PRACTICAL INCOME TAX ISSUES ARISING IN EVERYDAY ESTATE PLANNING AND ADMINISTRATION

By

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I. INTRODUCTION

Income tax issues routinely arise in common family estate and business planning transactions. However, such issues are often overlooked in situations where saving transfer taxes is the focus of the planning. Also, sometimes accountants and lawyers who are familiar with the general income tax rules applying to transactions between unrelated parties are unfamiliar with exceptions to the general rules that only apply to related party transactions. The purpose of this outline is to raise your awareness as to certain selected income tax issues that you may encounter in your T&E practice.

II. INCOME TAX CONSEQUENCES OF NON-CHARITABLE GIFTS

A. Income Shifting

1. Benefits are Limited. Income shifting will save only small amounts of income taxes today, which is a huge change from when the author started practice, due to rate reduction, bracket compression, expanded kiddie tax rules, prohibitions against multiple trusts, and the elimination of many income shifting devices (Clifford trusts, Rushing trusts, spousal remainder trusts, etc.).

2. Relevant Factors. Many factors besides bracket differential may impact the amount of tax savings achieved through income shifting, including the kiddie tax rules, the percentage limitations on various deductions (medical expenses, charitable deductions, casualty losses, miscellaneous itemized deductions, etc.), the partial disallowance of itemized deductions impacting high income taxpayers, capital and net operating loss carry-forwards, phase out of the $25,000 real estate exception to the PAL rules, AMT consequences, etc.

3. Shifting Income to Trust. Only a maximum of $1,681.80 (if the trust gets a $100 exemption) or $1,761.00 (if the trust gets a $300 exemption) of 2013 federal income tax savings will

result from shifting taxable income from a highest bracket individual taxpayer to a trust with no other income.

4. Kiddie Tax Rules. The kiddie tax rules have been expanded and now apply to children who are under 19 and dependent full-time students who are under age 24. For 2012, a child having only investment income will not pay income tax on the first $950 of such income and will pay income tax at the child's rate on the next $950 of investment income, with any excess taxed at the parents' rate. IRC § 1(g).

5. 529 Plans. Income earned in a 529 Plan that is subsequently spent on qualifying educational expenses will never be taxed to anyone. IRC §529.

B. Consequences of Gifts To The Donor

1. Any income generated on gifted property after the date of the gift is shifted from the donor's income tax return to the donee's income tax return.

2. Any unrealized gain in appreciated gifted property becomes the donee's problem (as the donee receives a carryover basis) unless the gift itself is characterized as a taxable disposition triggering gain to the donor (such as in the case of a gift of an installment obligation).

3. Gift loans (i.e., those containing a below market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a de minimis rule. IRC §7872.

4. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead to be paid by the donee), the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted cost basis in the property. Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981).

Example: Assume that a donor has no remaining exclusions or unified credit, and that such donor is in a flat 50% gift tax bracket. If a $1 million asset having no cost basis was gifted away in a net gift transaction (i.e., the donee was to pay any gift tax due), then a net gift of $666,667 would be made by the donor. The donee would pay the donor's $333,333 gift tax liability, which would be "boot" to the donor. The donor would have $333,333 of gain (i.e., the amount of boot in excess of basis).

5. Where a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that indebtedness exceeds the basis of the property. Winston F. C. Guest, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the nonrecourse obligation, and the fair market value of the property is irrelevant to the computation. Tufts v. Commissioner, 103 S.Ct 1826 (1983).

6. The transfer of an installment obligation by lifetime gift will constitute a disposition and cause an acceleration of the deferred gain for income tax purposes. IRC §453B.

7. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of suspended passive activity losses. IRC §469(j)(6).

C. Consequences of Gifts To The Donee

1. Gross income does not include the value of property acquired by gift, bequest, devise or inheritance. IRC §102(a).

2. Gross income does include the income derived from any property acquired by gift, bequest, devise or inheritance. IRC §102(b)(1).

3. Gross income does include the amount of such income where the gift, bequest, devise or inheritance is of income from property. IRC §102(b)(2).

4. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether the donee has received gross income. IRC §§61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift made gratuitously and with donative intent is not included in gross income. Helvering v. American Dental, 318 U.S. 322 (1943).

D. Adjusted Basis Of Gifted Property

1. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

2. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC §1015.

Example: Assume that the donor gives stock having a basis of $200 and a fair market value of $1,000 to child, and pays $400 of gift tax. The basis adjustment for the gift tax paid is [(1000 minus 200)/1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.

3. The basis of gifted property is increased (but not to above fair market value) by generation-skipping taxes paid. IRC §2654. This basis adjustment for GST taxes paid is applied after the basis adjustment for gift taxes paid pursuant to IRC §1015.

4. Any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis and benefit the donee (although a dual basis may exist, and such addition to basis, to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction). IRC §469(j)(6).

Example: Assume that the donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended PAL of $40. When the asset is gifted, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

5. For purposes of determining loss in a subsequent sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC §1015. This can result in the gifted asset having one basis for gain purposes and a different basis for loss purposes (i.e., dual basis).

Example: Assume that a donor has an asset with a fair market value of $100 and an adjusted cost basis of $150. If such asset is gifted during life, and if no gift tax is due on such gift, then the donee will have a $100 basis for loss purposes and a $150 basis for gain purposes. No gain or loss would be recognized by the donee if the property is subsequently sold for more than $100 and less than $150.

III. LOANS TO FAMILY MEMBERS

A. In order to avoid the adverse rules relating to below-market loans, which impute interest income and gifts to the lender if inadequate interest is charged, it is necessary to comply with the rules contained in IRC §7872.

B. No interest is imputed if the loan is $10,000 or less, and the loan proceeds are not used by the borrower for income producing investments.

C. No interest is imputed if the loan is $100,000 or less, provided that the borrower has no more than $1,000 of total net investment income.

D. If the loan is $100,000 or less, and the borrower does have investment income exceeding $1,000, then the imputed interest in any year will not exceed the borrower's net investment income for such year.

E. On other loans, interest at the applicable federal rate (the "AFR") must be charged if imputed interest problems are to be avoided. Such rates are published monthly for short-term (0-3 years), mid-term (3-9 years) and long-term (9+ years) loans.

IV. INCOME TAX CONSEQUENCES OF RELATED PARTY TRANSACTIONS

A. Who is a Related Party

Although the Internal Revenue Code has many different provisions dealing with related parties, IRC §267 is the key section defining related parties which is used by most of the other sections which contain special tax rules for related party transactions. Complex attribution rules govern the

determination of who is a related party. Pursuant to IRC §267(b), related parties include: (1) Members of a family as defined in subsection (c)(4) [i.e., brothers and sisters (half-blood and whole-blood), spouse, ancestors, and lineal descendants]; (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (3) Two corporations which are members of the same controlled group (as defined in subsection (f)); (4) A grantor and a fiduciary of any trust; (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) A fiduciary of a trust and a beneficiary of such trust; (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual; (10) A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock in the corporation, or more than 50 percent of the capital interest, or the profits interest, in the partnership; (11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; (12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or (13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

B. Section 1031 Exchanges Between Related Parties

Normally, taxpayers who do a 1031 exchange with each other don’t care what the other party does with the exchange property after the deal is closed. However, if a taxpayer exchanges property with a related person in a Section 1031 tax-free exchange and within two years of the last transfer which was part of the exchange, either party disposes of the property received by that party in the exchange, then the original transaction does not qualify for the non-recognition of gain or loss under Section 1031 for either party. IRC §§267 and 1031(f).

C. Sales of Depreciable Assets to Related Party

Gain on the sale of a capital asset is usually capital gain income (unless the recapture provisions contained in IRC §§1245 and 1250 apply). However, in the sale or exchange, directly or indirectly, of property between related parties, any gain recognized by the transferor is treated as ordinary income if the property in the transferee's hands is depreciable property. IRC §§267 and 1239.

D. Sale of Depletable Property to Related Party

IRC §1239, which applies to the sale of depreciable property between related parties, does not appear to apply to depletable property. PLR 8139052 (June 30, 1981).

E. Appreciated Property Acquired By Decedent By Gift Within One Year of Death

In the case of a decedent dying after 1981, if appreciated property was acquired by the decedent within one year prior to the decedent's death, and if such property is subsequently reacquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), then the original donor of such property will not receive a basis step-up at death. For example, a person owning highly appreciated assets could not gift them to his or her terminally ill spouse and get a stepped-up basis if such assets were subsequently reacquired by inheritance within a year. IRC §1014(e).

F. Disallowance of Losses on Sales Between Related Parties

A loss can normally be claimed when investment property is sold at a loss. However, no loss is recognized on the sale or exchange of property between related parties (including a trust and its beneficiaries). An estate and its beneficiaries are <u>not</u> deemed to be related parties for this purpose, so an estate (but not a trust, unless it had made a §645 election to be treated as a part of the estate) could recognize a loss if it funded a pecuniary bequest with loss property. Any disallowed loss is carried forward and can be applied to reduce the gain that would otherwise be recognized on the subsequent disposition of the property. IRC §267.

G. Guarantee of Loans to Related Parties

Normally, a guarantor's payment on a debt will be deductible, either as a business bad debt or non-business bad debt. A parent's payment as guarantor on a child's liability will usually <u>not</u> be deductible by the parent. It has been determined that it does not matter whether such a deduction was a business bad debt or nonbusiness bad debt because Treas. Reg. §1.166-9(e) allows bad debt deductions only where the taxpayer received reasonable consideration for making the guarantee and provides that consideration received from a spouse or other defined family member must be direct consideration in the form of cash or property. <u>Lair v. Commissioner</u>, 95 T.C. 35 (1990).

H. Installment Sale to Related Party

Normally, a taxpayer who sells property on an installment basis does not care how or when the buyer of the property subsequently disposes of it. However, if an installment sale is made to a related party who subsequently resells such property before the original seller has been fully paid (with a 2-year cutoff for property other than marketable securities), the sale by the second party accelerates the recognition of gain to the original seller. IRC §453(e).

I. Non-Recognition of Gain or Loss Between Spouses

When one spouse enters into a sale transaction with the other spouse, the transaction is ignored for income tax purposes (i.e., no gain or loss occurs, so basis is unchanged). IRC §1041.

J. Transfer for Value of Life Insurance

Life insurance proceeds are generally not taxed as income to the payee at the insured's death. However, if an existing life insurance policy is transferred for value to a non-excepted transferee (i.e., someone other than the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured was a shareholder or officer), then any proceeds realized in excess of basis will be income to the recipient. IRC §101(a)(2).

V. IMMEDIATE PRE-MORTEM INCOME TAX PLANNING

A. Gifts That Might Be Made or Received

1. Non-Appreciated Property Might be Gifted Away

If the dying client is going to make lifetime gifts, it will usually be desirable to make gifts of cash or of property which is not highly appreciated property (and would thus be entitled to stepped up basis at death if retained by the donor).

2. Loss Property Might be Gifted Away

A client may wish to make gifts of loss assets during life, to the extent that the client cannot utilize such losses during life. The donee can thus have such asset subsequently appreciate in the donee's hands and avoid some gain that would otherwise be taxed to the donee upon later disposition of such asset. IRC §§1014 and 1015.

3. Appreciated Property Might be Received as a Gift

The dying client without an estate tax problem (i.e., because his or her gross estate is under $5,250,000 (in 2013), or because the marital deduction will be used to eliminate the estate tax) may wish to receive gifts of appreciated property prior to death. Such property will be entitled to stepped up basis at the decedent's death unless reacquired by the transferor by inheritance within one year. IRC §1014(e). It appears that such property could be given to the dying spouse by the other spouse within one year of the dying spouse's death and qualify for stepped up basis if such property were left to a wholly discretionary family trust.

4. Certain Charitable Gifts Might be Made During Life

The client may wish to make charitable gifts planned to be made at death instead as lifetime gifts, so as to both get a charitable income tax deduction for such gift and remove such gifted property from the taxable estate. Charitable gifts at death may be taken as an estate tax deduction, but are not entitled to be taken as an income tax deduction.

5. Certain Property Might be Gifted to Charity at Death

The client making charitable gifts at death may wish to designate specific property to satisfy charitable gifts, such as IRA proceeds, pension benefits, other items of income in respect of a decedent (such as zero basis crops in storage, renewal commissions receivable, and installment notes receivable). The charity won't have to pay income tax upon receipt of the cash from such items, but family members would.

B. Planning to Optimize Gains, Losses and Credits

1. Generally Do Not Dispose of Appreciated Property

The dying client will want to retain appreciated property that will be entitled to stepped up basis at death. IRC §1014.

2. Losses Should be Recognized to the Extent Usable

The dying client will want to realize losses to the extent usable to offset gains (plus $3,000), as the basis of loss property is stepped down to its fair market value at the client's death. IRC §1014.

3. Disposition of PAL Assets

The dying client may wish to dispose of passive activity loss assets in a taxable transaction to utilize suspended passive activity losses that would be lost at death. IRC §469(g).

4. Terminate Sales Agreement That Will Generate IRD

The client who has recently entered into a large installment sale of an asset may wish to terminate the sales agreement and reacquire or retain the property in order to avoid the loss of stepped up basis at death.

5. Accelerate Income to Generate Estate Tax Deduction

It may be useful to trigger gain during lifetime so that the income tax paid (or still due at death) relating to the corporate liquidation will be deductible for estate tax purposes. The IRS has historically taken the position that the income tax liability that would be due upon the liquidation of a corporation is speculative and, if available, should be heavily discounted. Where the client has a C corporation holding land that will generate a great deal of income tax liability upon liquidation and such corporation will be liquidated anyway in the near term, a deathbed liquidation might make a lot of sense.

6. Adjust Estimate Income Tax Payments and Withholding

No estimated tax payments relating to the decedent's income need be made after the decedent's death, but the surviving spouse will want to amend his or her estimated tax declaration and withholding exemptions. IRC §6654.

7. Accelerate Income to Avoid Wasting Tax Benefits

It may be advantageous to cause income to be recognized during lifetime where net operating losses, charitable losses, unused investment tax credits, unused capital losses, or other tax benefits exist that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as pension benefits, renewal commissions receivable, and installment notes receivable). The client could elect out of installment sales treatment on sales, collect pension and IRA proceeds while still alive, elect to be taxed on accrued E and EE bond interest, etc.

8. Recognize Losses in Marital Deduction Trust

Assets with unrealized losses held in a marital deduction trust will have their cost basis adjusted downwards (to fair market value) at the death of such trust's beneficiary. IRC §§1014; 2041; 2044. But if such losses are realized prior to the beneficiary's death, they will be preserved for succeeding beneficiaries and, if not used within the trust, will pass out to the ultimate beneficiaries upon termination of the trust. IRC §642(h).

C. Structuring or Restructuring Business Interests

1. Negotiate to Require Section 754 Election

Where an interest in a partnership holding appreciated assets is owned, it will be beneficial to negotiate to require the partnership to make an IRC §754 election so that an inside basis adjustment can be made pursuant to IRC §743(b) upon the death of a partner. In the alternative, it may be possible to achieve the same result (i.e., stepped up basis) under IRC §732 if a liquidation of the partnership or sale of the partnership's appreciated assets can be accomplished within two years of the deceased partner's death.

2. Negotiate Short Year S Corporation Tax Reporting Treatment

S corporation shareholders are taxed on their pro rata share of income, deductions, and credits for the year of death on their final Form 1040. However, an option exists to prorate the income on a per day basis, or to close the books upon a shareholder's death and use an exact method. IRC §1366. In the case of a seasonal business it may be desirable to agree in a shareholder agreement which method is to be used.

3. Assure that S Corporation Status Can Continue After Death

Certain individuals and trusts do not qualify to hold stock in an S corporation, and the client's estate plan must be carefully examined to assure that S corporation stock will pass to a qualified shareholder upon the client's death. Generally, a Qualified Subchapter S Trust (QSST) must have a single beneficiary during such beneficiary's lifetime and must distribute all of its accounting income on an annual basis. IRC §1361.

D. Rearranging Joint Tenancy and Community Property Interests

1. Sever Certain Joint Tenancies With Non-Spouses

It may be desirable to sever certain joint tenancies between owners who are not married to each other. This is because IRC §2040, dealing with the taxability of joint tenancy interests between owners who are not married to each other, requires a tracing of contribution.

2. Sever Certain Joint Tenancies Between Spouses

Tax rules now in effect provide that one-half of property held by husband and wife as joint tenants is included in the estate of the first spouse to die and that the deceased spouse's one-half interest is subject to having its basis adjusted. IRC §§1014 and 2040. However, it has held that joint tenancy property acquired by a husband and wife prior to 1977 is subject to the pre-1977 rules which require a tracing of contribution to determine what portion of it is included in the deceased spouse's gross estate and subject to basis adjustment. Gallenstein v. United States, 91-2 USTC ¶60,088 (D.C. Ky. 1991), affirmed 92-2 USTC ¶60,114 (C.A. 6, 1992).

Pursuant to Gallenstein (and District Courts in the Patten and Anderson cases in the 4th Circuit), if husband and wife have loss property acquired prior to 1977 which is held by them as joint tenants, and if the spouse who is about to die contributed most (or all) of the consideration, then it will be desirable to destroy the joint tenancy prior to death in order to preserve more basis in the hands of the survivors. Likewise, if the client who is about to die made no contribution to the purchase of appreciated pre-1977 property, an application of Gallenstein would suggest that such joint tenancy ownership should be terminated prior to such spouse’s death in order to allow basis step-up to occur that would otherwise be denied.

3. Create Community Property With Appreciated Separate Property

It may be desirable to convert appreciated separate property into community property if the client is married and lives in a community property state (or to convert appreciated separate property to community property via the Alaska elective community property statute and an Alaska trust). This will be appealing because under IRC §1041 the conversion of separate property to community property is not a taxable event, and under IRC §1014(b)(6) both the decedent's interest and the survivor's interest in community property has its basis adjusted to fair market value at the death of either spouse.

4. Partition Community Property Which Has Depreciated

Conversely, it may be desirable to convert depreciated community property into separate property if the client is married and (because they lived in a community property state at some time) has community property. This results because IRC §1014(b)(6) results in a stepped down basis adjustment for both halves of community property at the death of either spouse, and such a conversion to separate property will allow the surviving spouse to perpetuate his or her higher historic cost basis in property which has declined in value.

VI. DRAFTING TO ALLOW FUNDING FLEXIBILITY

A. Choice of Fiduciaries. If a revocable trust is to be used in conjunction with a pour-over will, consider naming the same persons to be both personal representative and trustee of the revocable trust prior to settlement of the estate, so that tax elections and distributions can be more easily planned and coordinated.

B. Optional Mode of Distributions. Typically a pour-over will is payable to a revocable trust, and the revocable trust may create sub-trusts for the surviving spouse and descendants. Consider allowing the personal representative to optionally make distributions directly to the sub-trusts or beneficiaries of the sub-trusts (i.e., to skip funding steps), rather than only to the revocable trust (which is then an irrevocable administrative trust), to allow for administrative flexibility and moving DNI around.

1. Sample Will Language

a. Grant of Permissive Authority. At any time or times during the period that my estate is being administered, my personal representative (other than any who would financially benefit thereby) may distribute cash and/or other property out of my residuary estate (and the income therefrom) directly: (A) To any trust or trusts which, under the provisions of any trust instrument referred to in PART ONE, have come into existence as a result of my death, and/or, (B) To any individual beneficiary or beneficiaries of any such trust or trusts, other than any who is then under any legal disability, as such personal representative, in its discretion, believes will achieve the minimization of overall taxes and expenses of administration directed in the Article entitled "DEBTS, EXPENSES AND TAXES", provided, however, that (I) The identity of the trusts referred to in this Article and the identity of the persons who are beneficiaries of such trusts referred to in this Article shall be determined solely on the basis of written certification(s) to be furnished to my personal representative by the then acting trustee(s) of such trust(s), and (ii) No distribution which might thus be made to any trust or to any of its beneficiaries shall exceed the amount then remaining to be allocated to such trust as a result of my death under the provisions of said trust instruments, nor shall any distribution which might thus be made to the beneficiary of any trust exceed the maximum amount then distributable to such beneficiary under the terms of such trust. Such amounts shall be determined solely on the basis of written information to be furnished to such personal representative by such trustee.

b. Receipt and Discharge. The receipt evidencing distributions made by my personal representative in good faith pursuant to the provisions of this Article shall discharge and acquit my personal representative to the extent of such distributions and, to that extent, such distributions shall supersede distributions otherwise required to be made under the provisions of PART ONE.

2. Sample Trust Language

a. Certain Distributions Treated as Advancements. If the personal representative of the grantor's probate estate makes any discretionary distribution (as authorized by the grantor's will) directly to any trust which is to come into existence under the terms of this instrument as a result of the grantor's death or to any individual beneficiary of such trust, the amount of such distribution shall be treated as an advance under the Article entitled "DISPOSITION OF RESIDUARY TRUST ESTATE AT GRANTOR'S DEATH" on the allocation ultimately required thereunder to be made to that trust.

C. Pourbacks From the Trust to Estate. Where there is a pour-over will and revocable trust, typically the estate transfers money to the trust, not vice-versa. Consider allowing the trustee to optionally make distributions to the estate (which would enable it to pay debts and expenses with the funds distributed) in order to allow flexibility re moving DNI around, taking advantage of tax differences between estates and trusts, etc. Sample language is below.

1. Sample Trust Language

a. Discretionary Distributions. At any time or times during the continuance of the original trust hereunder after the grantor's death, the trustee may distribute to the grantor's probate estate, as a beneficiary of this trust, cash and/or other property out of any assets then held by this trust, including any which are classified as post death trust income, to whatever extent the trustee, in its sole and absolute discretion, deems advisable in the best interests of the grantor's probate estate and beneficiaries generally.

D. Allow Purchases and Loans. Empower the estate and revocable trust to make loans and asset purchases/sales to/from each other, so that transactions other than distributions (which would move DNI) can take place.

1. Sample Trust Language

a. Certain Purchases and Loans. After the grantor's death, the trustee shall have discretion to purchase any assets from the grantor's probate estate or from any trust, whether created by the grantor under this or by any other instrument or by any other member of the grantor's family, at fair market value, or to loan funds to the grantor's probate estate or any such trust with adequate security and interest rates.

VII. ISSUES ARISING AFTER DEATH

A. Administrative or Master Trust. Revocable trusts typically provide for the creation of subtrusts (i.e., marital trusts, credit shelter trusts, trusts for descendants, etc.) after the grantor's death. It is important to remember that the the revocable trust becomes a separate taxpayer at the grantor's death, and that it is a separate taxpayer from the sub-trusts that will later be funded by it.

B. Estates vs. Revocable Trusts

1. Lifetime Income Tax Consequences. Logically, a revocable living trust which is a grantor-type trust, fully taxable to its grantor during the grantor's lifetime, should be disregarded for all income tax purposes during the grantor's lifetime. Unfortunately, this is not always the case and sometimes inconsistent income tax treatment results. For example, a revocable living trust is an eligible shareholder for the purpose of holding title to stock in an S corporation during the grantor's lifetime. IRC § 1361(c)(2)(A)(I). However, shareholders otherwise entitled to ordinary loss treatment upon the sale of their stock in a qualifying corporation will lose this benefit if such stock is transferred to a trust. IRC § 1244(d)(4).

2. Effect of Grantor's Death

a. A revocable living trust typically allows the grantor, but no one else, to revoke it and thus becomes irrevocable at the grantor's death.

b. The income, deductions and credits attributable to such a grantor-type trust prior to the grantor's death will be reflected on the deceased grantor's final Form 1040.

c. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 C.B. 171. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number on income earned after the grantor's death.

d. If a grantor-type revocable living trust was not exempt from filing trust income tax returns or obtaining a taxpayer identification number during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old taxpayer identification number relating to items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

3. Post-Mortem Income Tax Differences

a. TRA '97 added new IRC §645, which allows most revocable trusts to elect to be treated as a part of the probate estate for income tax purposes during the administration of the estate. Otherwise, a number of differences exist after death with respect to how probate estates and

formerly revocable trusts are income taxed.

b. The revocable living trust becomes a separate taxpaying entity after the grantor's death; if no 645 election is made to treat it as part of the probate estate, it gets an added run up the tax bracket ladder (i.e., on the estate's return as well as the trust's tax return) and the advantage of separate exemptions ($600 for the estate, and either $100 or $300 for the trust). IRC §§ 1(e); 642(b).

c. After TRA '97, an estate is still allowed to recognize some losses for income tax purposes (i.e., losses resulting from the funding of a pecuniary gift), but losses in other taxable transactions between an estate or trust and its beneficiaries are not allowed to be recognized for tax purposes. IRC § 267(b)(5).

d. An estate is allowed to choose a fiscal year for income tax reporting purposes, but a revocable living trust must utilize a calendar year for reporting its income after the grantor's death. IRC § 645(a).

e. Estates are not subject to the throwback rules with respect to accumulated income from prior tax years, but post-TRA '97, some domestic trusts and all foreign trusts are still subject to throwback rules. IRC §§ 665-669.

f. Estates and (since TAMRA) revocable trusts are not required to make estimated income tax payments during their first two taxable years. IRC §6654(k). However, estates have less flexibility than trusts, as trusts can elect to have estimated income tax payments deemed distributed to the beneficiary in any year, but estates can only do so in their last year. IRC § 643(g).

g. Estates having a charitable residuary beneficiary can deduct amounts which are set aside for ultimate distribution to charity. IRC § 642(c). Post 1969-Act trusts are not entitled to the IRC §642(c) deduction, which makes it difficult for trusts to avoid income tax on capital gains realized unless a current year distribution of such gains can be made to charity.

h. Estates have a potentially unlimited charitable income tax deduction. IRC §642(c). But trusts having unrelated business income that is contributed to charity are subject to the percentage limitations on deductibility applicable to individuals. IRC § 681(a).

i. An estate (but not a trust) in its first two taxable years after death may deduct up to $25,000 of losses with respect to rental real estate against other income if the decedent was an active participant with respect to such real estate at the time of death. IRC § 469(i)(4).

j. An estate qualifies to hold to hold S corporation stock for a reasonable period of time, but a revocable trust can continue as an S corporation shareholder for only two years after the grantor's death. IRC §§ 1361(b)(1)(B); 1361(c)(2)(A)(ii).

k. The executor (or personal representative) and a trustee may have personal liability for a decedent's income and gift tax returns, but only an "executor" (as specially defined in IRC § 6905(b), which does not include a trustee) is entitled to a written discharge for personal liability for such taxes. IRC § 6905.

l. Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if so elected. IRC §§ 213(c); 642(g).

m. Estates qualify for IRC § 194 amortization of reforestation expenditures, but trusts do not.

C. Importance of Making Periodic Distributions. Making distributions at least annually in order to shift the income from the tax return of the estate or trust has never been more important than now. In 2013 trusts and estates are taxed at a 25% rate on taxable income in excess of $2,450 (compared to $72,500 for married persons filing jointly) and at a 39.6% rate on taxable income in excess of $11,950 (compared to $450,000 for married persons filing jointly). Threshold levels applicable to the new 3.8% Medicare surtax on investment income also often make it worthwhile to make distributions at least annually from trusts and estates.

D. Recognition of Gain Or Loss When Making Distributions.

1. Income Taxation of Specifically Gifted Assets.

a. No gain or loss is recognized by the estate or trust when it distributes specifically gifted property (e.g., 100 shares of AT&T stock, the family home, etc.).

b. The estate or trust gets no distributions deduction, nor is the beneficiary deemed to receive DNI, upon distribution of specifically gifted property. IRC §663(a)(1).

c. The distributee succeeds to the estate's or trust's income tax basis upon the distribution of specifically gifted property.

2. Income Taxation of Non-Formula Pecuniary Gifts.

a. A non-formula pecuniary gift is a gift of a specific amount of money (e.g., "I give $50,000 to Joe").

b. The estate or trust gets no distribution deduction, nor is the beneficiary deemed to receive DNI, upon the distribution of a specific amount pecuniary gift (e.g., $10,000 to Sally). IRC §663(a)(1).

c. The estate or trust does get a distribution deduction, and the beneficiary will be deemed to receive DNI, upon distribution of a specific amount payable in more than three installments under the terms of the governing instrument (e.g., $10,000 to John, which is required under the terms of the will or trust to be paid in 4 quarterly installments, the first to commence upon the grantor's death). IRC §663(a)(1).

d. The distribution of appreciated property in satisfaction of a pecuniary gift will trigger gain or loss to the distributing estate or trust. Treas. Reg. §1.1014-4(a)(3).

Example: The decedent's will leaves $100,000 to David. The estate gives David stock worth $100,000, but having a basis of $80,000, in satisfaction of such gift. The estate will be deemed to have sold the stock to David, resulting in a $20,000 capital gain. David has no taxable income, and will have a $100,000 basis in such property.

3. Income Taxation of Formula Pecuniary Gifts.

a. A formula pecuniary gift is one which uses a formula to back into the amount of the gift (i.e., "I give Joe an amount equal to one-half of my federal gross estate, valued as of my date of death."). Formula pecuniary gifts are often used to determine the amount of marital deduction gift to be made.

b. Gain or loss (unless IRC §267 prevents a loss from being recognized upon the distribution from a trust) will be recognized when a formula pecuniary gift is satisfied with property, rather than cash, based upon the fair market value of such property at the date of distribution. IRC §1.1014-4(a)(3).

c. However, under a much criticized (and seemingly inconsistent) Subchapter J regulation, a formula pecuniary gift is not deemed to be a gift of a specific sum. Accordingly, the estate or trust making such a distribution will get a distributions deduction, and the recipient will be deemed to receive DNI. Treas. Reg. §1.663(a)-1(b).

4. Income Taxation of Fractional Share and Residuary Gifts. A distribution made pursuant to a fractional or percentage share formula, or a distribution of the residue or a share of the residue, is not "a gift or bequest of specific property or of a specific sum of money". Treas. Regs. §1.663(a)-1(b)(2). Accordingly, such gifts will carry out the income of the estate or trust, if any, to the beneficiary.

5. Income Taxation of In-Kind Distributions.

a. Distributions in kind generally don't result in the recognition of gain or loss, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift. Treas. Reg. §1.1014-4(a)(3). In the case of in-kind distributions where no gain or loss is recognized, the beneficiary gets the estate's or trust's income tax basis in the property so distributed and a second tier distribution takes place

in an amount equal to the lesser of the property's basis or fair market value at the time of such distribution. IRC §643(e).

b. The executor or trustee can make an irrevocable election to recognize gain or loss upon the making of a distribution in satisfaction of a fractional or percentage share formula, or a distribution of the residue or a share of the residue. If such election is made, the property will be deemed sold to the beneficiary at its fair market value on the date of its distribution, and a second tier distribution will take place equal in amount to such fair market value. IRC §643(e)(3).

c. It is often desired to make non-pro rata distributions in kind to beneficiaries. For example, two equal beneficiaries may decide to let one take all of the AT&T stock and the other take all of the GM stock, with cash being used to equalize the distributions to the extent necessary, rather than splitting each and every asset. Such non-pro rata distributions can be taxed as constructive taxable exchanges between the two beneficiaries unless either the governing instrument (i.e., the will or trust) or applicable local law specifically allow non-pro rata distributions to be made.

6. Distributions of Installment Obligations and IRD Items.

a. An in-kind distribution by an estate of an installment obligation which was created prior to the decedent's death, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift, will not be a disposition of such installment obligation for the purpose of acceleration of gain. IRC §453(e)(6).

b. No such exception exists for in-kind distributions of an installment obligation created after the decedent's death, and any distribution of such an installment obligation will trigger gain.

c. When doing estate planning for a person whose assets consist of a great deal of installment obligations receivable and IRD items, it will be desirable to avoid pecuniary formula gifts under the estate planning documents that must be funded with such items and/or to make specific gifts of such items to the desired individuals or sub-trusts.

d. When administering an estate or trust with a highly appreciated asset which is about to be sold on an installment basis, consider first distributing the asset to the beneficiary and then letting the beneficiary enter into the installment sale. This will avoid having the gain accelerated upon the subsequent distribution of the installment obligation to the beneficiary of the estate or trust.

e. When administering an estate or trust that has a substantial installment obligation receivable that was created after the decedent's death, it may be desirable to find some excuse to keep the estate or trust open for as long as possible to avoid having to distribute the installment note and thus accelerating the gain.

E. **Termination of Trust or Estate**. An estate or trust is deemed terminated when all of its assets (less a reasonable reserve for liabilities) have been distributed. A trust will have a reasonable period after the distribution date established in the trust instrument (e.g., the trust might say it terminates when the beneficiary reaches age 30) to wrap things up; it will not be terminated as a trust for tax purposes until it actually effects final distribution. However, a constructive termination of an estate or trust will occur if administration is unduly delayed. Reg. § 1.641(b)-3(a).

VIII. HANDLING BACK INCOME TAX RETURNS AFTER DEATH

A. **Notice of Fiduciary Relationship**. The executor [or if none, the testamentary trustee, residuary legatee(s), or distributee(s)] should file Form 56 with the IRS to advise the IRS of the fiduciary relationship. This will cause the fiduciary to receive tax notices that otherwise would have been sent to the decedent. IRC §6903; Treas. Reg. §§601.503; 301.6903.

1. A short-form certificate or authenticated copy of letters testamentary or letters of administration showing that the executor's authority is still in effect at the time the Form 56 is filed, otherwise an appropriate statement by the trustee, legatee, or distributee, should accompany the Form 56. Treas. Reg. §§601.503; 301.6903.

2. The Form 56 must be signed by the fiduciary and must be filed with the IRS office where the return(s) of the person for whom the fiduciary is acting must be filed. Treas. Reg. §301.6903-1(b).

3. Written notice of the termination of such fiduciary relationship (on Form 56) should also be filed with the same office of the IRS where the initial Form 56 was filed. The notice must state the name and address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of fiduciary relationship. Treas. Reg. §301.6903-1(b).

B. **Gathering Income Tax Background Information.**

1. Need for Information. It will be necessary to determine what income tax returns have or have not been filed by the decedent, and to examine such returns, in order to ascertain whether or not all required returns have been properly filed.

2. Ascertaining What Tax Returns Have Been Filed. The IRS will inform you what tax returns have been filed by the decedent. It is necessary for the executor to make a written request for a "Record of Account" from the appropriate region. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

3. Ascertaining the Amount of the Decedent's Income. The executor may not be certain that he or she has information concerning all of the decedent's income relating to years for which

the executor will file income tax returns on behalf of the decedent. It is necessary to request in writing "All Information Returns" (you should be as specific as possible) in writing from the appropriate region. Information is available after August 1st relating to the prior year, and six years' worth of information is kept in the IRS computers. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. Call 1-800-829-1040 for details.

4. Getting Copies of Prior Filed Tax Returns. Copies of prior income tax returns filed by the decedent can be obtained from the IRS via Form 4506. Consider requesting at the same time copies of gift tax returns filed by the decedent. Be sure to make your request to the proper region or district, based upon where the decedent filed the return in question. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied for a fee ($57 per return the last time the author checked). Call 1-800-829-1040 for details.

5. Contact Area Disclosure Officer. Any questions concerning what information is available from the IRS, or procedurally how to get at such information, should be directed to the IRS Area Disclosure Officer. Such person is usually very knowledgeable and helpful with regard to such matters.

C. **Duty to File Income Tax Returns and Pay Tax Due**.

1. Liability of Fiduciaries.

a. The executor or administrator of the estate of a decedent, or other person charged with the property of a decedent, is required to file the final income tax return for such decedent. IRC §6012(b); Treas. Reg. §§1.6012-3(b)(1); 1.6012-1.

b. Pursuant to the concept of "fiduciary liability" the executor is personally liable for the income and gift tax liability of the decedent, at least to the extent that assets of the decedent come within the reach of such executor. 31 USC §3713.

c. Fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes the living or deceased debtor's property to other creditors before he satisfies a debt due to the United States. 31 USC §§3713(a) and 3713(b).

(1) Such liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate or of the insolvency and collective creditor proceeding involving a living debtor, the priority of 31 USC §3713(a) is applicable.

(2) The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States is paid.

(3) The fiduciary must know or have reason to know of the government's tax claim.

d. Fiduciaries will frequently delay making distributions until they are no longer liable for the decedent’s income tax and estate tax liabilities. Refunding agreements with beneficiaries and state law provisions allowing fiduciaries to get back prior distributions to settle estate liabilities are sometimes relied upon - but require that the beneficiary still have the funds to refund to the estate.

2. Liability of Transferees.

a. Transferee liability may make the transferee: (1) of property of a taxpayer personally liable for income taxes, (2) of property of a decedent personally liable for estate taxes, and (3) of property of a donor personally liable for gift taxes. IRC §6901.

b. Transferee liability at law exists under IRC §6901 if the government can prove:

(1) The taxpayer transferred property to another person;

(2) At the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for a tax;

(3) There is a valid contract between the taxpayer who is the transferor and the transferee; and

(4) Under the terms of that contract, the transferee assumed the liabilities of the taxpayer, including the obligation to pay the tax or specifically the obligation to pay the taxes of the transferor.

c. Transferee liability at equity exists under IRC §6901 if the government can prove:

(1) The taxpayer transferred property to another person;

(2) At the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for the tax;

(3) The transfer was made after liability for the tax accrued, whether or not the tax was actually assessed at the time of the transfer;

(4) The transfer was made for less than full or adequate consideration;

(5) The transferor was insolvent at the time of the transfer or the transfer left the transferor insolvent; and

(6) The government has exhausted all reasonable efforts to collect the tax from the taxpayer-transferor before proceeding against the transferee.

3. Liability of Consenting Spouses. In the case of joint income tax returns, joint and several liability is imposed on husband and wife for that year's income tax liability. IRC §6013(d)(3).

4. General Tax Lien. After assessment, demand, and failure to pay, a general tax lien attaches automatically to "all property and rights to property, whether real or personal, belonging to the [taxpayer]". IRC §6013(d)(3).

5. Priority of Tax Claims.

a. In a probate setting, the state law rules relating to the time and place for filing claims don't apply to the tax claims of the United States. Board of Comm'rs of Jackson County v. U.S., 308 US 343 (1939); United States v. Summerlin, 310 US 414 (1940).

b. Section 3713(a) of the Revised Statutes generally provides that a debt due to the United States be satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors.

c. Although no exceptions are made in Section 3713(a) of the Revised Statutes for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. GCM 22499, 1941-1 CB-272 and Rev. Rul. 80-112. 1980-1 CB 306.

D. Place for Filing Decedent's Income Tax Returns.

1. The final Form 1040 should normally be filed in the internal revenue district in which the legal residence or principal place of business of the person making the return is located (i.e., based upon where the executor is located, which is not necessarily where the decedent filed his or her returns), or at the service center serving such internal revenue district. IRC §6091(b)(1)(A); Treas. Reg. §31.6091-1(a).

2. If such person has no legal residence or principal place of business in any internal revenue district, the return should be filed with the District Director, Internal Revenue Service, Baltimore, Maryland, 21202, except as provided in the case of returns of taxpayers outside the United States. Treas. Reg. § 1.6091-2(a).

3. The return made by a person outside the United States having no legal residence or principal place of business in any internal revenue district should be filed with the Director of International Operations, Internal Revenue Service, Philadelphia, PA 19255, or as otherwise directed in the applicable forms and instructions. Treas. Reg. § 31.6091-1(c).

E. Applicable Statutes of Limitations.

1. Assessment of Additional Income Tax Due.

a. Income tax must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC §6501(a).

b. The normal three year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC §6501(e)(1).

c. There is no limit on the statute of limitations where a false return was filed, there is a willful attempt to evade tax, or no return was filed. IRC §6501(c).

d. The normally applicable statute of limitations is extended as to transferees --- for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC §6901(c).

e. The taxpayer and government can agree to indefinitely extend an income tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC §6501(c)(4).

2. Claiming Refund of Income Tax Paid.

a. A tax refund claim must generally be filed within three years from the time the related return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed, within two years from the time the tax was paid. IRC §6511(a).

b. Special rules extend the time for filing a claim for refund in cases where the period for assessing tax has been extended and in other cases. IRC §§6511(c); 6511(d).

c. Equitable mitigation provisions exist that may be useful in cases where a refund or credit would otherwise be barred by the applicable statute of limitations. See IRC §§1311-1314; 1341.

3. Request for Prompt Assessment. The executor may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the

executor by separately filing Form 4810. Treas. Reg. §301.6501(d)-1(b). It is not believed that this increases the audit exposure on such returns.

4. Discharge From Personal Liability. The executor may request a discharge from personal liability for estate, income and gift tax liabilities of the decedent (which gives the IRS nine months to collect such taxes from the executor) by making a request for such a discharge (Form 5495) pursuant to IRC §2204 (as to estate tax), or §6905 (as to income and gift tax). This does not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that this increases the audit exposure on such returns.

IX. THE DECEDENT'S FINAL FORM 1040.

A. General Income Tax Considerations

1. Applicable Rules and Definitions.

a. If client turned 65 on January 1, 2013, he or she is considered to be age 65 at end of 2012.

b. Gross income means all income received in the form of money, goods, property, and services that is not exempt from tax, including any gain on the sale of a home (even if part or all of the gain may be excluded or postponed).

c. Social Security benefits are not included unless the taxpayer is married filing separately and lived with his or her spouse any time during the year in question.

2. 2012 Income Tax Return Filing Thresholds. See IRC §6012(a).

a. If Single (including divorced and legally separated), under age 65 - Gross income of $9,750.

b. If Single (including divorced and legally separated), 65 or older - Gross income of $11,200.

c. If Head of Household, under age 65 - Gross income of $12,500.

d. If Head of Household, 65 or older - Gross income of $13,950.

e. If Married, Joint Return, both spouses under 65 - Gross income of $19,500.

f. If Married, Joint Return, one spouse 65 or older - Gross income of $20,650.

g. If Married, Joint Return, both spouses 65 or older - Gross income of $21,800.

h. Married, Filing Separately - Gross income of $3,800.

i. If a Single Dependent, under 65:

(1) Unearned income exceeds $950; or

(2) Earned income exceeds $5,950; or

(3) Total income exceeds larger of $950 or earned income (up to $5,650; and

(4) If client is blind, add $1,450 to these numbers.

j. If a Qualifying Widow(er) with dependent child, under age 65 - Gross income of $15,700. If client is blind, add $1,150 to these numbers.

k. If a Qualifying Widow(er) with dependent child, 65 or older - Gross income of $16,850. If client is blind, add $1,150 to these numbers.

l. If a Single Dependent, 65 or older:

(1) Earned income more than $7,400.

(2) Unearned income more than $2,400.

(3) Gross income exceeds total of earned income (up to $5,950) or $950, whichever is larger; and

(4) If client is blind, add $1,450 to these numbers.

m. If a Married Dependent, under 65:

(1) Unearned income exceeds $950.

(2) Gross income exceeds $3,800.

(3) Gross income was at least $5 and spouse files a separate return on Form 1040 and itemizes deductions;

(4) For purposes of (1) and (2), if client is blind, add $1,150.

n. If a Married Dependent, 65 or older:

(1) Unearned income exceeds $2,100.

(2) Gross income exceeds $4,950.

(3) Gross income was at least $5 and spouse files a separate return on Form 1040 and itemizes deductions.

(4) For purposes of (a), (b), and (c), if client is blind, add $1,150 to these numbers.

o. If owe any special taxes, such as self-employment tax, alternative minimum tax, nanny tax, recapture taxes, excise taxes. etc.

3. Voluntary Income Tax Filing Situations. It will be desirable to file a return not otherwise required to be filed in order to collect a refund due to withheld income taxes, estimated tax paid, other refundable tax credits, etc., or possibly just to get the decedent "out of the computer" at IRS.

B. Computation of Tax Due on Final Form 1040.

1. Income on the Final Form 1040.

a. Necessity of Receipt. The final income tax return includes only those items that the decedent would have in such period under the decedent's method (i.e., cash or accrual) of accounting.

b. S Corporations. S corporation shareholders are taxed on their pro rata share of items of income, deduction and credits for year of death on their final form 1040 (via the proration method unless all of the shareholders agree to the closing of the books method). IRC §1366.

c. Partnerships. Historically, partnerships did not usually terminate for tax purposes on the death of a partner. Treas. Reg. §1.706-1(c)(3)(ii). This meant that the final form 1040 of a partner who died on any date other than December 31st reflected no partnership income, and the successor (usually the estate) was taxed on the decedent's share of partnership income for its entire year. Effective for partnership taxable years beginning after 1997, the taxable year of a partnership will close upon the death of a partner, causing the pre-death share of the partnership's income to be reported on the deceased partner's final Form 1040. TRA '97, §1246.

d. Dividends and Interest. Dividends and interest received after date of death (but before the asset is retitled into the estate's name) will often have post-death income wrongfully reported as the decedent's income. In order to avoid IRS matching program problems, report on the final Form 1040 the full amount reported to the IRS on Form 1099s as taxable to the decedent, and back out

those amounts received after date of death which are properly reportable on the estate's Form 1041.

e. Savings Bonds. Accrued interest on Series E and EE United States Savings Bonds (and previously accrued Series E or EE interest rolled into Series H or HH United States Savings Bonds) which has not yet been income taxed can be reported as income in the decedent's final year if so elected. IRC §454(a).

f. Final Paycheck. A cash basis decedent will often have a final paycheck (plus accrued vacation time, sick time, etc.) paid after death.

(1) Such payment is an asset of the probate estate (and should be paid to the estate, not to the survivors directly), and should be reported as taxable to the estate (not the deceased individual).

(2) If payment of amounts due is made by the employer in the employee's year of death, no federal income tax is withheld, but Social Security tax, Medicare tax, and Federal Unemployment tax are to be withheld. IRS Publication #15 (1-98), Circular E, Employer's Tax Guide, Section 15.

(3) If payment of amounts due is made by the employer in any year subsequent to the year of the employee's death, no federal income tax, Social Security tax, Medicare tax, or Federal Unemployment tax are to be withheld. IRS Publication #15 (1-98), Circular E, Employer's Tax Guide, Section 15.

g. Estate and Trust Beneficiary.

(1) An income beneficiary of an estate or trust generally includes in gross income his or her share of such entity's income for its taxable year which ends with, or within, the beneficiary's tax year. IRC §§652(c) and 662(c). For example, all distributions made between July 1, 2012 and June 30, 2013 from an estate having a June 30 fiscal year end will be taxable to the distributee on his or her 2013 income tax return as if all such distributions were made on June 30, 2013.

(2) But if a cash-basis income taxpayer is the beneficiary of an estate or trust in his or her year of death, the decedent's final form 1040 must nevertheless include any distributions of income actually received before death. Treas. Reg. §§1.652(c)-2 and 1.662(c)-2. In the example set forth in the prior paragraph, if the distributions were made in July and August, 2013, and the distributee died in October, 2013, all such distributions would instead be taxable on distributee's final 2013 income tax return.

h. Transferable Stock Options. The IRS has held that the subsequent exercise by a donee of a transferable stock option is taxable to the employee at the time of exercise under IRC §83. See PLR 9616035 (4/19/96). If the employee dies before exercise, is there income on the decedent's final return, or does the income tax burden shift to the donee?

i. Advances and Draws. Income items, such as advances and draws against subsequent commission income, may be received with the possibility of having to be later repaid. Such items are income in the year received, pursuant to the "claim of right" doctrine.

j. Roth IRA Conversions Taxpayers could convert regular IRAs to Roth IRAs and report the tax due by reason of the conversion over a four year period (commencing in the year of conversion). IRC §408A. All such previously untaxed income resulting from such a conversion to a Roth IRA will be included as income on the decedent's final form 1040 unless the surviving spouse is the beneficiary of all of the decedent's Roth IRAs and elects to continue reporting the previously untaxed income under the four year rule. See proposed regulation, REG-115393-98 (Tax Analysts Doc. 98-115393-98), published 9/3/98, Fed. Reg. 9/3/98, Vol. 63 #171, at p. 446,939 and 446,940.

2. Deductions on the Final Form 1040.

a. Necessity of Payment. Only deductions relating to items actually paid prior to death are generally deductible on a cash-basis taxpayer's final Form 1040.

b. IRA Contributions. A decedent's estate may not make a post-death IRA contribution on behalf of an individual who could have made a contribution for the year involved, nor can the executor make a post-death contribution to a spousal IRA on behalf on behalf of a decedent's unemployed spouse. PLR 8439066.

c. Medical Expenses. Medical expenses of the decedent paid out of the estate (but apparently not those paid by a revocable living trust, unless an IRC §645 election is made) within one year after date of death may be deducted if so elected. This may require going back and amending a previously filed final form 1040. IRC §§213(c), 642(g).

d. Passive Activity Losses.

(1) Congress enacted the passive activity loss ("PAL") rules to limit a taxpayer's ability to offset non-passive sources of income (active income, such as salary, and portfolio income, such as dividends and interest) with losses from passive sources (such as rental real estate).

(2) Death of the owner of a PAL does constitute a defined disposition of a PAL. IRC §469(g)(2).

(3) A deduction is allowable on the decedent's final Form 1040 only to the extent that the suspended passive activity loss exceeds the IRC §1014 basis step-up.

(4) For example, assume that the decedent had an asset having a fair market value of $100, an adjusted basis before death of $60, and a suspended PAL of $50. The basis of such asset is stepped up by $40 to its $100 fair market value at the decedent's death, and a $10 loss (i.e., the $50 suspended loss, less the $40 basis step-up at death) is deductible on the decedent's final

Form 1040.

e. Unrecovered Basis in Annuity. ". . . where the annuity payments cease by reason of death of the annuitant, and as of the date of cessation there is a unrecovered investment in the contract, and the amount of that unrecovered investment shall be allowed as a deduction to the annuitant for his or her last taxable year. IRC §72(b)(3)(A)."

f. Dependency Exemptions. The decedent's right to claim a dependency exemption pursuant to IRC §152 may be impacted by the decedent's death. Death does not impact the relationship between the decedent and dependent. But death may cause the decedent to lose such dependency exemption by reason of having provided less than the required portion of the dependent's total support in the year of death.

3. Treatment of Open Transactions and Unused Carryforwards.

a. Decedent's Carryforwards. Carryforwards (capital losses, NOLs, unused charitable deductions, etc.) attributable to the decedent die with the decedent. Rev. Rul. 74-175, 1974-1 CB 52.

b. Spouse's Carryforwards. Carryforwards attributable to the surviving spouse can continue to be carried forward by such surviving spouse. It is thus necessary to allocate such carryforward items between the decedent and the surviving spouse.

c. Investment Tax Credits. Certain unused investment tax credits on termination may be taken as a deduction on the final income tax return, and are a "miscellaneous itemized deduction" for purposes of the 2% of AGI deduction floor. IRC §196(b); Treas. Reg. §1.196-1(b).

d. Pending Sale of Residence The gain from the sale of a personal residence by the executor of an estate under an executory contract entered into by the decedent prior to death qualifies for the pre-TRA '97 IRC §121 exclusion relating to the exclusion of gain from the sale of a personal residence. Rev. Rul. 82-1, 1982-1 CB 26, revoking Rev. Rul 70-459, 1970-2 CB 22.

e. Involuntary Conversion Proceeds. There is mixed authority as to whether the decedent's estate or other successor in interest can make a post-death reinvestment of involuntary conversion proceeds in order to avoid recognition of income. Much authority would allow such a tax-free reinvestment. But it would appear necessary that the estate (and not the subsequent distributee) make such reinvestment. See Goodman Estate (CA 3, 1952), 199 F.2d 895, 42 AFTR 877, 52-2 USTC ¶9556; Morris Estate (CA 4, 1972), 454 F.2d 208, 29 AFTR2d 72-391, 72-1 USTC ¶9177, affg 55 USTC 636 (1971); Gregg Estate, 69 TC 468 (1977); Chichester v. U.S. (DC AL, 1978), 42 AFTR2d 78-5139, 78-1 USTC ¶9458; Rev. Rul. 58-407, 1958-2 CB 404. But see Jayne Estate, 61 TC 744 (1974); Rev. Rul. 64-161 CB 298, revoking Rev. Rul. 58-407, 1958-2 CB 404.

C. Other Final Form 1040 Issues and Considerations.

1. Accounting Periods and Methods of Accounting.

a. For the decedent's taxable year which ends with the date of his death, the return shall cover the period during which the decedent was alive. IRC §6012(b)(1); Treas. Reg. §1.6012-3(b)(1).

b. A decedent's final tax year thus ends with the date of his or her death. Treas. Reg. §1.451-1(b)(1).

c. The final return is filed and the tax paid as if the decedent had lived until the end of his or her last tax year (i.e., needn't annualize final return benefits such as exemption). Treas. Reg. §1.443-1(a)(2).

2. Return Filing and Tax Payment Deadlines.

a. The decedent's final income tax return is due on the normal date that it would have been due if the decedent had not died (i.e., usually April 15th of the calendar year following the death of the decedent). Treas. Reg. §1.6072-1(b). This will frustrate survivors in the case of many smaller estates, where the only reason why settlement of a decedent's affairs cannot be completed is the need to file the final Form 1040 (which cannot be filed prior to January 1st following the decedent's date of death).

b. An extension of time to file the income tax return may be requested. IRC §6081.

c. An extension of time to pay the income tax due may be requested. IRC §6161.

3. Filing Status in Year of Death.

a. A joint income tax return for the year of the decedent's death can be filed for the decedent's income through date of death and the surviving spouse's income for the entire year if so elected. IRC §6013(a).

b. Husband and wife status for a given year is determined at the time of death if one spouse dies before the end of the tax year. Thus an estate would have to file either "jointly" or as "married filing separately", and a surviving spouse (unless he or she remarried prior to year end and thus qualifies to file jointly with the new spouse) similarly must file either "jointly" or as "married filing separately" (i.e., not as single). IRC §6013(d)(1)(B).

c. A joint return can be filed where the taxable years of the decedent and surviving spouse are different only if such taxable years begin on the same day and end on different days because one or both of them died. IRC §6013(a).

d. No joint return with the decedent can be filed if the surviving spouse remarries prior to the end of the taxable year or if the tax year of either spouse is a 'short' year because of a change in accounting method. Treas. Reg. §1.6013-1(d)(2).

e. Normally the decedent's executor must consent to the filing of a joint return on behalf of a decedent. However, a surviving spouse can unilaterally file a joint return if: (a) No return has yet been made by the decedent for the tax year for which the joint return is made, (2) No executor has been appointed by the time the joint tax return is filed, and (3) no executor is appointed before the due date for filing the surviving spouse's tax return. Treas. Reg. §1.6013-1(d)(3).

f. The executor can disaffirm any joint return filed by the decedent's surviving spouse. IRC §6013(a)(3).

g. A joint final form 1040 should be signed by both the executor and surviving spouse, but the surviving spouse can sign on his or her own behalf and "as surviving spouse" if no executor has been appointed.

h. If a joint return is filed, there is joint and several liability for the entire tax due. IRC §6013(d)(3).

i. It is necessary to allocate the joint tax liability or joint refund between the decedent and the surviving spouse in order to determine what must be included (or can be deducted) on the Form 706 (Federal Estate Tax Return) of the deceased. Treas. Reg. §20.2053-6(f). <u>See</u>, Rev. Rul. 57-78, 1957-1 CB 300, <u>clarifying</u> Rev. Rul. 56-290, 1956-1 CB 445. Such determination may also be relevant to creditors or children from a prior marriage where all of the decedent's assets do not pass to the surviving spouse (i.e., imagine a case where the decedent’s assets are placed in trust, income to the second spouse for life, remainder to the kids from the first marriage — the parties want the right amount, but no more, relating to the decedent’s share of the taxes paid from the estate).

4. <u>Execution of Final Return</u>. The word "DECEASED" should be written across the top of the Final form 1040 and the date of the decedent's death should appear after the decedent's name in the name and address box at the top of the final form 1040. IRS Pub 559 (2012), page 8.

5. <u>Estimated Income Tax Payments</u>. The estate may not be required to file or pay estimated tax with respect to decedent's income on the final Form 1040. See IRC §6654; Treas. Reg. §§1.6015(b); 1.6153-1(a)(4).

6. Miscellaneous Elections. Miscellaneous elections may be available for events occurring prior to death, such as for involuntary conversions, and exclusion of gain from the sale of a personal residence. IRC §§121; 1033; former §1034 (repealed by §312(b) of P.L. 105-34 for sales after 5/6/97).

7. Claim for Refund.

a. Generally, a person who is filing a return for a decedent and claiming a refund must file a Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, with the return.

b. However, if the person claiming the refund is a surviving spouse filing a joint return with the decedent, or a court-appointed or certified personal representative filing an original return for the decedent, Form 1310 is not needed.

c. But the personal representative must attach to the return a copy of the court certificate showing that he or she was appointed the executor. IRS Pub 559 (2012), page 4.

8. Taxes Due by Military and Other KIAs.

a. Active duty military personnel and certain military or civilian employees of the United States who are killed in action, or die as a result of certain terroristic or military action, may have all of their income tax liabilities for the year of death and prior years excused. See IRC 692.

b. Certain survivor benefits paid by reason of the death of a public safety officer will be exempt from income taxation, effective for amounts received in taxable years beginning after 1996, with respect to individuals dying after that date. Section 1528 of TRA '97, amending IRC §101.

D. Planning Considerations for Final Returns.

1. Adjust Estimated Income Tax Payments and Withholding. No estimated tax payments relating to the decedent's income need be made after the decedent's death, but the surviving spouse will want to amend his or her estimated tax declaration and withholding exemptions. IRC §6654.

2. Accelerate Income to Avoid Wasting Tax Benefits. It may be advantageous to cause income to be recognized on the final form 1040 where net operating losses, unused charitable deductions, unused investment tax credits, unused capital losses, or other tax benefits exist that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as electing out of installment sales reporting on installment notes receivable, electing to be taxed on accrued E and EE savings bond interest, the surviving spouse not electing to continue the installment reporting of

conversion income resulting from the conversion of a regular IRA to a Roth IRA, etc.).

3. Accounting Method for Computing Flow-Through Entity Income. S corporation shareholders (and after TRA '97, partners in partnerships) are taxed on their pre-death share of income, deductions, and credits for the year of death on their final Form 1040. S Corporation income is apportioned using the averaging method, unless the closing of the books (exact) method is elected. Partnerships use a closing of the books (exact) method, unless the averaging method is elected.

4. Offsetting Transactions by Surviving Spouse. The surviving spouse may want to recognize gains or losses, or accelerate income or deductions, so as to offset/utilize the losses, gains, or high income of the decedent through the filing of a final joint return.

5. Coordinate With Other Fiduciaries. It is not uncommon for there to be wasted or under-utilized deductions and credits, or an unusually low effective income tax bracket, on the decedent's final form 1040. If a joint final return is to be filed, choice of a fiscal year (e.g., December 31st or sooner) and the making of distributions from the estate or trust that will carry out DNI that will be taxable to the surviving spouse in the year of death, should be considered to shift income onto the final return.

E. Income Taxation of the Surviving Spouse.

1. Joint Return Option. The surviving spouse may file separately or join in the filing of a joint return for the year of death. However, if the surviving spouse is not remarried and does not file jointly, he/she must use married filing separately status in the year of the decedent's death. IRC §6013. Beware of the joint and several liability for all of the tax on a joint return that is created by filing jointly.

2. Continued Use of Joint Rates. A surviving spouse may be entitled to use joint tax rates for two additional years if he/she maintains a home for a dependent child. IRC §§1(a); 2(a).

3. Continued Use of Head of Household Rates. A surviving spouse may be entitled to use head of household tax rates while unmarried and not a surviving spouse if he/she maintains a home for a dependent child or other qualified dependent. IRC §§1(b); 2(b).

4. Adjust Own Withholding Status and Estimated Tax Payments. The surviving spouse will want to review and possibly amend his/her withholding status and/or estimated tax payments.

5. IRA Contribution by Non-Working Surviving Spouse. A non-working surviving spouse can make a post-death spousal IRA contribution to the surviving spouse's own IRA for the year of the working spouse's death, provided that the working spouse had sufficient pre-death earnings, although no post-death contribution can be made to the decedent's IRA. PLR 8527083.

6. Available AMT Exemption Amount. A "surviving spouse" as defined in IRC §2(a), for the year of the decedent's death and the succeeding two tax years, is entitled to the increased AMT exemption normally available on joint returns rather than the lesser amount that would otherwise be available absent this special provision. IRC §55(d).

7. Computation of Subsequent NOLs. An NOL incurred by a surviving spouse and carried back to a marriage year can only be applied against the surviving spouse's own income in such prior year. Rev. Rul. 65-140, 1965-1 CB 127. It does not matter that the surviving spouse was remarried in the loss year, nor that the surviving spouse resided in a community property state in the loss year. Rev. Rul. 71-382, 1971-2 CB 156.

8. Grandfathered Interest Exclusion. A surviving spouse electing to leave life insurance proceeds payable by reason of his or her spouse's death with the life insurance company may exclude up to $1,000 per year of interest income pursuant to provisions of IRC §101(d). Such provisions still allow such exclusion with reference to amounts received with respect to deaths occurring on or before October 22, 1986. Section 1001(d) of Pub. L. 99-514 (TRA '86), amending IRC §101(d).

9. Community Property Basis Adjustment. The decedent's property is, of course, going to have its basis adjusted to fair market value pursuant to IRC §1014. Additionally, the surviving spouse's one-half interest in community property will also have its basis adjusted to fair market value at the decedent's death. IRC §1014(b)(6).

X. BASIS ADJUSTMENTS AT DEATH

A. General Rule. The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

B. Property Acquired From a Decedent. Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706 Federal Estate Tax Return.

Example: Often missed, especially where no estate tax return is due, are adjustments which should be made to the basis of non-probate assets such as UGMA and UTMA accounts where the donor was serving as custodian, the home of an elderly parent which was titled in joint tenancy with (or wholly in the name of) the children to avoid probate, etc.

C. Exceptions to General Basis Rules.

1. Alternate Valuation Exception. If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

a. Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.

b. If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no "pick and choose").

c. Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed of or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.

d. Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1 CB 244.

2. Special Use Valuation Exception.

a. If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.

b. If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f).

c. If no election is made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251.

d. It should be noted that no similar provision applied to IRC §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

3. Income in Respect of a Decedent ("IRD") Exception.

a. General Rule. Items of income in respect of a decedent under IRC §691 are not entitled to stepped-up basis at the decedent's death. Examples of such items include IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

b. Special Rules for Partnerships. The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other

successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Treas. Reg. §1.742-1.

c. Special Rules for S Corporations. The basis of S corporation stock is date of death or alternate value, reduced by the income in respect of a decedent attributable to such stock. IRC §1367(b)(4), effective with respect to decedents dying after August 20, 1996

d. Certain Lifetime Constructive Sales. Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going "short against the box" during lifetime in order to lock in profit and pull out cash, will no longer be able to be closed out income tax free after death, as the pre-death portion of the gain will be considered IRD taxable to the estate or other successor. TRA '97, §1001(d)(3), adding IRC §1259, effective (with complex exceptions) to constructive sales made after June 8, 1997.

4. Exception for Qualified Conservation Easement. A carryover of the decedent's income tax cost basis will occur with respect to that portion of a property which is excluded from the decedent's estate by reason of a qualified conservation easement. TRA '97, §508, amending IRC §§170,1014, 2031, and 2032A, effective for decedents dying after 1997.

5. Exception for Certain Recently Gifted Property. Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. IRC §1014(e).

6. Exception for Previously Gifted Property.

a. Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as IRC §§2035, 2036, 2037, or 2038 property) will be entitled to an IRC §1014 basis adjustment by reason of the decedent's death, but the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Treas. Reg. §1.1014-3(d).

b. Conceptually difficult issues are raised when previously gifted property included in the decedent's estate (such as IRC §§2036, 2037, or 2038 property) has been sold and reinvested in something else prior to the decedent's death. For estate tax purposes, the original property is deemed included in the decedent's estate. But if it has been sold, can the donee file and amended income tax return and claim the date of death value as the adjusted basis? See Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

7. Exception for Certain Spousal Joint Tenancies.

a. The current rules relating to estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased spouse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under

IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.

b. Prior to 1982 (pursuant to TRA '1981), the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under IRC §2040 (and have its basis adjusted in IRC §1014).

c. Several cases have now held that the TRA '1981 amendments to IRC §2040(b)(2) did not repeal the effective date of IRC §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. See Gallenstein v. U.S., 975 F.2d 286 (6th Cir. 1992); Patten v. U.S., 116 F.3d 1029 (4th Cir., 1997); Anderson v. U.S., 78 AFTR 2d 96-6555 (DC MD 1996), and Hahn v. U.S., 110 TC 140 (1998).

8. Exception for Community Property Interests.

a. The survivor's one-half interest of community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. IRC §1014(b)(6).

b. It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided in a non-community property state at death. Additionally, Alaska has adopted an elective form of community property.

c. Some states now allow community property to be held in joint tenancy, and it is unclear whether the joint tenancy or community property rules will apply to such arrangements. See Estate of Wayne-Chi Young, 110 TC No. 24, Doc. 98-14934 (1998).

9. Exception for Stock in a Foreign Personal Holding Company. The post-death basis of stock in a foreign personal holding company becomes the lower of (a) its fair market value at the date of the decedent's death, or (b) its basis in the decedent's hands. IRC §1014(b)(5).

10. Exception for Stock in a DISC. The post-death basis of stock in a Domestic International Sales Corporation (DISC) becomes its fair market value, reduced by the amount that would have been treated as ordinary income under IRC §995 if the decedent had been alive and sold the stock on the estate tax valuation date. IRC §1014(d).

D. Special Basis Transitional Dates. A number of special basis transitional dates exist to deal with changes in the law. IRC§1014(b).

1. Death After 12-31-51. IRC §1014 applies to property transferred to a revocable trust.

2. Death After 10-21-42 But Before 12-31-47. Basis of surviving spouse's share of community property was the greater of its adjusted basis or its estate tax value.

3. Death after 12-31-47. The surviving spouse's one-half share of community property assumes the same basis as the decedent's share.

4. Death Between 1-1-51 and 12-31-53. The survivor's interest in a joint and survivor annuity received a basis adjustment if the decedent's interest was includable in his/her gross estate.

5. Death After 12-31-53. All property acquired from a decedent by reason of death receives a stepped-up basis.

6. Death After 8-26-37. The decedent's stock or securities in a foreign corporation which is a foreign personal holding company receives a basis which is the lower of the fair market value at date of death or the decedent's basis.

E. New Carryover Basis Rules Apply After 2009. After 2009, the rules of IRC §1014 are repealed and replaced with the new and complex IRC §1022 carryover basis rules. IRC §1014(f).

F. Other Basis Issues.

1. Appraisal Necessity. The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC 2032. The appropriate values will appear on the Form 706.

2. Where No Form 706 Required. Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

3. Impact on Depreciation, Depletion, etc. Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent’s gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

4. Elective Partnership Basis Adjustments. A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner’s death. IRC §754.

5. Appreciated Undistributed Devises Due Decedent. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. Compare Manufacturers Hanover Trust Company v. U.S., 410 F.2d 767 (Ct. Cl. 1969) and Connecticut National Bank v. U.S., 937 F.2d 90 (6th Cir. 1991).

6. Post-Death Capital Gains and Losses.

a. All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. IRC §1223(11).

b. Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment.

c. Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of $3,000 per year.

7. Certain Joint Spousal Trusts. It has been suggested that husband and wife can create a single trust with their collective assets (called a "joint spousal trust"), wherein the first to die has a general power of appointment over the entire trust, with the result that all of the their collective assets will have their basis adjusted to fair market value upon the death of the first spouse to die. The IRS has ruled that this doesn't work. See PLRs 200210051, 200101021, 9308002, 9026036.