



Income Tax Considerations and Elections in Estate Administration

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Final Form 1040

- Filing Status
- Due Date
- Form 1310, “Statement of Person Claiming Refund Due a Deceased Taxpayer”
- Signing and Mailing
- Request for Prompt Assessment of Decedent’s Income Taxes (Form 4810)

Allocation of Income & Expenses

- Income allocated based on income actually or constructively received before DOD
- Deductions taken for expenses actually or constructively paid before DOD

Example:

Dividend payable date is deemed date “received” not record date.

Roy Birch died 10/1/25. At the time of his death, Roy owned 250 shares of Hitech, Inc common stock. Hitech Inc declared an annual dividend on 9/15/25 payable to shareholders of record on 9/30/25. The dividend of \$2,500 was paid on 10/6/25. In 2026, Roy’s executor received a Form 1099-DIV from Hitech reporting the dividends for 2025 under Roy’s name and social security number.

Since Roy is a cash basis taxpayer, the \$2,500 dividend is reported on the Estate’s fiduciary income tax return (Form 1041). However, the entire amount reported on the Form 1099 is reported on Roy’s final Form 1040 with the amount “backed out” as being reported by the Estate and referencing the Estate’s EIN.

Allocation of Income & Expenses

Assets Held Jointly or POD (payable on death)

- Income received after DOD is reported by person receiving assets regardless of when the asset is actually transferred.
- Report total amount on Form 1099 and “back out/”nominee” portion to be included on income tax return of beneficiary including name and social security number of the beneficiary.

Tax Attributes of Final Form 1040

Carryovers – expire in year of death

Charitable contribution carryover; investment interest carryover; capital loss carryover; minimum tax credit carryover; unused NOL carryover

Exceptions

- NOL generated in final year of 1040
- Business credit carryover
- Foreign tax credit carryover
- Unused PALs at time of death

Example:

Robert was the sole owner of a residence used as a rental and was considered passive when he died. In his will, he left the property to his brother Tim. At Robert's date of death, the value of the rental was \$500,000 with an adjusted basis of \$494,000 and he had an unused PAL of \$8,000. Since Tim's basis of the rental is increased by \$6,000, the deduction on decedent's final Form 1040 would be limited to \$2,000 (\$8,000 - \$6,000). The \$6,000 expires unused.

If the inherited basis had been \$502,000, none of the suspended PAL would have been deductible. ($\$502,000 - \$494,000 = \$8,000$; $\$8,000 - \$8,000 = \$0$).

Tax Attributes of Final Form 1040

Exclusion of Gain on Sale of Residence

- Decedent's period of ownership and use carryover to SS as long SS not remarried at time of the sale
- SS may use \$500,000 exclusion provided:
 - Sale is within two years of the date of death
 - SS is not remarried at time of sale
 - Other requirements for gain exclusion are met

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Elections

Medical Expenses

Election can be made to treat expenses paid within one year after DOD as if paid by the decedent and therefore claimed on Final Form 1040

- Election made by attaching statement (in duplicate) with the Final Form 1040 or on an amended return.

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Elections

Waiver of Right To Deduct Medical Expenses On Decedent's Estate Tax Return

Deceased Taxpayer: John Jones
SSN: 123-45-6789
Form: 1040
Year: 12/31/11

The undersigned executrix of the above-named taxpayer hereby waives the right to deduct the taxpayer's following medical expenses paid within one year of death on the decedent's estate tax return. In accordance with IRC Sec. 213(c) and Reg. 1.213-1(d)(2), these medical expenses have not been claimed as a deduction under IRC Sec. 2053 on Form 706.

<u>Description</u>	<u>Amount</u>
XYZ Company (Long term care for December)	\$5,550

Signed: _____
Executrix

Elections

US Savings Bond Interest (Section 454 Election)

All interest accrued from acquisition date through DOD on Series E and EE bonds can be included on decedent's Final Form 1040 via election made on a timely filed return (including extensions)

Example:

Terry Died in March, 2025. At the time of her death, she owned \$10,000 (face value) of Series EE bonds that had a basis to her of \$5,000. The accrued (and unrecognized) interest at the time of her death was \$2,525. Terry's taxable income for 2025 (through her date of death) is approximately \$15,000.

Terry is in the 12% tax rate bracket and her beneficiary will be in the 37% tax rate bracket. Terry's executor should elect to recognize the \$2,525 of accrued Series EE bond interest on her final income tax return. The election will result in tax savings of \$631 $[(37\% - 12\%) \times \$2,525]$ because Terry's marginal tax rate on her final return is less than the rate of her beneficiary.

The bond is redeemed by the beneficiary in September, 2026 for the \$8,000 representing \$5,000 principal and \$3,000 interest. The beneficiary would then include \$475 as interest income $(\$3,000 - \$2,525 \text{ interest already recognized under 454 election})$ on his/her 2026 income tax return.

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Elections

SCHEDULE B
(Form 1040A or 1040)

Interest and Ordinary Dividends

OMB No. 1545-0074

2025

Attachment
Sequence No. **08**

Department of the Treasury
Internal Revenue Service (99)

▶ Attach to Form 1040A or 1040.

▶ Information about Schedule B (Form 1040A or 1040) and its instructions is at www.irs.gov/form1040.

Name(s) shown on return

Your social security number

Part I Interest

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions and list this interest first. Also, show that buyer's social security number and address ▶

VALLEY NATIONAL BANK
ACCRUED INTEREST ON US SAVINGS BONDS - SECTION
454 ELECTION

Amount

75.

2,525.

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the

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ELECTION TO ACCRUE INTEREST ON US SAVINGS BONDS

ON BEHALF OF THE DECEDENT TAXPAYER, AN ELECTION IS HEREBY MADE UNDER IRC SEC. 454(A) TO CURRENTLY RECOGNIZE AS INCOME ALL PREVIOUSLY UNREPORTED INTEREST INCOME ON U.S. SAVINGS BONDS DESCRIBED IN REG. 1.454-1(A)(1) THAT WERE OWNED AS OF MAY 18, 2025 (DECEDENT'S DATE OF DEATH). THE DECEDENT OWNER, WHO HAD PURCHASED THE BONDS WITH HIS OWN FUNDS, USED THE CASH METHOD OF ACCOUNTING, AND HAD NOT PREVIOUSLY ELECTED UNDER IRC SEC. 454(A) TO INCLUDE THE ANNUAL INTEREST INCOME IN GROSS INCOME.

Other Issues

- Decedent's IRA/401k
 - MRD for year of death
 - Federal estate tax deduction
 - Exclusion from NJ gross income for date of death value of annuity/pension/retirement benefits subject to NJ Inheritance Tax
- Unclaimed Property (www.missingmoney.com)

Income Tax Elections for Estates

- Choice of Fiscal Year
- IRC 645 Election
- 65-Day Election (IRC 663(b))
- IRC 643(e)(3) – Property Distributions
- IRC 691(c) – Estate Tax Deduction
- Deducting Expenses on Form 1041 vs. Form 706

Choice of Fiscal Year

- Option to use any month for year-end (cannot be more than a 12-month year).
- Election made when Form 1041 has been filed, not upon applying for the estate EIN or upon filing the extension.

Deferring Income / Accelerating Deductions:

- Choosing optimal fiscal year – income deferral, acceleration of deductions, avoidance of wasting deductions, timing of income inclusion on the beneficiaries' income tax returns versus the estate's income tax return.
- Fiscal year beginning 2/1/26 and ending 1/31/27 defers income reporting (assuming distributions made) by the beneficiary to 2027.
- 11/30/26 Estate Year-End – 2026 Schedule K-1 from a pass-through entity would be included in the 11/30/27 year-end

Example:

The Estate of Jane Doe's current fiscal year ends on 11/30/26. Jane's estate owns an interest in a partnership, Jane Doe, LLC, which has a calendar year-end. The Schedule K-1 for the partnership's year ending 12/31/26 will be included in the estate's income tax return for the fiscal year ending 11/30/27, resulting in an almost full year of income deferral.

Choice of Fiscal Year

Final Year Considerations:

- Excess deductions on termination – the nature of the deductions will determine their deductibility on the beneficiary's individual income tax return.
 - Miscellaneous itemized deductions - not deductible.
 - Deductions under IRC 67(e) – deductible if specific to estate administration (fiduciary and executor commissions, court and probate fees, appraisal fees, etc)
 - Nonmiscellaneous itemized deductions under IRC 63(d) – deductible but subject to any applicable limitations at the individual level (ex: state or local taxes)
- Capital losses of the estate passed out to the beneficiaries.
- If the estate has an interest in a passive activity that is being distributed to a beneficiary (other than in satisfaction of a pecuniary bequest), any suspended PALs associated with the activity at the time of distribution increase the basis of the interest to the beneficiary.
- An NOL of the estate passes out to the beneficiaries to be utilized on their individual income tax returns.
 - In tracking the number of years remaining for the NOL carryover, the final year of the estate and the first year in which the beneficiary reports the NOL count as two separate years.

IRC 645 Election

- Inclusion of qualified revocable trust with estate income tax return.
 - Qualified revocable trust is a trust that is treated as owned by the decedent under IRC 676 due to a power to revoke that was exercisable by the decedent.
- Allows fiscal year-end instead of calendar for trust activity.
- Reduces the administrative burden of filing two separate income tax returns.
- Allows the trust to take advantage of specific income tax provisions that are only allowable for estates.

IRC 645 Election

- Allows the trust to take advantage of specific income tax provisions that are only allowable for estates.
- The allowance to deduct up to \$25,000 of losses from rental real estate activities against non-passive income for the first two years after the deceased owner's death (provided the decedent actively participated in the rental real estate activity).
- Not having a two-year deadline for qualifying as an eligible S corporation shareholder if the trust owns S corporation stock.
- Being eligible to deduct losses for funding pecuniary bequests with noncash property distributions.

IRC 645 Election

Making the election:

- Check the box on page 1 of Form 1041 and include the trust's EIN (new EIN obtained following the decedent's death).
- Attach Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, to the timely filed (including extensions) tax return for the first tax year of the related estate.
- Irrevocable election once made.

Election period – begins on the date of the decedent's death and ends on the earlier of:

- The day on which the electing trust and related estate have distributed all of their assets, or
- The day before the applicable date.

1041



IRC 645 Election

Applicable Date is:

If a Form 706 was required to be filed, the later of:

- **2 years** after the date of the decedent's death, or
- **6 months** after the final determination of liability for estate tax.
 - If a Form 706 was not required to be filed, then 2 years after the date of the decedent's death.

65-Day Election (IRC 663(b))

- Available to estates and complex trusts.
- Ability to treat any distribution made within the first 65 days of the subsequent tax year as having been made in the prior year (by March 6, 2027, for the 2026 year).
 - If the amount(s) distributed within the first 65 days of the subsequent year exceed the amount needed for the election, only the portion for which the election is desired needs to be included in the election.
- Shift income out of compressed trust/estate income tax brackets to beneficiaries (try to avoid the highest tax rates and Medicare surtax).
 - 37% rate applies once taxable income exceeds \$16,000 for 2026.

65-Day Election (IRC 663(b))

- Allows for “hindsight planning” to determine if shifting income out of the estate to the beneficiaries is desirable.
 - Communication between the fiduciary return preparer and beneficiaries’ individual income tax return preparer(s) is key.
- Maximum amount for which the election can be made is the greater of fiduciary accounting income (FAI) or distributable net income (DNI).
- Check the box in the Other Information section on page 3 of Form 1041 and attach the election statement.

65-Day Election (IRC 663(b))

ELECTION UNDER IRC 663(b) TO TREAT TRUST DISTRIBUTIONS UNDER "65-DAY RULE"

Trust Name: _____ EIN: _____

Trustee Name(s): _____ Year Ended: _____

Address: _____

Trustees elect pursuant to Internal Revenue Code 663(b) to treat the distribution(s) listed below as having been made on the last day of the trust's current tax year.

<u>Amount Distributed</u>	<u>Date of Distribution</u>	<u>Recipient Beneficiary</u>
\$XXXXXX		

IRC 643(e)(3) – Property Distributions

General Rule for Property Distributions

No gain or loss is recognized (unless the distribution is in satisfaction of a pecuniary bequest), and the estate's basis in the asset carries over to the beneficiary.

IRC 643(e)(3)

Allows for the recognition of gain (but not loss, due to related party rules) on the distribution of property to the residual beneficiaries of an estate.

IRC 643(e)(3) – Property Distributions

The result of this election is that the asset is treated as “sold” by the estate on the date of distribution.

- If gain is recognized, the beneficiary’s basis is the fair market value (FMV) on the date of distribution.
- If the loss is realized (not allowed to be recognized by the estate), then the beneficiary needs to keep track of two bases:
 - The estate’s basis in the asset will be used to compute a gain on the asset’s disposition by the beneficiary.
 - The FMV of the asset will be used to compute a loss on the disposition of the property by the beneficiary.

If the beneficiary sells the asset at a price that is between the FMV and the estate’s basis of the asset on the date of distribution, no gain or loss will be recognized by the beneficiary.

IRC 643(e)(3) – Property Distributions

Holding Period

When an IRC 643(e)(3) election is made, the beneficiary's holding period begins on the date of distribution.

Making the Election:

Check the box in the Other Information section on page 3 of Form 1041 and report the estate's gain(s) on Schedule D. It is recommended to include "IRC 643(e)(3)" in the asset description on Schedule D.

- Once made, the election applies to all distributions of property made during that tax year and is irrevocable. **
- **Not including specific bequests of property, distributions in satisfaction of pecuniary bequests, and distributions of claims to receive income in respect of a decedent (IRD).

IRC 643(e)(3) – Property Distributions

- Circumstances under which the election should be considered:
 - The estate has capital losses or unused deductions to offset the distribution gains.
 - The beneficiary plans to sell the asset and there is a built-in unrealized gain at the time of distribution.
- There are multiple beneficiaries, and the election will assist in equalizing the tax consequences of property distribution among the beneficiaries.
 - There is a desire to shift income to the beneficiaries, and using FMV will cause the property distributions to carry out more DNI.
- Caution should be taken to avoid creating a disadvantageous tax situation. It is important to consider both the estate's and the beneficiaries' tax situations (such as the estate's capital gains rates and net investment income tax threshold vs. the beneficiaries' and the availability of capital losses at the beneficiary level).

IRC 691(c) – Estate Tax Deduction

Code Section 691(c)

Allows an income tax deduction for the estate tax that was paid on items of income in respect of a decedent (IRD). IRD items are subject to estate tax in the decedent's estate and income tax when the income is received by either the estate or the beneficiary.

Examples of IRD:

- Wages of the decedent received after death
- IRA distributions
- 401(k) distributions
- Annuities
- Accrued interest and dividends as of the decedent's DOD
- Installment note income

IRC 691(c) – Estate Tax Deduction

- If an estate had IRD assets and the federal estate tax was paid, a computation must be performed to determine the estate tax attributable to the IRD assets. This estate tax is an income tax deduction on the IRD recipient's income tax return.
- The deduction is available only in the tax years in which IRD is included in income. The pro-rata deduction amount is based on the current amount and the total IRD to be received.
- For estates, the deduction is taken on page 1, line 19 of Form 1041, and a computation of the deducted amount must be attached to the return.

Deducting Expenses on Form 1041 Vs. Form 706

Comparison of estate tax savings versus income tax savings:

- Consider limitations on the Form 1041 (disallowed 2% floor deductions and allocations to tax-exempt income).
- OBBBA 2/37th reduction rule – discussed later
- Consider the timing of payment versus income recognition on the Form 1041.
- Consider the impact on marital deduction (and the amount of exemption available for portability) and charitable deductions on the Form 706.
 - Estate transmission expenses.
 - Estate management expenses.

Deducting Expenses on Form 1041 Vs. Form 706

Estate Transmission Expenses:

Administration expenses that would not have been incurred if not for the decedent's death. Such as:

- Executor commissions
- Legal fees
- Probate fees
- Appraisal fees

If estate transmission expenses are paid from marital or charitable property, the estate tax marital or charitable deduction must be reduced. If the costs that cause this reduction are being deducted on Form 1041, then there is no offsetting deduction for the decrease in the marital or charitable deduction on the estate tax return. As a result, there will be an increase in the taxable estate and, consequently, a decrease in the remaining exemption available for the surviving spouse via portability or possibly the creation of an estate tax liability.

Deducting Expenses on Form 1041 Vs. Form 706

Estate Management Expenses:

- Expenses incurred for the investment, preservation, and maintenance of estate assets.

Examples:

- Investment advisory fees
- Stock brokerage commissions
- Custodial fees
- Interest

Deducting Expenses on Form 1041 Vs. Form 706

- The estate tax marital or charitable deductions will not be reduced by management expenses attributable to *and* paid from the marital and charitable shares unless the management expenses were deducted as administration expenses on the federal estate tax return.
- The estate tax marital or charitable deductions will be reduced for management expenses paid from the marital share or charitable share but *not* attributable to those shares.
- If the marital or charitable deductions on the estate tax return are significant, it will most likely make sense to take the management expenses attributable to those shares on the Form 1041 to avoid the reduction of those deductions.

Deducting Expenses on Form 1041 Vs. Form 706

Examples of expenses that can be taken on either Form 706 or Form 1041 but not both:

- Executor commissions; legal and accounting fees; appraisal fees and probate fees

Examples of expenses that can be taken on both returns:

- Deductions in Respect of Decedent (DRD): The decedent must have been liable for the expense as of his/her date of death in order for it to be a DRD item:
 - Expenses related to the decedent's business allowable under IRC 162; interest expense allowable under IRC 163; taxes allowable under IRC 164; investment expenses under IRC 212 and percentage depletion allowable under IRC 611.

Deducting Expenses on Form 1041 Vs. Form 706

Election statement outlined in Treas. Reg. 1.642(g)-1 may be handled in either of two ways:

1. Attached to each Form 1041 on which the deductions, which would otherwise have been allowable on Form 706, are being taken.
 2. Filed within the statutory period of limitation for the respective Form 1041 with the appropriate IRS Center for the return.
- Must be filed in duplicate with both statements signed by the executor.
 - Consideration should be given to delaying the filing of the election statement for the deductions until the earlier of the final estate tax assessment or the statute of limitations for the Form 1041.

OBBBA 2/37th Reduction Rule

2/37th rule – for tax years starting 1/1/26 or later, limitation applies to itemized deductions (including charitable deductions, fiduciary fees, professional fees, etc).

Limit reduces otherwise allowable itemized deductions by 2/37ths of the lesser of:

- The itemized deductions or
- The amount by which taxable income exceeds the threshold for the 37% bracket (\$16,000 for 2026)
- Prior to OB3, trusts and estates were exempt from itemized deduction limitations. OB3 repealed that exemption.
- Because of the low threshold for the 37% bracket, most non-grantor trusts and estates will be impacted.
- Note: A trust or estate that distributes all income to charity may now have a tax liability due to the reduction of the charitable deduction.
- Will the DNI deduction be reduced by this threshold? Does that mean that a portion of the DNI will be double taxed – both to the beneficiary and to the estate/trust?
- Congress never clearly stated that it intended to overturn the long-standing trust/estate exemption from itemized deduction limitations. The language in OB3 suggests it was meant for individuals only. Tax practitioners are asking for clarification.
- ***This is as of May 18, 2026.



Questions?



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