

Tax Considerations in the Year of Death

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1

Agenda

- Tax opportunities in the year of death.
- Decedent's Final Income Tax Return.
- Estate Income Tax Filing.
- Trust Income Tax Filing.
- Estate Tax Return.
- Stepped-Up Basis.
- Qualified Disclaimers.
- State-Specific Considerations.
- Action Plan— Putting it All Together

2

Tax Opportunities

- Electing Estate Fiscal Year.
- Use Decedent's carryforward losses.
- Filing Federal Estate Tax Return for Portability and Step Up in Basis.
- Distributable Net Income Deduction.

3

Decedent's Final Income Tax Return

- ❑ Due for the period from January 1 of the year of death until the Date of Death.
- ❑ Filed by April 15 of the year following the year of death, or October 15, with extension.
- ❑ Filed by the Executor in the case of a single individual, or by the surviving spouse in the case of a married individual filing jointly.
 - ❑ **Note** – An Executor must be appointed in order to file the federal income tax return. Even if the probate estate has no assets due to a Revocable Trust or transfer and death planning, an Executor should be authorized in order to file the final income tax return.
 - ❑ **Note** – The Executor has personal liability for the payment of income taxes for the decedent, including any previously unfiled tax years (See §3713), if distributions are made to beneficiaries before taxes are paid. The income tax filing must be made under penalties of perjury.
 - ❑ **Note** – There is a 3-year statute of limitations for claiming any refund that may be due.
 - ❑ **Practice Tip** – File [Form 4506-T, Request for Transcript of Tax Return](#) to obtain a tax to transcript for any unfiled tax years to verify if any taxes are owed or refunds due.

4

Decedent's Carryforward Losses

- ❑ Use it or Lose it.
- ❑ **Long Term Capital Losses** – Capital loss carry forward is lost for future tax years. Capital loss carry forwards can be utilized by the estate or the surviving spouse on the final income tax return filed for the year of death. Capital losses are losses generated by capital assets (e.g. Real estate, stocks). Capital losses cannot offset ordinary income, only capital gain income.
 - ❑ **Practice Tip – Surviving Spouse**. Examine the immediate prior year tax return for any carryforward losses and the current year for any realized losses. While the decedent's assets will enjoy a stepup in basis, the spouse's assets, or the spouse's share of joint assets, will not enjoy a stepup in basis. Examine built-in capital gains in the spouse's assets and consider liquidating assets to match against carryforward and same year losses.
 - ❑ **Practice Tip – Estate**. This will only apply to gains following date of death since the stepup in basis will eliminate built-in gains during lifetime. Before the end of the tax year consider any gains since date of death and if assets can be liquidated and the gains offset against the losses.

5

Decedent's Carryforward Losses (Cont'd)

- ❑ **Net Operating Losses** – Net Operating Loss carry forward is lost for future tax years unless the surviving spouse is operating the business that generates the Net Operating Loss. Net Operating Losses can be used by the surviving spouse in the year of death to offset ordinary income. Operating Losses are generated by business activity (e.g. sole proprietorship, limited liability company, limited partnership, S-Corporation).
 - ❑ **Practice Tip – Surviving Spouse Operates Business**. Surviving spouse can carry forward 50% of the Operating Losses into future years.
 - ❑ **Practice Tip – Surviving Spouse Generates Ordinary Income**. The surviving spouse does a Roth IRA conversion in an amount so that the ordinary income generated by the Roth IRA conversion in the year of death is equal to the Net Operating Loss and is reflected on the final joint income tax return.

6

Decedent's Carryforward Losses (Cont'd)

Excess Charitable Contributions— Charitable contributions can be deducted up to 30% - 60% of Adjusted Gross Income. Excess charitable contribution deductions are lost for future tax years. Further, the excess charitable contribution deductions continue to be limited to 30%-60% of adjusted gross income.

Practice Tip – Surviving Spouse Defers Additional Deductions. The surviving spouse defers additional deductions in the year of death, pushing them to a future income tax year, so that as much of the surviving spouse's income as possible can be absorbed by the Excess Charitable Contribution.

7

Estate – Income Tax Year

General Rule – A Estate may use a calendar year or fiscal year as its tax year (See §441(e), §443, §7701(a)(1), §7701(14)). A fiscal year is a 12-month period ending on the last day of any month other than December. A Fiscal Year tax return is due by the 15th day of the 4th month after the end of the fiscal tax year.

Example – Harry dies on August 25, 2023. His Executor chooses a fiscal year ending March 31. The first year of the estate begins August 26, 2023 and ends March 31, 2024. The next year will be from April 1, 2024, to March 31, 2025. If the estate terminates on September 15, 2025, the last fiscal year will begin April 1, 2025, and end September 15, 2025.

Note – The first and last tax years of the estate will be short years.

Making a Fiscal Year Election - A fiscal year can only be adopted when Executor files the estate's first Form 1041. The following do NOT select a Fiscal Tax Year, so a Fiscal Tax Year can be elected on a late filed return:

- Application for automatic extension of time to file a federal income tax return (Form 7004)
- Application for an employer identification number (Form SS-4)
- Payment of estimated taxes.

8

Estate – Income Tax Year (Cont'd)

Why Select a Fiscal Year? Timing of Taxation of Distributions to Beneficiaries– Income distributed to a beneficiary is deemed distributed on the last day of the estate's fiscal year, regardless of when the actual distribution occurred. As a result, a beneficiary who receives a distribution in one calendar year may not have to report any income resulting from the distribution until the following year.

Example – Harry dies on August 25, 2023. His Executor chooses a fiscal year ending March 31. The first year of the estate begins August 26, 2023, and ends March 31, 2024. The estate makes a distribution of \$1,000,000 to Beth, of which \$100,000 is income to the Estate, on December 15, 2024. The distribution of \$100,000 of income is "deemed" to be made to Beth on March 31, 2025. This means that Beth will receive the \$100,000 in December 2024, but the income will not reported until Beth's 2025 income tax return, and the tax will not be due until April 15, 2026.

9

Trust – Income Tax Year

- General Rule** – A trust must use the calendar year (See §644).
- Revocable Trust Can Elect to be Treated as part of the Estate for Income Tax Purposes** – This election allows a decedent’s Revocable Trust to be treated as an estate for a limited timeframe and to take advantage of tax rules that apply to estates but not to trusts. (See §645). These may include:
 - Using the estate’s fiscal year for income tax purposes.
 - Being entitled to the charitable set-aside deduction under §642(c).
 - Being an eligible S corporation shareholder.
 - Being permitted to recognize loss upon the satisfaction of a pecuniary bequest with assets that have a fair market value less than basis pursuant to §267(b)(13).
 - Having the active participation requirements under the passive loss rules waived for tax years ending less than two (2) years after the decedent’s death pursuant to §469(j)(4).

10

Trust – Income Tax Year (cont’d)

- Making the Election** – The election is made on Form 8855 and is effective for all taxable years of the estate but:
 - If an estate tax return is required, not longer than six (6) months after the final determination of the federal estate tax liability (One (1) year after the date of the closing letter for the estate tax return).
 - If an estate tax return is not required, the election is effective for two (2) years after the date of death.
 - Note: An estate tax return filed solely to elect portability is not a “required” return for this purpose.
 - The election must be made by the Executor and the Trustee by the due date of the first Form 1041, including extensions.
 - The election is irrevocable.

11

Grantor Trusts → Non-Grantor Trusts

- Issue** - Upon the Grantor’s death all Grantor Trusts - Revocable and Irrevocable - become Non-Grantor Trusts.
- EIN** – A new EIN should be obtained for (1) any Revocable Trust, and (2) any Irrevocable Trust that was taxed as a Grantor Trust during the Grantor’s lifetime.
 - Practice Tip** – These EIN’s are likely to be short-lived and only utilized during the period of administration until the trust assets are distributed to the ultimate beneficiaries, either (1) individuals, or (2) resulting trusts, which should each have their own separate EIN.
- First Income Tax Year** –
 - Revocable Trust** – Unless an election is made so that the Revocable Trust is treated as part of the Estate, the first tax year will be from the day after the Date of Death until December 31. A Form 1041 must be filed by April 15 of the following year, or October 15 if a timely extension is filed.
 - Irrevocable Trust** – The first tax year will be from the day after the Date of Death until December 31. A Form 1041 must be filed by April 15 of the following year, or October 15 if a timely extension is filed.

12

Income Taxation of Estates and Non-Grantor Trusts

- Compressed income tax rates.
- Distinction between Trust Accounting Income and Trust Taxable Income.
- Distributable Net Income considerations before the 65th day of the next tax year.

13

Estate/Non-Grantor Trust Tax Rates

2023 Federal Estate and Trust Income Tax Rates	
If taxable income is:	The tax is:
Not over \$2,900	10% of taxable income
Over \$2,900 but not over \$10,550	\$290 plus 24% of the excess over \$2,900
Over \$10,550 but not over \$14,450	\$2,126 plus 35% of the excess over \$10,550
Over \$14,450	\$3,491 plus 37% of the excess over \$14,450

← 20% Long Term Capital Gains and Qualified Dividends

14

... Compare to Individual Income Tax Rates

Tax Rate	For Single Filers	For Married Individuals Filing Joint Returns	For Heads of Households
10%	\$0 to \$11,000	\$0 to \$22,000	\$0 to \$15,700
12%	\$11,000 to \$44,725	\$22,000 to \$89,450	\$15,700 to \$59,850
22%	\$44,725 to \$95,375	\$89,450 to \$190,750	\$59,850 to \$95,350
24%	\$95,375 to \$182,100	\$190,750 to \$364,200	\$95,350 to \$182,100
32%	\$182,100 to \$231,250	\$364,200 to \$462,500	\$182,100 to \$231,250
35%	\$231,250 to \$578,125	\$462,500 to \$693,750	\$231,250 to \$578,100
37%	\$578,125 or more	\$693,750 or more	\$578,100 or more

Source: Internal Revenue Service

← Compare to \$14,450

15

... Compare to Individual Capital Gain Tax Rates

	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
0 %	\$0	\$0	\$0
1 5 %	\$44,625	\$89,250	\$59,750
2 0 %	\$492,300	\$553,850	\$523,050

Source: Internal Revenue Service

16

Estates/Non-Grantor Trusts – Income Tax Issues

- Fiduciary Accounting Income** – Income defined under the Uniform Principal and Income Act and the Estate/Trust governing documents.
- Taxable Income** – Income defined under the Internal Revenue Code.
- Distributable Net Income** – Income that can be “shifted” from the Estate/Trust to the Beneficiary’s income tax bracket.

17

Fiduciary Accounting Income

Income	Principal
Interest	Capital Gains
Dividends	Insurance Proceeds
Rent	
Administration Expenses	Principal Debt Payments
50% Fiduciary Commissions	50% Fiduciary Commissions
50% Attorneys Fees	50% Attorneys Fees
50% Property Insurance	50% Property Insurance

18

Taxable Income

Taxable Income
Interest
Dividends
Rent
Capital Gains
Administration Expenses
Fiduciary Commissions
Attorneys Fees
Property Insurance
Capital Losses

19

Distributable Net Income ("DNI")

Taxable income with modifications:

- Adjusted Taxable Income (taxable income minus deductions)
- + Capital Losses
- + Tax Exempt Interest
- Capital Gains not paid or distributed to a beneficiary
- Distributable Net Income (for tax purposes)**

20

Example - DNI Difference

DNI	\$	100,000.00
Tax - Retained by Trust	\$	31,653.00
Tax - Paid to Beneficiary	\$	14,768.00
<u>Difference</u>	\$	<u>16,885.00</u>

21

DNI – 65 Day Rule § 663(b)

- Election** – A Fiduciary may make a distribution within the first 65 days of the new tax year and treat that distribution as if it was made on the last day of the prior tax year.
- Election Date** –
 - Calendar year returns – March 6 of the following year (unless a leap year, then March 5).
 - Fiscal year returns – 65 days after the end of the Fiscal Year.
- Practice Tip:**
 - In the 4th quarter of the current tax year, estimate Accounting Income, Taxable Income, and DNI. Consider making distributions of DNI to beneficiaries in lower income tax bracket.
 - 30 days into the next tax year, calculate Accounting Income, Taxable Income, and DNI. Consider making distributions of remaining DNI to beneficiaries in lower income tax bracket before 65 days.
 - Consider combining a Fiscal Year election of an Estate with DNI distributions to lower the overall tax on the Estate's taxable income and push the taxation of the DNI distribution to a future tax year of the beneficiary.
 - Consider the state of residency of any beneficiary in doing DNI calculations.

22

Estate Tax Return

- Due** - 9 months after date of death.
 - Automatic 6-month extension of time to File.
 - No automatic extension of time to Pay.
- Required** for taxable estates (gross estate plus prior taxable gifts is in excess of the exemption amount at date of death).
- Strongly recommended** where there is a surviving spouse for Portability of the deceased spouse's Estate Tax Exemption Amount (currently \$12,920,000).
 - Practice Tip** – Revenue Procedure 2022-32 allows for a late estate tax exemption for portability to be made up to 5 years from a deceased spouse's date of death.
 - Practice Tip** – If the surviving spouse chooses not to file a federal estate tax return to elect Portability, obtain written confirmation of their informed decision not to file for Portability.
- Strongly recommended** where there are assets subject to an appraisal for valuation purposes (business, real estate, litigation proceeds, etc.). There is a 3-year statute of limitations for the IRS to challenge any valuations. Thereafter, the beneficiaries may rely on the valuations for establishing basis of assets.

23

Step-Up in Basis - § 1014 – General Rule

- (a) In general - Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be – **(1) the fair market value of the property at the date of the decedent's death,**

24

Step-Up in Basis - § 1014 – Property Acquired From Decedent

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For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

- (1) Property acquired by **bequest, devise, or inheritance, or by the decedent's estate from the decedent;**
- (2) Property transferred by the decedent during his lifetime in trust to **pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust**
- (3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to **pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;**
- (4) Property passing without full and adequate consideration under a **general power of appointment exercised by the decedent by will;**

25

Step-Up in Basis - § 1014 – Property Acquired From Decedent (cont'd)

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For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

- (6) ... property which **represents the surviving spouse's one-half share of community property** held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, **if at least one-half of the whole of the community interest in such property was includable in determining the value of the decedent's gross estate** under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) ...;
- (9) ...**property acquired from the decedent by reason of death**, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), **if by reason thereof the property is required to be included in determining the value of the decedent's gross estate** under chapter 11 of subtitle B ...
- (10) Property includable in the gross estate of the decedent under section 2044 (**relating to certain property for which marital deduction was previously allowed**). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

26

Step-Up in Basis - § 1014 – Transfers Within One Year of Death

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(e) ...if— (A) appreciated property was **acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death**, and (B) such property is acquired from the decedent by (or **passes from the decedent to**) the **donor of such property** (or the spouse of such donor),

- **the basis of such property** in the hands of such **donor (or spouse)** shall be the **adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.**

Practice Tip – Always have a disclaimer trust available in the Foundation Estate Plan so assets shifted from well spouse to ill spouse will can pass to a trust (a separate taxpayer from the donor spouse).

27

Qualified Disclaimers §2518

- Requirements –**
 - Irrevocable and unqualified.
 - In writing.
 - Within nine (9) months of date of death.
 - Disclaimant cannot have accepted any interest disclaimed or any of its benefits.
 - The interest disclaimed must pass either (1) to the spouse of the decedent, or (2) to a person other than the disclaimant, without any direction on the part of the person making the disclaimer.
- Opportunities –**
 - Disclaim retirement account to an individual in a lower tax bracket.
 - Disclaim property transferred to the ill spouse within 1 year of date of death to a Credit Shelter Trust to get a basis step-up.

28

State Tax Issues

- Depending on the state of residency of the decedent, state income tax returns may need to be filed (equivalent of Form 1040, Form 1041).
- Determine the state of residency of the beneficiaries to give guidance on Distributable Net Income.
- Consider if any additional estate tax/inheritance tax returns are due the timeframe for filing the same.

29

Action Plan

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| <p>Documentation:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Three (3) prior year file tax returns. <input type="checkbox"/> Tax transcript if no prior returns. <input type="checkbox"/> Beneficiary state of residency. <p>Tax Elections:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Estate Fiscal Year. <input type="checkbox"/> Revocable Trust treated as an Estate. <p>Grantor Trusts (Revocable and Irrevocable):</p> <ul style="list-style-type: none"> <input type="checkbox"/> New EIN to report income as of date of death through the end of the trusts tax year. <p>Carryforward Losses:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Examine prior years 1040 determine if there are any carryforward losses and plan to generate income to offset them before lost. | <p>Tax Return Filings:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Final Form 1040 <input type="checkbox"/> Estate First Year Form 1041 <input type="checkbox"/> Grantor Trust Final Form 1041 <input type="checkbox"/> Irrevocable Trust First Year Form 1041 <input type="checkbox"/> Estate Tax Return <p>Distributable Net Income:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Consider in the fourth quarter of the Estate/Trust tax year. <input type="checkbox"/> Calculate and distribute within 65 days of the end of the Estate/Trust tax year. <p>Qualified Disclaimer:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Consider within 9 months of date of death. |
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30
