The "Bare Bones" of Distributions Under Oregon Probate Law and Federal Income Tax Law

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Representing clients before the probate court is a lawyer's domain and an often mysterious one at that. Probate law is governed, in its entirety, by state law. In Oregon, that law is codified in the "Oregon Probate Code." Federal income tax returns are, however, based upon federal income tax laws, of course. Yet, Oregon's regimented probate laws will impact how CPAs prepare fiduciary income tax returns for Oregon estates. Many significant tax issues involve the timing of distributions to beneficiaries. Understanding how and when distributions are deemed to have been made is particularly important as tax professionals strive to reduce the estate's taxable income.

A decedent's estate is a "disfavored" income tax entity for two reasons. First, a fiduciary income tax return is required if the estate has gross income of $600 or more[1] (well below the threshold for individuals) or if the estate has a beneficiary who is a non-resident alien.[2] Second, estate taxable income greater than $11,650 is taxed at 35 percent, while a single taxpayer, or a married taxpayer who is filing a joint return, reaches that bracket at $388,350.[3] CPAs and attorneys are likeminded in trying to minimize an estate's taxable income whenever possible. This article will review Oregon probate law and provide examples of how CPAs must consider when distributions are deemed to have occurred in accordance with those laws during the fiduciary income tax return preparation process.

Oregon Probate Code Primer

Probate is a court's oversight of the transfer of title of a decedent's assets to the decedent's heirs and devisees. Probate is the legal procedure through which the court settles claims, ensures that taxes are paid or provided for, and determines who will ultimately receive the decedent's property. Mechanically, a probate is comprised of approximately a dozen filings with the court over a period usually ranging from six months to three years.

A probate requires the appointment of a Personal Representative (often referred to as an executor in states other than Oregon). A Personal Representative's powers, authority, and duties flow from statutory law (the Oregon Probate Code), the will (if any), and the orders/judgments of the probate court. The Personal Representative is a fiduciary and, therefore, has a legal duty to act primarily for the benefit of others in matters connected to their undertaking. The Personal Representative, not the estate, is the client of both the lawyer and the CPA.

Interplay Between Oregon Probate Code and Income Taxation of Estates

Properly preparing fiduciary income tax returns for an estate requires that CPAs understand three important concepts:

1. What is an "Estate"? While this question may seem very basic, the answer depends on the context in which the question is being asked. It is that context which can affect how a CPA prepares an estate's tax returns.

Probate: For Oregon Probate Code purposes an "estate" is defined as "… the real and personal property of a decedent, as from time to time changed in form by sale, reinvestment or otherwise, and augmented by any accretions or additions thereto and substitutions therefore or diminished by any decreases and distributions therefrom."[4] Assets passing by operation of contract (life insurance, IRA, bank accounts and bonds with pay on death language) and assets passing by

operation of law (joint tenancy with rights of survivorship) are not part of the decedent's probate estate.

Estate Tax: In the estate tax arena, the term "estate" is broadly defined. The Internal Revenue Code uses the term "gross estate," which is defined as "… the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated" [5] but only "…to the extent of the interest therein of the decedent at the time of his death."[6]

Fiduciary Income Tax: The fiduciary income tax concept of an "estate" is much narrower in scope than the estate tax concept and is consistent with that of Oregon Probate Code. For fiduciary income tax purposes, an "estate" is the separate taxable entity for which the decedent's assets have become subject to the control of a fiduciary who is responsible for collecting assets, paying debts, taxes, and legacies, and distributing the balance of the assets to the heirs or residuary legatees.[7] In short, an estate for fiduciary income tax purposes consists only of property that passes into the Personal Representative's effective control during the period of administration.[8]

2. When Can Distributions to Beneficiaries Be Made? A Personal Representative can only distribute an estate's assets to its beneficiaries, regardless of whether or not the distribution is partial or final, *after* the probate court enters an order/judgment of distribution.[9] Factors the probate court considers in determining whether to enter an order/judgment of distribution depend on the type of distribution being sought.

Partial Distribution: A partial distribution of an estate occurs during the estate's administration, including, but not limited to the following circumstances: (i) as a way to dispose of assets that are difficult and time-consuming to manage (i.e., an ongoing business); (ii) when there is substantial cash in the estate not needed for administration purposes; (iii) to dispose of assets specifically devised; or (iv) to dispose of income-producing assets. A partial distribution of an estate will be allowed by the probate court so long as sufficient assets remain in the estate to pay support for a surviving spouse and children, administration expenses, and all known unpaid creditors, and as long as there will be no loss to creditors, the estate, or interested parties.[10]

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Final Distribution: A final distribution of an estate occurs after the probate court enters a judgment of final distribution. In order to receive a judgment of final distribution, the Personal Representative must file a final account declaring, under penalty of perjury, that all of the necessary tasks of estate administration have been completed including: (i) filing of the appropriate notices and publications; (ii) payment and settlement of claims; and (iii) payment of any taxes and the filing of tax returns.[11]

3. When is an Estate Allowed an Income Distribution Deduction? An estate is allowed an income distribution deduction equal to the sum of:

(1) The amount of income required to be distributed currently under the terms of its governing instrument (a so-called "first-tier distribution");[12] and

(2) Any other *amounts properly paid, credited, or required to be distributed* (a so-called "second-tier distribution").[13]

Whether or not a distribution was "properly paid" for purposes of IRC§ 661 is determined *under state law*, e.g., the Oregon Probate Code.[14] Courts have interpreted the requirement that amounts be "properly credited" as meaning that the income must be so definitively allocated to the beneficiary as to be beyond recall. Thus, an entry on the books of the Personal Representative is not a "credit" unless the entry means that the "credit" is equivalent to payment.[15]

How the Oregon Probate Code Affects Fiduciary Income Tax Return Preparation

The following are a few scenarios involving the interplay of Oregon probate law and federal fiduciary income tax law:

Scenario 1

A decedent died with a valid will and two surviving children. The estate owns, among other assets, a land sale contract that arose when the decedent sold Oregon real property at a gain. The contract produces the only taxable income of the estate. The Personal Representative receives monthly payments of principal and interest income on the contract. During the estate's first tax year: (i) the court *did not* enter an order/judgment of distribution of any estate assets, and (ii) the estate did not make any distributions of assets to the beneficiaries.

Query: Can the CPA prepare and issue form K-1 to the estate's beneficiaries, thereby in effect distributing the estate's taxable income to them?

Answer: No. The court has not entered an order/judgment of distribution (either partial or final) allowing the Personal Representative to distribute assets to the beneficiaries. Therefore, the estate has no income distribution deduction because no amounts were "properly paid, credited, or required to be distributed" during the year. The estate shoulders the fiduciary income tax burden of the income received during this year.

Scenario 2

An Oregon resident died intestate (without a will) in 2012. The decedent had no surviving spouse or children. Under Oregon law, the heir of the decedent's ▶

estate is his nephew. Decedent's probate estate consists of an IRA that was payable to the decedent's estate because the IRA did not name a beneficiary. The estate received the distribution of funds from the IRA in 2012 and, as a result, the estate had taxable income of $50,000 for tax year 2012. In addition to the probate estate, the decedent had a bank account with $15,000 on deposit. The bank account was owned by the decedent, but the decedent named his nephew as a P.O.D. (pay on death) beneficiary.

Query: Can the CPA prepare a 2012 form 1041 for the estate and report the estate's income resulting from the estate's receipt of the IRA on forms K-1 issued to the decedent's nephew?

Answer: No. Because the bank account passed to the decedent's nephew under its P.O.D. provision, the bank account is not part of the decedent's probate estate.[16] The monies in the bank account that were paid directly to the decedent's nephew under the P.O.D. provision were not "properly paid, credited, or required to be distributed" *by the probate estate*. Therefore, the distribution of the bank account to the nephew does not equate to a distribution by the estate for purposes of allowing an income distribution deduction for the IRA income.

Scenario 3

The decedent died on January 1, 2010 with a will. The Personal Representative elected a calendar year end. The Personal Representative was able to procure a general judgment of final distribution that was entered in the court records on December 23, 2011. Due to the holidays, the Personal Representative was not able to pay the estate's administrative expenses (Personal Representative fees, attorney fees, and CPA fees) and distribute the estate's assets to the beneficiaries until January 15, 2012. For 2012, the estate had excess deductions of $17,500.

Query: IRC§ 663(b) allows a Personal Representative to elect to treat distributions to beneficiaries made within 65 days after the end of the fiscal year as if they were made during the fiscal year. As the estate's assets were distributed before March 7, 2012, does the "65-day rule" allow the CPA to file the 2011 fiduciary income tax return as the final return for the estate?

Answer: No. The 65-day rule is a federal income tax rule applicable to distributions to beneficiaries. Making the 65-day rule election does not change the fact that the probate estate, in this case, has three tax years: the first fiscal year is January 1, 2010 through December 31, 2010; the second fiscal year is January 1, 2011 through December 31, 2011; and the third fiscal year is January 1 through January 15, 2012. This estate will need 2010, 2011, and 2012 fiduciary income tax returns. The filing of the 2012 fiduciary return is required to pass the excess deductions to the estate's beneficiaries.[17]

Conclusion

The interplay between the Oregon Probate Code and Internal Revenue Code makes this area of practice particularly challenging. In an effort to reduce an estate's federal income tax costs, professionals may file forms 1041 that reflect distributions to beneficiaries when, under the Oregon Probate Code, no such distributions were made. In addition, professionals may use the 65-day rule to reduce the number of fiduciary income tax returns for an estate when, under state law and the Internal Revenue Code, additional returns are required. Therefore, even though navigating a client through the probate process is a domain that is usually reserved for attorneys, we recommend that tax professionals preparing fiduciary income tax returns understand the nuances of the Oregon Probate Code.[18]

Authors' profiles appear on page 4.

Endnotes

1 IRC Section 6012(a)(3).

2 IRC Section 6012(a)(5).

3 IRC Section 1; see also Revenue Procedure 2011-55, Section 3, Tax Rate Tables for taxable years beginning in 2012.

4 ORS 111.005 (15).

5 IRC§ 2021(a).

6 IRC§ 2033.

7 Rev. Rul. 59-375, 1952-2 CB 161; B

8 The instructions to form 1041 (2011) state: "Before preparing Form 1041, the estate or trust fiduciary must figure the accounting income of the estate or trust under the will or trust instrument and local law* to determine the amount, if any, of income that is required to be distributed, because the income distribution deduction is based, in part, on that amount." (*emphasis added).

9 Note that the distribution of an asset is different from a Personal Representative allowing a beneficiary to have "custody" of an asset during administration. In the situation where a beneficiary is allowed "custody," the Personal Representative retains the right to request the return of the asset.

10 ORS 116.103.

11 ORS 113.145, ORS 113.155, ORS 115.003, ORS 116.083(4)(b), ORS 116.083(a), ORS 116.1133(2).

12 IRC§ 661(a)(1).

13 IRC§ 661(a)(2); Treas. Reg. 1.661(a)-2(a).

14 Buckmaster v. U.S., 984 F.2d 379 (10th Cir. 1993).

15 Comm'r v. Stearns, 65 F.2d 371 (2d Cir. 1933), cert. denied sub nom. Stearns v. Burnet, 290 U.S. 670 (1933); Harris v. U.S., 370 F.2d 887 (4th Cir. 1966); Igoe v. Comm'r, 19 T.C. 913 (1953). Although not overtly stated in IRC§ 661, "income required to be distributed," and "amounts properly paid, credited or required to be distributed" refers to events taking place, or to take place, within the taxable year. Thus, even though under a Will or the laws of intestate succession the Personal Representative will eventually distribute the estate's assets to beneficiaries does not mean that for any taxable year before actual distribution, the assets are "required to be distributed."

16 For assets passing by operation of contract to be excluded from the decedent's probate estate, the assets must not be payable to the decedent's estate.

17 The ability to pass unused excess deductions out to an estate's beneficiaries is only available in the year of termination of an estate or trust. IRC §642(h). The beneficiaries can use this excess deduction as a miscellaneous itemized deduction subject to the 2 percent floor on their own individual income tax return. Treas. Reg. 1.642(h)-2(a).

18 The risk of course is that an income tax audit may occur years after an estate is closed and its assets distributed to beneficiaries. The Personal Representative may be liable for any unpaid taxes, interest and penalties.