final return for the estate, even though it straddles two calendar years. By filing a single return, the tax preparation costs can be minimized.

If the individual passes away during 2021, then the initial return will be filed on a 2021 Form 1041. The proper form to be filed is determined by the year in which the fiscal year begins.

Early in the estate process, a Form SS-4 application will need to be made to obtain a tax identification number for the estate. If you are the personal representative, you can go online at the IRS website and apply for a tax id # directly. If you are applying on behalf of the personal representative, you will need to have their authorization on the Form SS-4 before you go online and request a tax id # for them. At this same time the estate should complete and file a Form 56 notifying the IRS of the fiduciary relationship.

If an individual has a both a living trust that was funded as well as assets that will be passing through probate, it will be necessary to obtain separate tax identification numbers for the trust and the estate. If the trust already has a tax identification number this number will continue to be used, however, if the trust has been reporting under the decedent's social security number it will need to obtain its own tax number when the individual dies.

Normally, trusts are required to file their tax returns using a calendar year end. If the decedent's trust was a qualified revocable trust at the time of their death, then the trustee and personal representative can elect to file a single return reporting the combined activity of the estate and trust. Even if there is no separate probate estate, the election under Section 645 can be made to file the trust return(s) as if they were an estate. This election is valid only for two years following the decedent's death.

Filing the trust return as if it is an estate allows the trust to take advantage of certain tax planning advantages not normally available to trusts. For instance, the trust can claim a charitable deduction under Section 642(c) for amounts set aside for charitable purposes. Passive activities may also be treated as active for a two-year period after the owner's death in an estate (or in the trust filing under Section 645). The joint filing allows the estate to select a fiscal year end – and thus may make deferral of tax possible. Finally, the use of a fiscal year end may also allow the trust return to be filed on a single first and final return. However, any Distributable Net Income calculations must be made separately for the estate and the trust.

What estates are required to file an income tax return? Any estate that has gross earnings of $600 or more during its selected fiscal period must file a tax return.

Income taxable to an estate is similar to what would be taxable to an individual. Thus, amounts reported for interest, dividends, royalties, rents, and pension income are all sources of taxable income for an estate and are taxed in the same manner as if an individual earned these amounts. Installment income is also taxed to the estate in the same manner as it was being taxed on the individual's return. If the individual was reporting 40% of principal collected on a contract as long-term capital gains, then their estate would continue to report 40% of principal collected on the contract as long-term capital gains. Similarly, annuities and retirement income will retain its same character in the estate as it did on the individual's returns.

Because of the basis step-up under Section 1014, the estate's basis in assets at the time of death gets an automatic step-up or step-down to the current fair market value at the time of death. For any assets sold after the date of death, any gain or loss is merely the difference between the sales price and the fair market value of the property at the date of death. If the alternate valuation date is elected on the inheritance tax return, it is the value as of this date that is used rather than the date of death values. The recent tax provisions put forth by President Biden would eliminate the basis step-up for assets in excess of $1,000,000. At this time this is merely a proposal.

Deductions allowed on the income tax return for the estate are similar to those that are allowed to individuals. For depreciable assets receiving a step-up in basis, depreciation starts over with the new basis amounts as of the date of death. Thus, a fully depreciated rental property, will be able to be depreciated again based on its current market values as of the date of death.

The estate is allowed to deduct its administration expenses including legal fees, accounting fees, fiduciary fees and expenses, and litigation fees to the extent that they are ordinary and necessary. Miscellaneous itemized deductions are subject to the same 2% limitation as they would be on a 1040 – except for the administration expenses detailed above that were only incurred for administration of the trust or estate and would not have been incurred otherwise. Expenses allocable to tax exempt income are non-deductible just as they would be on an individual's return.

The expenses of administration, casualty losses, and theft losses that are taken as a deduction on the estate tax return cannot be claimed on the income tax return. These will be allowed on either the income tax return or the estate tax return. The benefit of the deduction on each of the returns should be evaluated to determine the optimal reporting of expenses.

An estate can have net operating losses arising from the estate's business activities. The amount of net operating loss created in the estate does not include deductions for administrative expenses. Thus, if the estate has significant administration expenses, these can only be used against current year income. An exception to this is the final year of the estate. In the final year of the estate the residual heirs will receive a K-1 with their proportionate share of the "excess deductions on termination" -- their administrative expenses in excess of their income.

Like other entities – the estate pays tax based on its net income reported on its return. The estate or trust is allowed a deduction from its taxable income for amounts that has been distributed to the heirs. The amount must either be paid out to the heirs by the end of the estate's fiscal year, or distributed within 65 days of year end in order to claim the income as a deduction on the estate's return. To the extent that income is distrusted to heirs – they will receive a K-1 reportable on their personal return of income from the estate. Thus, an individual could have interest income, dividends, capital gains, and other items to be reported on their personal return depending on the sources of the estate income. The estate may treat distributions to heirs made within the first 65 days as being distributed to the heirs as if it was made by the end of the fiscal year. The estate will need to determine how it wants to treat distributions made in the first 65 days of the next year as it files its federal income tax return. Amounts paid as a specific bequest - $5,000 to my nephew Johnboy – do not carry out income to the heirs. Thus, recipients of specific bequests will not receive a K-1 for any income associated with the property they receive.

In the estate's final year, the residual heir's K-1 will include information on any current year income amounts, plus additional information if there any unused capital losses, NOLs or excess deductions on termination.

Although available on individual returns, the estate is also allowed to deduct federal estate tax paid on items of IRD (Income with Respect to Decedent). The deduction is determined by calculating what the federal estate tax owed on the federal return was versus the amount that would have been owed if all IRD items were omitted. The current IRD amounts over the total IRD amounts times the tax paid on the IRD items is allowed as a deduction. In calculating IRD, all items of accrued income and expenses should be considered. The most common IRD income items are accrued interest, rents and dividends; tax-deferred IRA or retirement plan accounts; and installment sales.

Commonly seen deductions would be expenses incurred on a business or rental property and not paid until after the date of death. Although there are fewer federal estate tax returns being filed, for those with tax paid this can be a significant deduction that is often overlooked. Because the 2021 federal estate tax exemption is currently 11.7 million – this deduction is only available on taxable estates greater than 11.7 million.

The estate is not required to make federal estimated tax payments until 2 years after the decedent's pass. Likewise, a trust electing to file as an estate is not required to make estimated tax payments for the first two years as well. However, all other trusts are required to make estimated tax payments.

Notable also in the tax planning process for estates is the compressed bracket amounts applicable to estates. For 2021, an estate is subject to a top marginal tax rate of 37% at income of only $13,050. The estate may also be subject to a 3.8% Net Investment Income Tax (NIIT) on amounts of interest, dividends and other investment income in excess of the $13,050. For individuals the 37% bracket would only be applicable for income in excess of $523,600 for single taxpayers, or $628,300 for a married couple. Almost always will the trust/estate beneficiaries be at a lower personal tax rate than the estate or trust itself. Accordingly, it may be beneficial to make distributions of income to heirs within 65 days of year end so that these amounts can be taxed at the heirs' lower tax rates.

As a part of the initial filing for the estate, it will be necessary to determine the method of accounting to be used for the estate. Although most estates/trusts utilize the cash method of accounting, the estate/trust can elect to be an accrual entity. For instance, it may be beneficial in some instances to elect the accrual method so that a deduction could be taken for accrued expenses that weren't paid until after year end. If you had an estate with income that wasn't distributed within 65 days of year end you may be able to accrue expenses and eliminate the tax liability.

II. Estate tax considerations

A. Washington State Estate Tax

Since 2018, the State of Washington has required all estates with gross assets of $2,193,000 or more to file a Washington Estate Tax return, even if no tax is owed when the return is filed. This filing threshold will continue to apply through 2022. The filing requirement applies to both Washington state decedents, as well as deceased non-residents that are over the filing threshold and own property in Washington State.

The same $2,193,000 is also allowed for the applicable exclusion amount. Thus, the net estate will not have a tax liability unless the net estate assets exceed $2,193,000. Once the estate exceeds this amount the first million of additional assets is taxed at 10%. There is a graduated estate tax rate for estates between $1 and $9 million. All taxable amounts in excess of $9 million are taxed at a 20% rate.

The Washington State Estate Tax Return and the payment of any tax is due 9 months after the date of death.

The Washington Estate Return reports a snapshot in time of the decedent's assets and liabilities at the time of death. An election can be made to value the assets at the alternate valuation date 6 months after the date of death, if it results in a smaller estate tax liability. When completing the estate tax return it is noteworthy that there is a special deduction available to both estates that hold farm properties or small businesses. Each of these deductions has strict requirements for availability, but can result in substantial tax savings. For instance, the farm deduction requires that the property passes to a qualified heir, makes up over ½ of the decedent's estate's adjusted gross value, and has been used in farming for 5 of the last 8 years. There are a number of additional requirements, but if the farm property qualifies there is an unlimited deduction for the property. For the farm deduction, the heir does not need to continue to hold the property.

Notable also is the qualified family owned business deduction (QFOBI) which allows up to $2,500,000 of value to be excluded from a taxable estate. This deduction requires the decedent to have owned the business for at least 3 years, and requires the heir to continue the business for 3 years in order to qualify for the deduction. This deduction is also integrated with the farm deduction so that a double-benefit cannot be obtained.

In most aspects, the Washington State Estate tax provisions mirror those of the Internal Revenue Code for federal taxable estates. An exception is that the Washington provisions do not allow for any unused exclusion to be used by the surviving spouse. This key difference should not be overlooked when drafting estate documents. Another key difference is that the Washington does not have a gift tax, so most gifts made during an individual's lifetime are not included in the estate tax calculation.

B. Federal Estate Tax

The federal estate tax is imposed on taxable estates in excess of $11.7 million in 2021 and $12.06 million in 2022. The current exemption amount will be indexed for inflation through 2025. The legislation that created the indexed $10 million exemption sunsets in 2026 and the exemption will revert back to the $5 million dollar level. Estates are currently taxed at a flat 40% tax rate. Only approximately 1 per cent of all estates are required to file a federal estate tax return. When calculating the assets subject to estate tax prior gifts are included in the calculation of the taxable estate – thus, the federal estate tax is a unified tax on both estates and lifetime gifts.

Even if an estate is under the $11.7 million, it can be beneficial to file an estate tax return after the death of the first spouse. An exclusion that is unused on return is allowed to be carried over to the surviving spouse (DSUE). Certain requirements apply in order to be able to claim the exemption carryover—the most important of these is that a Form 706 estate tax return must be filed after the first spouse's death in order to claim the unused exemption by the surviving spouse. There is a simplified filing procedure for the Form 706 if it is only being filed to claim the DSUE amounts which allows the personal representative to estimate values for property that is subject to the marital or charitable deductions.

C. Marital Deduction Planning – Qualifications and Basis Formula Approaches

For a single individual or a married couple that has a total net worth of $2,193,000 or less – significant estate planning is not necessary. The couple can utilize a community property agreement or simple will without worrying about estate tax implications. In fact, many of their assets can be set up as JTWROS or POD accounts, or beneficiary designations – although I would advise that they should still obtain a will for any property not covered by beneficiary designations.

For married couples with assets exceeding the $2,193,000 greater planning is needed to allow up to $4,386,000 of assets to pass estate tax free. The most powerful tool to avoid immediate death taxation and to split an estate thus doubling the exemption amount for tax purposes is to utilize a tax bypass or credit shelter trust and the marital deduction. In a case where the husband and wife together have a net worth between $2,193,000 and $4,386,000 the estate plan should provide for the first to die to leave an amount equal to the maximum amount allowed to pass estate tax free to a credit shelter trust with any other bequests to surviving spouse qualifying for the marital deduction. There are two basic formulas which will be discussed below. Regardless of which is used, the pattern should provide for 100% of the allowable exemption amount to pass to the surviving spouse in the form of a trust which will not be subject to taxation on the death of the surviving spouse. For the balance of the estate, the marital deduction bequest can be outright or in trust.

Such a bypass or credit shelter trust would provide the spouse with income, but the spouse cannot have the uncontrolled ability to withdraw principal. This means that the spouse could be allowed to be a trustee of that trust and withdraw funds based on what is called an ascertainable standard, or could have a separate independent trustee appointed, or could have a 5 by 5 power.

1. An ascertainable standard is a standard under state law by which a trustee must distribute principal under a direction based upon the health, welfare, support or maintenance of beneficiary in accordance with their accustomed standard of living. The theory is that a beneficiary could go into state court and compel the distribution to the beneficiary of additional principal to meet the specific requirements. Any amount the beneficiary-trustee withdrew in excess of this amount would be a breach of his or her fiduciary duty. On the other hand, a standard where a beneficiary-trustee has the right to withdraw principal based upon happiness, joy or for any other purpose the trustee feels is in best interests of the beneficiary is not considered to be an ascertainable standard. If a spouse has such a non-ascertainable standard and is a trustee and can withdraw principal then all such principal will then be included in the spouse's estate as that spouse will have a general power of appointment. A spouse cannot have a general power of appointment over principal but could have a limited power of appointment. A limited power of appointment is an ability to appoint the assets to

anyone other than their spouse, their estate, their creditors or the creditors of the estate.

2. If one appoints an independent trustee that trustee can have a non-ascertainable and discretionary powers without the influence of the surviving spouse to make distributions to the spouse of any purpose. Flexibility in the ability to distribute principal and terminate a trust can be useful for non-tax reasons as well as tax planning give the frequent changes in the law in recent years.

3. Finally, a 5 by 5 power allows a beneficiary to withdraw for whatever reason an amount no greater of 5% or $5,000 per year of the amount of the principal on a non cumulative basis. The possession this power means that all of the corpus will not be included in the estate of the decedent but it does mean that the 5% or $5,000 amount will be includible in the estate of the decedent because if the person had that power during their last year of their life to have withdrawn the funds, that 5% or $5,000 would be an asset the decedent had control over, even if the decedent did not take the funds.

A credit shelter trust may be allowed to accumulate income and need not pay it all to the surviving spouse, but any income accumulated will be subject to being taxed at high income tax rates. Furthermore, a credit shelter trust can be designed to spray the income among the family members. It is a basic principle of trust taxation that if a person is capable of taking all the income for themselves that person will be taxed on all that income even if they redistribute it elsewhere. A spouse therefore who is acting as a trustee who has the ability to spread income among her children will be taxed on all that income even if she distributed it to her children.

Another alternative would be to give the trusteeship to a third party or the power to distribute the income to a third party. That third party then, as an independent trustee or fiduciary could divide the income among the spouse and children and the spouse would be taxed only what she received.

If the estate is larger than $2,193,000 where the decedent leaves the balance of the funds will produce significant estate tax consequences. If, for example, the decedent has an estate in excess of $2,193,000 of separate property the maximum estate tax savings for Washington exemption amount would be $2,193,000. Any amount in excess of that amount left to the surviving spouse will qualify for the marital deduction. If it does not qualify for the marital deduction, estate tax will be due.

B. Marital Deduction Planning. The marital deduction amount may either be left to the surviving spouse outright or in trust. In order to qualify as a marital deduction trust, the trust must include certain provisions.

NOTE: Be sure to ascertain the citizenship of each spouse. Bequests to spouses who are not US citizens do not qualify for the marital deduction unless left in a Qualified Domestic Trust (QDOT).

Generally, a marital deduction bequest cannot be of a terminable interest. A terminable interest is one that fails as a result of the passage of time or the occurrence of a contingency such as death. For example, if Joe Decedent leaves an income interest to Susie Decedent, and following her death the property passes to his brother, Bubba, the bequest is not deductible. However, there is a significant exception for a qualified terminable interest trust (QTIP). A qualified terminable interest trust will qualify for the marital deduction if the surviving spouse is entitled to all the income for life from the property payable at least annually and no person (including the spouse) has the power to appoint property to any person other than the surviving spouse during the surviving spouse's lifetime. The executor must make an election and ultimately the qualified terminable interest trust's assets will be included in the gross estate of the surviving spouse on his or her death for estate tax purposes.

In my example above, if Joe Decedent wanted to provide for his brother Bubba, he could leave the property in trust for his spouse for life in which she receives all the income payable at least annually and all the principal stays in trust and if the Personal Representative makes an election, the trust will qualify for the marital deduction. Any estate tax in Susie Decedent's estate attributable to this property may be made payable out of the property in the QTIP trust on the death of the surviving spouse.

Furthermore, in order to compute the marital deduction the amount of the deduction will be reduced by any death taxes payable out of that marital deduction gift as well as any administrative expenses so payable. Therefore the spouse first to die should have a tax clause to provide these death taxes and administration expenses are paid from other non-marital assets in the estate.

The real advantage to the qualified terminable interest trust is that in this modern day and age, as many older folks may complain, couples don't stay married forever as they did back in the old days. Often there are second marriages and children by prior marriages. In these situations a QTIP trust is very helpful because a decedent can provide for his spouse during that spouse's lifetime and leave the assets to his or her children by the prior marriage and not the new love interest of the surviving spouse once that surviving spouse survives no longer.

Marital deduction trusts can be funded in one of two ways in a will or revocable trust. They can either be established by means of a pecuniary bequest or fractional share bequest. A pecuniary bequest is based upon a formula that leaves a fixed amount which is funded using the date of death values (or alternative valuation date values). The following are examples of a pecuniary bequest:

I give my spouse the smallest pecuniary amount that, if allowed as federal estate tax marital deduction, would result in the least possible estate tax being payable by reason of my death.

Or, I give the greatest amount that may pass federal estate tax free by reason of the unified credit and any other deductions available to the credit shelter trust and the balance of my assets to my spouse outright (or by means of the marital trust.)

In one case, the formula defines the credit shelter trust and everything else is left to the marital deduction. In the other case, the marital deduction is defined then everything else passes to the credit shelter trust.

The fractional share bequest is based on a formula equal to a percentage of the assets as of the date of death value (or alternate valuation date) which percentage stays the same but the value of the assets will go up or down with appreciation or depreciation in the assets.

An example of a fractional share is as follows:

I give a fractional share of my residuary estate of which (a) the numerator is the smallest amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death, and (b) the denominator is the value of my residuary estate as finally determined for federal estate tax purposes.

Most marital deduction bequests in Eastern Washington are normally outright marital gifts. When we do fund a marital trust the normal practice is to use a pecuniary bequest because it is simpler to administer. The real difficulty lies with asset allocation in funding the trust.

With regarding to available funding mechanisms, there are certain approaches allowed by the Internal Revenue Service and some of these would recognize appreciation or depreciation and fairly allocate those between the marital gift and the credit shelter trust. Washington State law allows the executor the maximum discretion in allocating gifts either in kind or in cash. The reason for the law in this area is that there could be a lot of manipulation available by which the credit shelter trust could be allocated the property that has appreciated radically in value and the marital deduction trust which is going to be taxed on the spouse's death, be allocated the assets that have depreciated.

III. Federal Generation-Skipping Tranfer Tax

The Generation Skipping Transfer Tax was designed to keep mega-wealthy families from *transferring assets to more than one generation below the Transferor's generation.* A family could preserve substantially more wealth for lower generations and avoid estate tax obligations if the grandparents were to give their inheritance to their grandchildren rather than their children. To avoid wealthy families being able to avoid the estate tax, the generation skipping transfer tax imposes a 40% tax on transfers down more than 2 generations or to individuals more than 37 ½ years younger than the decedent. The GST lifetime exclusion is currently $11,700,000. Amounts in excess of $11,700,000 that pass to grandchildren, great grandchildren or individuals more than 37 ½ years younger would be subject to the 40% GST tax in addition to any estate tax that was due. Note that a gift to a grandchild is not subject to the generation-skipping gift if the grandchild's parent is deceased.

IV. Conclusion

A clear understanding of the estate income, estate and generation skipping transfer tax rules, as well as understanding of the objectives of your client will allow you to design the appropriate estate and gifting structure.