



## Take Your Pick: The Importance of Selecting a Fiscal Year for an Estate

By: Arthur F. Dicker, Esq., LL.M., CFP®



**A** decedent's estate can choose a taxable year other than the calendar year for income tax purposes. For the estate's first tax year, the executor can select any period ending on the last day of any month up to one year following the decedent's date of death. For example, if the decedent died on June 4, 2008, the estate's first tax year could end on June 30, 2008, or on May 31, 2009, or on any month-end in between. The selection involves the timing and interplay of the estate's income, deductions, and distributions to beneficiaries. Making the best choice can have meaningful tax consequences for the estate and its beneficiaries.

*Very often the executor will select the longest initial fiscal year possible, for deferral purposes.* For example, if the decedent died on February 15, 2008, the estate's initial tax year could end as late as January 31, 2009. Since all payments to beneficiaries throughout the year are deemed to be made on the last day of the fiscal year, in this case the recipients would not report "distributable net income" (DNI) on their personal income tax returns until calendar year 2009. If the estate has any net taxable income of its own (after subtracting DNI distributions), its income tax payment is not due until May 15, 2009. An estate is not required to make estimated tax payments for its first two years.

*However, in some cases it makes sense to select a short initial fiscal year.* For example, suppose the estate includes valuable personal property, such as a coin collection or a family heirloom, to be distributed to residuary or intestate beneficiaries, which are not specific bequests. Such distributions transfer income to the recipients, to the extent the estate has DNI for the period. By making such distributions early in the administration, before the estate has accumulated significant net income, and electing a short first taxable year, the executor can minimize the amount of DNI reported to the recipients by virtue of these distributions. (Specific bequests do not distribute DNI.) Or, if the decedent died late in the calendar year, the executor might select a January 31 fiscal year-end, so that in subsequent years the reporting of DNI received by beneficiaries is deferred to later calendar years.

*Care must be taken in making this selection.* For any fiscal year selected, if the estate has an "adjusted total loss" (i.e., deduc-

tions exceed income, before distributions), then distributions can be made to beneficiaries income tax-free for that year, but the estate's net loss will be wasted. Only in its final taxable year does the estate distribute a net loss to beneficiaries as a miscellaneous itemized deduction subject to the 2%-of-AGI limitation on their returns. Also, for a short tax year, the estate must annualize its net income for alternative minimum tax purposes (but not for regular income tax purposes). The result can be a surprising AMT adjustment passed through to beneficiaries who receive distributions.

*One other interesting planning opportunity is presented.* IRC Section 645 permits the trustee of a "qualified revocable trust" (including most individual revocable trusts) and the executor of the grantor's estate to elect to have the trust's income, deductions, and distributions reported with the estate's income tax return, for the first two years after the grantor's death. (The trustee can make this election alone, if there is no estate apart from the trust.) In this way the trust can enjoy the benefits of selecting a fiscal tax year. Otherwise trusts in general must report their income, deductions, and distributions based on a calendar year.

*The selection of an appropriate initial fiscal year can be a complicated decision.* The executor and his tax advisor must consider a variety of factors, including the tax situation of the beneficiaries. In some cases the executor may wish to postpone or accelerate the payment of deductible expenses and/or beneficiary distributions, depending on tax year considerations. Because an estate has a compressed tax rate schedule, in most cases the executor will want to avoid the retention of significant net taxable income (other than long-term capital gains and qualified dividend income) within the estate for any taxable year, if at all possible.

*Mr. Dicker is a graduate of Princeton University and Harvard Law School and received his LL.M. in taxation from New York University. He is admitted to practice law in New York, New Jersey and California and is a Founding Member of the Advisors Forum. For more information contact Arthur Dicker at [adicker@pierrolaw.com](mailto:adicker@pierrolaw.com).*