CONSIDERATION OF SPECIAL INCOME TAX ISSUES AFFECTING DECEDENTS' ESTATES

A. Estate Plan Income Tax Considerations

1. Income Tax Basis

a. When selling an asset, you pay tax on the difference between the selling price and adjusted basis (original cost plus improvements minus depreciation) of the asset. IRC § 1001.

b. Example: If you sell land for $100,000 and your adjusted basis (cost) for the land is $20,000, your taxable gain is $80,000.

c. Basis is your cost to recover when you sell an asset. The basis is determined by how you acquired the asset.

i. If You Purchased the Asset: Your basis is what you paid for the asset plus improvements minus any depreciation you have claimed on it. IRC § 1012.

ii. If You Inherited the Asset: Your basis is the Fair Market Value ("FMV") or special use value assigned the asset as it passed through the estate. IRC § 1014(a).

- Assets that are inherited and pass through an estate receive a new or "stepped up" basis. The "stepped up" basis is usually the FMV on the date of death.

- Receiving the "stepped up basis" provides a strong incentive to hold low basis property until death to achieve the "stepped up" valuation for heirs.

- Example: Jane Doe sold 160 acres of farmland for $2,500 per acre or $400,000. It had a basis of $100,000. Her taxable gain (whether sold for cash or by installment method) is $300,000. Because of the sale, either she or her heirs must pay tax on the $300,000 gain. Capital gain taxes at a 15% tax rate would be $45,000. If, however, Jane retained the property until her death, the estate would receive a

stepped up basis in the property of $400,000 (FMV). The heirs could later sell the property for that amount and pay no taxes. Total taxes saved by keeping the property until death and passing it through the estate would be $45,000.

iii. If You Received the Asset as a Gift: Your basis is the same as the donor's basis. IRC § 1015.

2. Gift Tax Return

a. It is good practice to file gift tax Form 709 even though no gift tax is due.

b. Filing Form 709 constitutes "adequate disclosure" and can eliminate future gift tax issues.

3. Installment Sales

a. Reporting sales of property on the installment method allows the taxation to be spread out proportionally during the years that principal payments are made. This option may be useful to keep as many dollars in the lower tax brackets as possible. IRC § 453.

b. Using installment reporting late in life on low basis assets may not be wise because no stepped up basis is received on installment contracts. Heirs must continue to pay income taxes on the principal and interest payments as they receive them.

c. Example: You own 40 acres of land worth $100,000. You have a basis (purchase cost) of $10,000 in the land. At age 85 you sell the land to your son for $100,000 on an installment contract payable over 20 years. Your profit ratio on the amount of each principal payment, which is taxable, is 90% ($90,000 profit ÷ $100,000 sale price = 90%). You receive principal payment of $5,000 each year for 4 years. Each year you include 90% of $5,000 or $4,500 as taxable income on your tax return plus any interest received. At age 89 you die, leaving the contract equally to your two daughters and son. Your two daughters will continue to receive 2/3 of the $5,000 annually and must include 90% of the amount on their tax return for

the remaining 16 years. They will each receive $26,667 in principal payments and will have to pay income taxes on $24,000 of it (90%). The son, who holds the contract, inherits the entire $26,667 in the year of death. The 90% or $24,000 is taxable income to him in the year of your death.

i. If you and your children together must pay taxes at a capital gain rate of 15%, a total of $13,500 tax will be paid on this contract over the years.

ii. If you had kept the property in your estate and not sold it, it would have passed to your children valued at $100,000 (stepped up basis) and they would owe no tax if they sold the property for that value.

iii. Selling on an installment sale late in life costs this family $13,500 in unnecessary taxes.

4. Personal Residence

a. If you sell your farm, which includes your personal residence, parcel out the house sale because it qualifies for a possible exemption from tax. IRC § 121.

b. For sales after May 5, 1997, homeowners can exclude from gross income up to $250,000 per individual of gain ($500,000 for joint filers). You must have owned your home and lived in it for a period of two of the past five years prior to the sale. You need not buy a replacement home to qualify for this tax exemption.

c. If you sold your home prior to May 6, 1997, different, more restrictive rules apply.

d. These provisions apply to the house only, not to land or buildings used as business property.

5. Tax Free Exchange

a. Selling property outright will cause a taxable event. If you have improved land or buildings, a like-kind tax free exchange, known as

a IRC § 1031 exchange, might be considered. You find a person who has property that is "like-kind" to yours and work out a trade.

b. Your tax basis follows to the new property. It is a complicated tax process, but can position the younger generation on the home farm and leave the older generation with more remote, low maintenance farmland. Using the tax-free exchange can avoid or postpone taxation of the parent's capital gains on low basis property.

6. Income Averaging

a. As of January 1, 1998, qualifying farmers are allowed to use "income averaging". This provision allows high income from a current year to be carried back equally to utilize lower tax brackets from the three previous years. IRC § 1301.

b. This provision can help reduce income taxes for retiring farmers.

7. Spread Out Income

a. In most cases, as a farmer retires and they sell off their farm business assets, a larger self-employment and income tax bill emerges. It may be wise to plan ahead and spread the final sales over a two or three year period.

b. Leveling out income usually results in lower taxes paid than does bunching income into one year.

B. Final Individual Income Tax Return

1. Filing Requirements

a. The personal representative or other person charged with the decedent's property is required to file a final income tax return. IRC § 6012(b)(1).

b. This return is due April 15 of the year following death.

c. The decedent's tax year ends on the date of death

d. The personal representative is responsible for filing tax returns for years prior to death if the decedent failed to do so.

e. If there is no personal representative, these duties are required of the person in control of the decedent's property (i.e. the trustee of a trust).

f. If there is no personal representative or a surviving spouse, a refund may be claimed by filing IRS Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer. (*See* Schedule A)

2. Filing Extension

a. IRS Form 4868 may be filed to receive an automatic 4 month extension. (*See* Schedule B)

b. Payment of estimated tax is not due with Form 4868, but interest and penalties might be charged depending upon the tax finally reported.

c. If an additional extension is required, file IRS Form 2688, Application for Additional Extension of Time. (*See* Schedule C)

3. Notice of Fiduciary Relationship

a. File IRS Form 56, Notice Concerning Fiduciary Relationship (*See* Schedule D) to notify the IRS of the creation or termination of any fiduciary relationship. IRC § 6903.

b. Form 56 is not mandatory, but is recommended if the address of the personal representative is not the same as the decedent's last address, and more important when the decedent failed to pay taxes in the prior years.

c. There is no specific time limit for filing Form 56.

4. Surviving Spouse - Joint Returns

a. It is generally wise to file a joint return with the surviving spouse, if applicable.

b. The personal representative may join with the surviving spouse on a joint return. If there is no personal representative, the surviving spouse may make a joint return for the decedent and surviving spouse. IRC § 6013(a)(3).

c. The medical expenses of the decedent, if paid within one (1) year of death, are deductible on the decedent's final individual return or the estate tax return (not on the fiduciary return), so this can add deductions to the surviving spouse's joint return.

5. U.S. Savings Bonds

a. The personal representative may elect to recognize deferred interest income on any United States Series E or EE bonds in the decedent's final year. IRC § 454.

i. This election may be prudent if the decedent had little taxable income in the year of death or if a joint return can be filed with the surviving spouse, or if the decedent had losses or deductions that would expire unused unless they could be used to offset accelerated interest income on the last return.

ii. Any tax liability that results from accelerating the interest on the decedent's final return may be deducted on the federal estate return.

C. Coordinating and Filing the Estate Tax and Fiduciary Income Tax Return

1. Employer Identification Numbers

a. All estates are required to obtain an Employer Identification Number ("EIN"). IRC § 6109.

b. File Form SS-4, Application for Employer Identification Number (*See* Schedule E)

c. Once Form SS-4 is completed, an EIN may be obtained online at www.irs.gov.

d. Notify banks and other interest-paying entities of the EIN and instruct them to report all interest payable after the decedent's death to the estate's EIN.

2. Beneficiaries' Taxpayer Identification Numbers

a. The personal representative will need the Taxpayer Identification Numbers ("TIN") of all heirs or devisees, other than those receiving specific gifts.

b. Beneficiaries may complete IRS Form W-9, Request for Taxpayer Identification Number and Certification (*See* Schedule F) to obtain a TIN, or Social Security Numbers ("SSN") may be used.

c. The TIN or SSN must be listed on the federal estate tax return, if required, and on the fiduciary income tax return and Schedules K-1.

3. Estate Tax Year

a. The estate's tax year may be calendar or fiscal.

b. The tax year begins on the date of death and must end on the last day of a month.

c. The first year may not be more than twelve (12) months in duration.

4. Filing Requirements

a. The U.S. Fiduciary Income Tax Return, Form 1041 is due on the 15th day of the 4th month after the end of the estate's tax year. Reg. 1.6072-1(a).

b. A return is required if the estate earned more than $600 of gross income. IRC § 6012(a)(3).

c. If the estate does not have more than $600 of gross income, the personal representative may still wish to file a return in the final year if the estate has excess deductions or capital loss carryovers which can be passed through to the beneficiaries.

d. The personal representative or trustee (or other fiduciary) is responsible for filing the return and paying the tax. Reg. 1641(b)-2.

5. Extension of Time to File

a. Form 2758, Application for Extension of Time to File (*See* Schedule G) can be used if additional time is needed to file the fiduciary return. IRC § 6081.

b. Form 2758 must be filed prior to the due date.

c. An extension DOES NOT extend the time for paying the tax.

6. Estimated Tax Payments

a. Generally, an estate is required to make estimated tax payments in the same manner as individuals with some exceptions. IRC § 6654(1).

b. No estimated tax payment are required:

i. For any tax year ending before two (2) years after the date of the decedent's death;

ii. If the tax for the current year is less than $1,000; or

iii. If the estate had no tax liability for the preceding twelve (12) month tax year.

c. Use From 1041-ES, Payment Voucher (*See* Schedule H) to figure and pay the estimated tax.

d. The estate or the fiduciary may elect to treat any part of an estimated tax payment as made by a beneficiary by filing Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries (*See* Schedule I). This election is often made in the final year of the estate.

D. Fiduciary Income Tax Calculation

1. Gross Income

a. An estate's gross income is generally calculated according to the same rules as for individuals (*See* IRC § 641(b)) and includes

i. Interest income;

ii. Dividends;

iii. Business income;

iv. Capital gains and/or losses; and

v. Rents, royalties, and partnership income.

b. When appreciated property of an estate is used to satisfy a pecuniary gift or a specific gift or other property, the estate will recognize gain.

2. Income In Respect Of Decedent

a. Income in respect of a decedent ("IRD") is income attributable to the decedent that was not properly included on the decedent's last tax return due to the accounting method. IRC § 691.

b. IRD is reported by the estate in the year it was received.

c. IRD is also reported in the decedent's gross estate for estate tax purposes.

d. IRD items do not receive a stepped up basis. IRC § 1014(c).

e. Examples of IRD: unpaid salary, accrued interest, qualified plan benefits and IRAs, non-qualified deferred compensation benefits, undistributed partnership income, and installment payments.

3. Deductions

a. Deductions include the following:

i. Interest on investments, to a limited extent;

ii. Interest on a qualified residence (mortgage);

iii. State and local income and personal property taxes;

iv. Estate administration expenses, including fiduciary fees, attorney and accountant fees, administrative costs that would not have been incurred had the property not been in an estate, and other miscellaneous deductions not subject to the 2% floor;

v. Other miscellaneous expenses to the extent that the total amount exceeds 2% of the adjusted gross income; and

vi. A $600 personal exemption, except in the estate's final year.

b. The following are not deductible on the fiduciary income tax return (IRC § 642(b) & (h)):

i. Funeral expenses;

ii. Medical and dental expenses;

iii. Miscellaneous itemized deductions not in excess of 2% of adjusted gross income; and

iv. Personal interest (i.e. charge cards and the like).

4. Depreciation

a. Depreciation is apportioned between the estate and the beneficiaries unless depreciable items are specifically devised, in which case the depreciation deduction goes to the specific devisee.

5. Net Operating Losses

a. Net operating losses may be generated if the estate operates a trade or business. These do not pass through to beneficiaries except in the final year of the estate. IRC § 642(h).

6. Excess Deductions

a. Deductions in excess of income are not distributable to beneficiaries except in the final year of the estate. IRC § 642(h).

b. There is no carry-over from year to year during the estate's existence, thus resulting in the possibility of wasted deductions.

7. Capital Gains and Losses

a. Capital gains and losses are generally retained by the estate.

b. Basis is generally stepped up or down to the fair market value as of the date of the decedent's death, with some exceptions. IRC § 1014.

8. Capital Loss on Sale of Decedent's Residence

a. Because the basis of the residence is stepped up to fair market value at the decedent's death, on the subsequent sale of the residence there is almost always a loss due to the expenses of the sale.

b. Generally, capital losses are not allowed on the sale of the decedent's residence unless it had been converted to income producing property.

c. Some recommend that the estate attempt to rent the decedent's personal residence in order to convert it into income producing property. Arguably, a loss would be deductible if an attempt had been made to rent it, even though that attempt was unsuccessful.

9. Charitable Deductions

a. An unlimited charitable deduction is permitted for gross income paid to a charity. There is no limit on the charitable deduction for estates like there is for individuals. IRC §642(c).

b. The charity (or charities) does not have to be a U.S. charity, as long as it qualifies under IRC § 170(c).

c. Wills usually do not direct that gifts to charity be paid or permanently set aside from gross income, therefore, charitable deductions on the fiduciary return are uncommon.

   i. If the gross estate is not large enough to be subject to the estate tax, there will be no deduction at all for the charitable gift.

   ii. Some recommend that when drafting Wills with charitable provisions for estates under the applicable exclusion amount, consider directing that the gift be paid from the gross income of the estate.

10. Specific Gifts

a. Specific gifts are not subject to fiduciary income tax distribution rules under IRC §§ 661-662.

b. To be a "Specific Gift", the gift must be:

   i. Specific sum of money or specific property (amount of money or specific property must be ascertainable under the terms of the Will as of the date of death or under the terms of the Trust, as of the date of inception of the Trust).

      – Examples:
        – Gift of $1,000
        – Gift of 1,000 shares of a certain stock
        – Gift of all stock owned by Decedent at death
        – Gift of specifically described real estate, household items, personal effects, automobile, jewelry, etc.

   ii. Paid or credited all at once or in not more than three (3) installments.

11. In-Kind Distributions

a. In-kind distributions which qualify as specific gifts under IRC § 663(a) are not income to the beneficiary. IRC § 102(a).

b. The beneficiary takes a carryover basis, which will usually be a stepped-up basis to date of death or alternate valuation date under IRC §1014(a).

c. In-kind distributions which do not qualify as specific gifts carry distributable net income to the extent of the lesser of the property's basis or its FMV at the time of distribution.

12. Distributable Net Income

a. Distributable net income ("DNI") is a way to account for the difference in tax law income and fiduciary accounting income.

b. It is taxable income with no deduction for distributions or personal exemptions.

c. It limits the distribution deduction available to the estate and the amount included in gross income by the beneficiaries.

13. Distributions Deduction

a. All items of income required to be distributed, excluding specific gifts, are deductible by the estate. IRC § 661.

b. The distribution deduction cannot exceed DNI.