

JANUARY 16, 2025

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FORM 706 VS. FORM 1041: WHAT IS DEDUCTIBLE?

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Navigating the tax landscape during estate administration is like solving a complex puzzle with each piece representing opportunity and risk. One challenge is determining where key expenses can be deducted – on the estate tax return (Form 706) and/or the estate's income tax return (Form 1041). Making this decision impacts the estate's overall tax liability and can also significantly affect beneficiaries. This advisory explores the nuances of these deductions.

OVERVIEW OF FORM 706 AND FORM 1041

Form 706 is filed to report the value of the decedent's estate and calculate estate tax liability. Deductions on Form 706 reduce the taxable estate, potentially lowering the estate tax due. The current federal estate tax rate is 40% on the estate's value that exceeds the federal estate tax exemption amount (\$15,000,000 for 2026).

Form 1041 is filed to report income earned by the estate during administration as the estate is its own tax paying entity. Deductions on Form 1041 reduce taxable income, thereby lowering the estate's income tax liability or the income tax liability of the beneficiaries if distributions were made.

WHEN IS FORM 706 REQUIRED?

The fiduciary of an estate must file Form 706 if a decedent's gross estate, plus adjusted taxable gifts made during the decedent's lifetime, exceed the federal estate tax exemption amount.

If a decedent's surviving spouse wants to use the decedent's unused tax exemption, called the Deceased Spouse Unused Exemption (DSUE), the fiduciary must file Form 706 even if the estate is below the federal estate tax exemption amount. This filing is commonly called the "portability election."

WHEN IS FORM 1041 REQUIRED?

The fiduciary must file Form 1041 for a domestic estate that (1) has gross income for the tax year of \$600 or more; (2) has a beneficiary who is a nonresident alien; or (3) held a qualified investment in a qualified opportunity fund (QOF) at any time during the year.

An estate is a domestic estate if it is not a foreign estate. A foreign estate is an estate where the income is from sources outside the United States that is not effectively connected with the conduct of a U.S. trade or business and is not includible in gross income.

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FORM 706 VS. FORM 1041: WHAT IS DEDUCTIBLE?

DEDUCTIONS ON FORM 706

Some of the deductions that can be taken on Form 706 include the below:

- **Funeral Expenses.** Certain funeral expenses qualify for a deduction including, but not limited to, costs related to the decedent's burial or cremation, tombstone, monument, mausoleum, or burial lot.
- **Unpaid Debts of the Decedent:**
 - Debts owed at the time of death, like loans, mortgages, home equity lines of credit, credit cards, outstanding bills are deductible on Form 706.
 - Property taxes accrued prior to the decedent's death, thus owed at the time of death are deductible on Form 706.
- **Claims Against the Estate.**
- **Medical and Dental Expenses.** Expenses related to medical and dental treatment also qualify for deductions if not taken on the decedent's final Form 1040.
- **Certain Taxes.** Deductions apply to certain taxes, including, but not limited to, state death taxes (estate, inheritance, legacy, or succession taxes paid on any property included in the gross estate as the result of the decedent's death to any state or the District of Columbia).
- **Theft and Casualty Losses.** A deduction for theft and casualty losses can only apply before such property is distributed to beneficiaries, and certain criteria must be met, including the IRS definitions for theft and loss.
- **Statutory Deductions Unrelated to Expenses:**
 - A marital deduction (Section 2056 or 2056A of the Internal Revenue Code) is a statutory deduction that generally applies to the value of the property that passes from the estate to the surviving spouse.
 - A charitable deduction (Section 2055 of the Internal Revenue Code) is another statutory deduction that generally applies to the value of the property that passes from the decedent's estate to the United States, any state, a political subdivision of a state, the District of Columbia, or a qualifying charity for exclusively charitable purposes.

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FORM 706 VS. FORM 1041: WHAT IS DEDUCTIBLE?

Certain administrative expenses can be claimed as deductions on either Form 706 or Form 1041, but not both. These are often referred to as "elective deductions." Simply put, the law allows the estate to claim such expenses as either an estate tax deduction on Form 706 or an estate income tax deduction. Such administrative expenses include the below.

■ Estate Administration Expenses:

- Probate and court filing fees
- Executor or trustee fees
- Legal fees related to estate administration
- Appraisal fees necessary
- Accounting fees for estate tax preparation

■ Investment Related Expenses:

- Fees related to the management and preservation of the estate

DEDUCTIONS ON FORM 1041

In addition to the elective deductions that can be claimed on either Form 706 or Form 1041, not both, below are some further deductions that can be taken on Form 1041:

- **Property Taxes.** Property taxes on real estate held by the estate that accrue after the decedent's death and are paid by the estate.
- **Theft or Casualty Losses.** These include losses that occur during the estate administration (must meet certain criteria including the IRS definitions for theft and loss).
- **Income to Qualified Charitable Organizations.** Gross income paid or permanently set aside for qualified charitable organizations, provided such distribution is specifically provided for in the decedent's will or trust.
- **Losses.** Losses incurred on the estate's assets from sale or otherwise.
- **Mortgage Interest and Other Interest.**

Income tax deductions on Form 1041 may be subject to additional limitations under income tax rules, such as miscellaneous itemized deduction thresholds.

Key Considerations for Choosing the Appropriate Form for Deductions

Knowing that elective deductions can be claimed on either Form 706 or Form 1041, but not both, creates a tax planning opportunity for fiduciaries and their professional advisors. If an estate's total value exceeds the federal estate tax exemption amount, claiming deductions on Form 706 can reduce the taxable estate and therefore the federal estate tax liability. If an estate's gross value^{the value before any deduction/s} below the federal estate tax exemption, deductions on Form 706 provide no tax benefit. In such cases, elective deductions may achieve better tax savings if taken on Form 1041, particularly for estates with significant income.

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This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

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The rules preventing double deductions do not apply to deductions for taxes, interest, business expenses, deductible alimony, and other items accrued before the decedent's death. These expenses are allowable as a deduction for estate tax purposes as claims against the estate on Form 706 and are also allowable as deductions in respect of a decedent for income tax purposes on Form 1041. Deductions for interest, business expenses, and other items not accrued at the date of the decedent's death are allowable only as a deduction for administration expenses for both estate and income tax purposes and do not qualify for a double deduction.

Adequate records must support the allocation of expenses to ensure compliance with IRS guidelines.

STATE INCOME TAX CONSIDERATIONS

In addition to the federal estate tax, some states impose a state estate tax and state income tax. For a decedent of a state that imposes a state estate tax, a deduction on Form 706 may not affect the federal estate tax liability but may reduce or eliminate the state estate tax liability if the same deduction is taken on the state estate tax return. Fiduciaries of such estates may consider various factors—the state estate tax rate, the amount of income earned by the estate, and the estate beneficiaries' income tax and financial situation—in determining the appropriate return on which to take the deduction.

CONCLUSION

If the estate is unlikely to owe estate tax, it is often more advantageous to deduct elective deductions on the estate's income tax return to reduce the estate's income tax liability. Conversely, in taxable estates, these deductions can significantly lower the estate tax burden.

If you have any questions or need guidance on navigating the tax landscape during estate administration, please do not hesitate to contact a Wiggin and Dana attorney.