

20. Income Tax Consequences at Death

When you die, your income tax situation changes: your estate becomes a separate taxpayer and your tax situation is more complicated. However, the situation also presents tax planning opportunities. Knowing the complications and the opportunities can help you (or your personal representative) minimize the income tax payable by your estate and your surviving spouse.

This article will briefly review the income tax rules when a person dies. It will also set out some practical advice to help you plan to minimize income tax, or to better understand the advice of your attorney, accountant, or other tax advisor.

Briefly, this article will:

- Describe the decedent's estate as a new and separate taxpaying entity.
- Explain what income is reported on the decedent's final, individual return and on the estate's income tax return.
- Explain that estimated tax payments by the estate are not required after the decedent's death.
- Summarize when returns must be filed,
- Review who must pay the decedent's income tax or who gets any refund.
- Explain how the decedent's property receives a new income tax cost basis at the decedent's death and why this is generally a benefit.

Creating a New Tax Entity at Death

At death, the deceased person's tax year ends. The decedent's probate estate is a new taxpayer. So, in the year when an unmarried person dies, here are two different and separate taxpayers. The decedent is the taxpayer from January 1 to the date of death and the estate is the taxpayer from then on.

For a married person who had been filing a joint return, the surviving spouse is a third different and separate taxpayer who will have a regular, 12-month calendar tax year.

The tax year for the decedent's probate estate can end on the last day of any calendar month within 12 months from the date of death. The personal representative must select a year-end and often selects December 31 to have the estate's tax year parallel the surviving spouse's tax year. However, choosing a tax year ending other than December 31 may provide income shifting and tax deferral opportunities.

What Income Is Reported on Each Return?

The return for an unmarried deceased taxpayer includes income actually received from January 1 through the date of death. Deductions include expenses actually paid by the date of death.

Income earned at the time of death but received after the date of death is taxable income to the decedent's probate estate (or to the person receiving the income). Deductible expenses incurred but unpaid at the time of death are deductions for the decedent's probate estate.

Special and more complicated rules govern the timing of income received from a decedent's ownership in a partnership, a trust, a Subchapter S corporation, or an accrual-accounting proprietorship. You should seek professional advice in dealing with a decedent's investments in any of these business forms.

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A joint return for a married decedent and the surviving spouse may be filed for the year of death. A joint return usually produces a lower total tax, but in some situations separate returns for the decedent and surviving spouse might be advantageous. Income tax should be computed under both methods to determine which gives the better result.

Separate Returns

If separate returns are filed, the decedent's final tax return includes 100% of separate income through the date of death and one-half of the community income received through the date of death. The surviving spouse's separate tax return then includes one-half of the community income through the date of death and the survivor's separate income for the entire year. This will include income earned after the date of death from property the survivor receives directly upon death, such as a joint tenancy bank account.

Joint Returns

If a joint return is filed, it includes all community income through the date of death, 100% of the decedent's separate income through the date of death, and all the surviving spouse's separate income for the entire taxable year. Deductions follow these same general rules.

To file a joint return, the decedent and surviving spouse must have been legally married at the time of death, the survivor must not have remarried prior to year end, and the personal representative and surviving spouse must consent to filing a joint return.

Estimated Tax Payments

Since death terminates the decedent's tax year, no further estimated tax payments are required on the decedent's behalf. However, the surviving spouse continues to be subject to estimated tax payment requirements. The surviving spouse usually must revise the estimated tax payment schedule to avoid underpayments or overpayments of tax.

Often, the surviving spouse's payments decrease substantially because the decedent's share of subsequent income is taxable in the estate.

When Returns Must Be Filed

The taxpayer's death does not change the due date for his or her individual income tax return. Both the decedent's final income tax return and the surviving spouse's return are due April 15 of the year following death. The decedent is still entitled to a full personal exemption amount, and may use the standard deduction, including the additional standard deduction for persons over age 65 and/or blind.

Payment of Tax or Receipt of Refund

Filing of a joint return creates joint and several liability for the entire tax due on the return, which means each spouse is liable for the whole tax. This applies regardless of the amount of taxable income actually allocable to each spouse. Hence, the IRS may collect the entire amount of tax due from either the surviving spouse or the decedent's estate.

As between the surviving spouse and the decedent's estate, the actual tax liability (based on income) is allocable between them. The estate's liability is considered a liability of the decedent at the time of death and is therefore deductible from the decedent's gross estate in computing the amount of any federal estate tax. Predeath income tax payments (for example, estimated payments) are identified with the decedent or surviving spouse in computing the amount of tax liability allocable to each.

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Any tax refund for the year of death is divided between the surviving spouse and the decedent's estate, based on actual tax liability (if any) and the amounts paid by the decedent and surviving spouse. The estates share of any tax refund is considered an asset of the decedent at the time of death and is therefore, includible in the decedent's gross estate.

Tax Rates

The 2001 Tax Act reduces income tax rates for individuals, estates, and nongrantor trusts. Beginning in 2001, individuals have a new 10% tax bracket, and the rates in the tax brackets greater than 15% are reduced in phased-in amounts over five years. The 2001 tax rate tables for individuals and estates and nongrantor trusts are shown below:

<u><i>Individuals:</i></u>		<u><i>Estates and Nongrantor Trusts:</i></u>	
<i>Tax Rate</i>	<i>Taxable Income</i>	<i>Tax Rate</i>	<i>Taxable Income</i>
<hr/>		<hr/>	

	<i>Over</i>	<i>Not Over</i>		<i>Over</i>	<i>Not Over</i>
10%	N/A		10%	N/A	
15%	\$0	\$27,050.	15%	\$0	\$1,800.
27.5%	\$27,050.	\$65,550.	27.5%	\$1,800.	\$4,250.
30.5%	\$65,550,	\$135,750,	30,5%	\$4,250.	\$6,500.
35.5%	\$135,750	\$297,350.	35,5%	\$6,500.	\$8,900.
39.1%	\$297,350		39.1%	\$8,900.	

Because of these compressed rates for estates (and trusts) the personal representative for the estate (and any related trusts) must work closely with the tax advisors prior to year end to minimize the income taxes paid by the estate (and any related trusts) and the estate's (or trust's) beneficiaries.

The New Income Tax "Basis"

Generally, the "income tax cost basis" of property acquired from a decedent (the cost basis for determining a gain or loss when the property is late sold) is the value of the property for federal estate tax purposes. This is the fair market value of the property at the decedent's death or six months following the date of death if alternate valuation applies. Alternate valuation may be used only if the value of the total estate and the amount of federal tax due are both reduced. Thus, alternate valuation does not apply where no tax is due. An increase in the income tax basis may be called a "stepped-up basis." (Of course, the income tax basis may also decrease at death and would be called a "stepped-down basis.")

The surviving spouse is considered to have acquired his or her own one-half share of community property *from the decedent*. Thus, the surviving spouse also gets a stepped-up basis for his or her own one-half of the community property. Depreciable property received from a decedent also gets a stepped-up basis for purposes of computing depreciation. Property acquired from a decedent which is sold or otherwise disposed of within 12 months of the date of death is considered to have been held for more than 12 months.

"Income in respect of a decedent" (IRD) is income to which the decedent was entitled at death but had not received. IRD items do not get a stepped-up basis. For example, a receivable from the sale of land, with the gain reported on the installment basis,

does not receive a stepped-up basis. If it did receive a stepped-up basis, the new higher basis would eliminate the previously unreported gain, instead, the unreported income is considered to be taxable income to the subsequent recipient in the same manner as the decedent would have reported the income had the decedent lived to receive the IRD.

To the extent that federal estate taxes are paid with respect to items of income in respect of a decedent, an itemized deduction for the estate tax paid is allowable to the recipient of the income in respect of a decedent for the year in which the income is actually received.

Beginning in 2010, the 2001 Tax Act provides new rules for determining the tax basis of inherited assets. Under the modified carryover basis system, the basis in inherited assets is the lesser of date of death value or the decedent's adjusted basis. Each estate will have a minimum \$1.3 million basis increase (\$60,000 for nonresident, noncitizen decedents) that can be allocated to assets acquired from the decedent up to their fair market value. Rights to income in respect of a decedent, certain assets that the decedent acquired by gift, and stock or securities in certain foreign entities are not subject to basis adjustments. An additional \$3.0 million basis increase is allowed for certain assets passing to a spouse. These rules apply only to the year 2010, unless the 2001 Tax Act provisions are extended.

Conclusion

The filing of the decedent's final income tax return, the surviving spouses income tax return and the fiduciary income tax returns for the decedent's estate and any related trusts provides a challenge to the decedent's surviving spouse and/or personal representative. Minimizing the overall tax liability of the various related taxpayers is the goal and planning is crucial to this process. You should consult with your tax professionals.