CHAPTER 27

Estate Tax Deductions

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When you die, it is likely that those charged with administering your final affairs will have responsibility for paying, from your estate or revocable trust, a variety of costs, expenses, and other financial obligations on your behalf. These may include your funeral expenses, debts you owe at your death, and expenses required to administer your estate. The good news is that these expenses are deductible on your estate tax return, which in turn, can produce estate tax savings for your family. The even better news is that if you do not owe an estate tax at your death, many of these expenses can instead be taken as income tax deductions, thereby translating into income tax savings for your family. However, it is important that those who administer your estate understand these rules in order to obtain the tax savings available.

There are four types of expenses that qualify as estate tax deductions. They are:

Funeral Expenses. Examples include funeral and cemetery charges and payments to officiating clergy.

Administration Expenses. Costs incurred to administer your final affairs are also deductible for estate tax purposes. These deductible expenses include accounting fees to prepare your final income tax return, income tax returns for your estate or trust, and your estate tax return, if necessary. They also include attorney fees, executor fees, trustee fees, and probate costs necessary to administer your property and affairs. Finally, administration expenses include other miscellaneous expenses, such as appraisal fees, and expenditures to maintain property in good condition prior to distribution to beneficiaries.

Claims. Claims are amounts you owe at your death that your estate is legally obligated to pay. They include items such as final utility bills for the month in which you die, credit card balances owed at your death, and any other financial obligations you have incurred but which are still unpaid at your death. They also include any income taxes due for income you earned in the year of your death.

Mortgages. Any indebtedness secured by a mortgage on real estate you own at your death also qualifies for an estate tax deduction. For example, if you die with a

$100,000 mortgage on your home and an additional home equity loan of $25,000, a deduction of $125,000 can be taken on your estate tax return.

In addition to deducting the foregoing expenses, any casualty losses, such as theft losses or losses resulting from a fire or flood occurring during the administration of your estate not otherwise compensated by insurance are deductible for estate tax purposes.

The biggest impediment in making use of estate tax deductions is that for the majority of people who die, no estate tax is due regardless of whether estate tax deductions are claimed. This occurs for two reasons. First, if you are married when you die and leave your estate to a surviving spouse, there is no estate tax due regardless of the size of your estate because of the unlimited marital deduction. Second, if the value of your estate is less than the amount of the estate tax exemption in the year of your death, no estate tax will be due. For example, for persons dying in 2009, the amount of the estate tax exemption is $3.5 million. Therefore, if you die that year with an estate less than that amount, there is no estate tax.

The fact that no estate tax is due does not mean your family cannot benefit from estate tax deductions, because the portion of your estate tax deductions that qualify as administration expenses, if not deducted on an estate tax return, may be deducted on the income tax return for your estate or revocable trust during the administration of your estate or revocable trust. In addition, medical expenses incurred by you prior to your death paid within one year of your death may be deducted on your personal income tax return for the year in which you incurred those expenses if they are not deducted on your estate tax return.

The examples that follow will help clarify how your family can best benefit from your available estate tax deductions.

SCENARIO 1: At the time of your death, you are not married, and your estate has a value of $4.5 million. The estate tax exemption at that time is $3.5 million and the estate tax rate is 45%. Your estate is entitled to the following estate tax deductions:

Funeral bill	$ 5,000
Credit card balances	2,000
Other debts	5,000
Appraisal fees	2,000
Executor and Trustee fees	10,000
Accounting fees for income and estate tax return preparation	10,000
Attorney fees	10,000
TOTAL DEDUCTIONS	**$44,000**

Since the estate tax rate in this example is 45%, taking $44,000 in deductions on your estate tax return saves your family $19,800 in estate taxes ($44,000 x 45%).

SCENARIO 2: The facts are the same as in Scenario 1 except that you are married at the time of your death. If your estate plan took advantage of the unlimited marital deduction, there is no estate tax due even though the gross value of your estate exceeds the exemption amount. Therefore, no tax benefit would result by claiming your estate tax deductions on an estate tax return. However, those estate tax deductions that qualify as administration expenses can be deducted on your estate's income tax return. In our example, all expenses other than the funeral bill, credit card balances, and other debts qualify as administration expenses. These administration expenses total $32,000. If your estate is in a 33% income tax bracket and these are taken as deductions on the estate's income tax return, your family will save $10,560 in income taxes ($32,000 x 33%).

SCENARIO 3: At the time of your death, your estate has a value of $1 million, and the estate tax exemption is $3.5 million. Whether or not you are married, there will be no estate tax due because the exemption is greater than the value of your estate. As in our prior example, there would be no tax benefit by claiming your estate tax deductions to reduce your estate tax. However, as in Scenario 2, those estate tax deductions qualifying as administration expenses can be deducted on your estate's income tax return. If those expenses and the tax rate are the same as in the previous scenario, the same $10,560 in income taxes is saved for your family.

SCENARIO 4: There is no estate tax due upon your death. However, $50,000 in medical expenses are incurred in the year of your death in connection with your final illness. If those medical expenses are paid within one year of your death and are not claimed as estate tax deductions, then you are entitled to claim the medical expenses as an itemized deduction on your personal income tax return for the year of your death.

What you should do: Carefully choose the parties who will act as executors of your will and/or trustees of your revocable trust to be sure that they have the experience and know how to take advantage of the tax saving opportunities available after your death. Include language in your estate planning documents to grant them the flexibility they need to take advantage of those opportunities. Such language would be similar to:

> *"My Trustee's authority to make tax elections shall include, but shall not be limited to, the right to elect whether to take administration expenses as estate tax deductions or income tax deductions."*

Steven B. Spewak works with his clients to preserve wealth and protect assets while achieving personal and family objectives, minimizing taxes, and providing comfort and peace of mind.