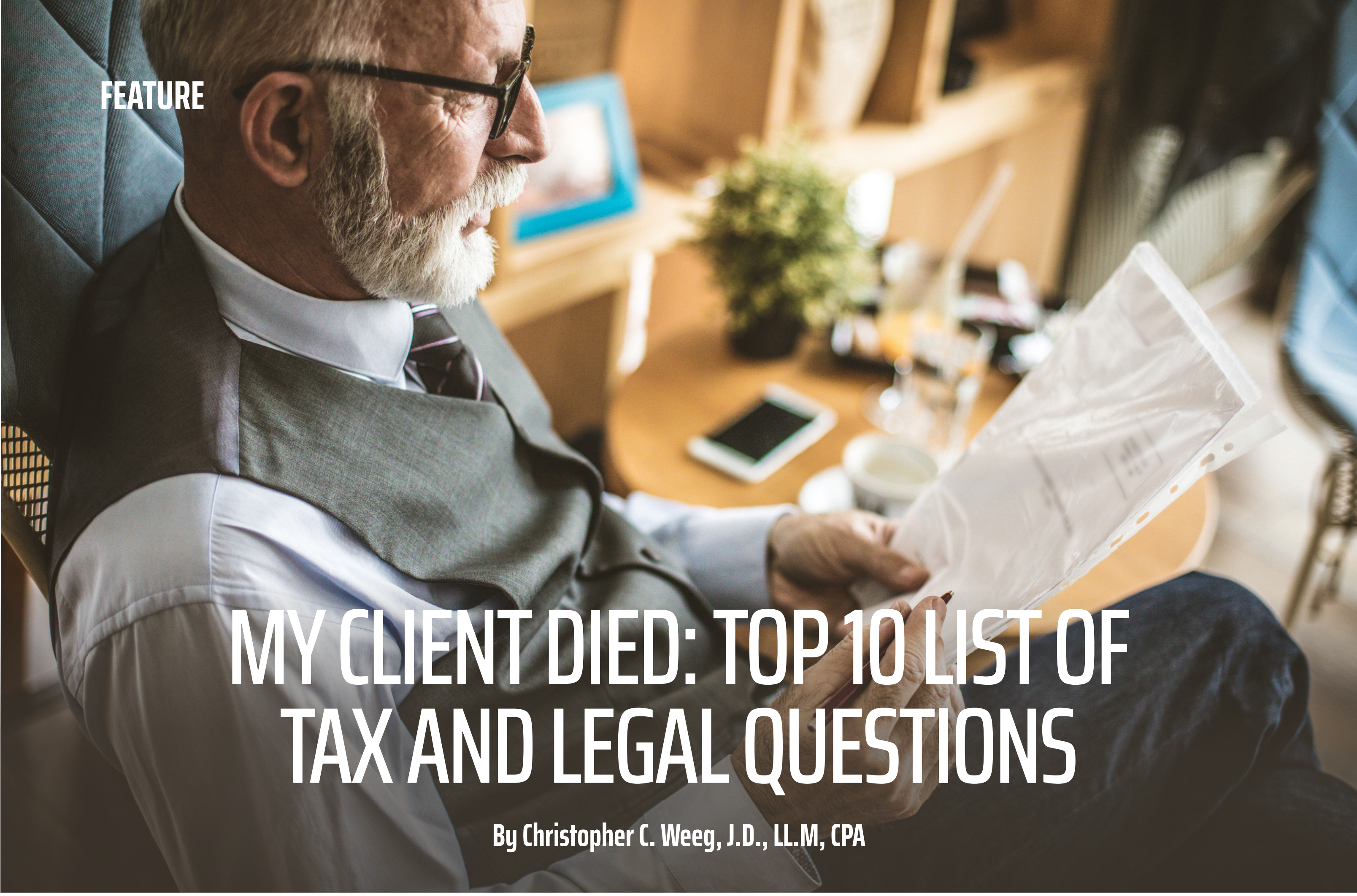


FEATURE

MY CLIENT DIED: TOP 10 LIST OF TAX AND LEGAL QUESTIONS

By Christopher C. Weeg, J.D., LL.M, CPA

Estate planning and tax attorneys regularly work with a client's CPA during estate administrations. Countless issues arise during this lengthy process, including questions on accounting, federal tax law, state property and probate law, and the interpretation of the decedent's will and trust agreements.

The purpose of this article is to answer the top 10 common questions that clients ask during an estate administration. Keep in mind, each of these topics warrants further detailed discussion; for this article, the approach is a mile-wide-and-an-inch-deep overview of the subject matter.

What is an Estate?

This article covers federal tax issues, but we generally must look to state law for the legal ownership and transfer of assets to determine federal tax consequences. Let's first examine the concept of an estate under Texas law. At the moment of death, a decedent's property becomes his/her estate. Therefore, an estate is comprised of assets and liabilities that produce income and incur expenses. An executor of an estate controls the estate property and is tasked with managing estate assets, paying off estate liabilities and distributing the remainder to the estate's beneficiaries.

For a married decedent, Texas community and separate property laws affect what the decedent's estate and the surviving spouse own. Community property is generally all property acquired during marriage not otherwise characterized as separate property, subject to a few exceptions.

A decedent's separate property becomes estate property and a surviving spouse's separate property remains his/her own. Community property upon death vests one-half in the estate (and ultimately its beneficiaries) and one-half in the surviving spouse, who may request a partition of the property into two equal moieties. For example, a community property brokerage account is owned equally between the decedent's estate and the surviving spouse. Accordingly, the estate reports income attributed to its one-half ownership in the account and, likewise, the surviving spouse reports income attributed to his/her one-half ownership.

For federal tax purposes, an estate is a separate taxable entity with its own taxpayer identification number (or EIN) and income tax filing requirements. An estate's taxable income is calculated in the same manner as an individual with a few exceptions.

How is Income Reported in the Year of a Decedent's Death?

The executor of a decedent's estate files and signs the decedent's final income tax return (Form 1040). The filing of the final Form 1040 and payment of tax may be made as though the decedent lived throughout his/her last taxable year. An individual's final tax year, however, ends on the date of death and only amounts properly includable under the method of accounting used by the taxpayer are included in the computation of taxable income for that year.

Thus, for a cash-basis taxpayer, income actually or constructively received and expenses actually paid until the decedent's date of the death are reported on the final return, and income and deductions arising after death are reported on the income tax return for the decedent's estate (Form 1041). Finally, items of income that the decedent was entitled to receive, but not properly includable in the decedent's final Form 1040, are considered income in respect of a decedent and are included in the gross income of the estate or beneficiary who receives the income.

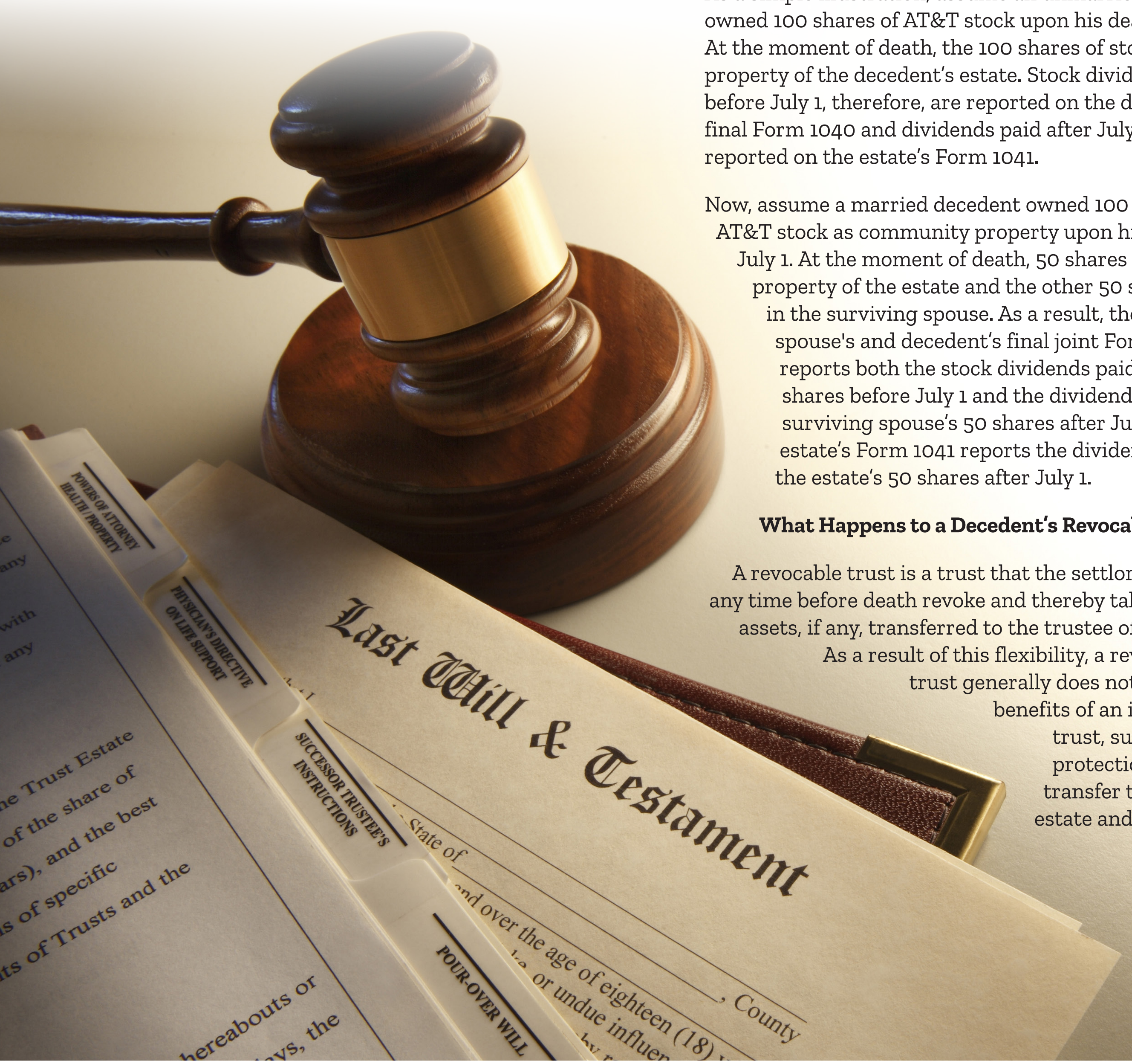
For a married decedent, the surviving spouse and executor may file a joint Form 1040 that reports the spouse's income and deductions for the full year and the decedent's pre-death income and deductions. The decedent's post-death income and deductions are reported on the estate's Form 1041.

As a simple illustration, assume an unmarried decedent owned 100 shares of AT&T stock upon his death on July 1. At the moment of death, the 100 shares of stock become property of the decedent's estate. Stock dividends paid before July 1, therefore, are reported on the decedent's final Form 1040 and dividends paid after July 1 are reported on the estate's Form 1041.

Now, assume a married decedent owned 100 shares of AT&T stock as community property upon his death on July 1. At the moment of death, 50 shares become property of the estate and the other 50 shares vest in the surviving spouse. As a result, the surviving spouse's and decedent's final joint Form 1040 reports both the stock dividends paid on the 100 shares before July 1 and the dividends paid on the surviving spouse's 50 shares after July 1, and the estate's Form 1041 reports the dividends paid on the estate's 50 shares after July 1.

What Happens to a Decedent's Revocable Trust?

A revocable trust is a trust that the settlor may at any time before death revoke and thereby take back the assets, if any, transferred to the trustee of the trust. As a result of this flexibility, a revocable trust generally does not offer the benefits of an irrevocable trust, such as creditor protection and transfer tax (i.e., gift, estate and generation-



skipping transfer tax) planning, but it does provide asset management, probate avoidance and privacy. Typically combined with a pour-over will, a revocable trust often serves as the integral document in a decedent's estate plan that will control the disposition of assets upon death and creates marital deduction, bypass and generation-skipping transfer (GST) trusts.

During life, a revocable trust is treated as the settlor's "grantor trust" for federal income tax purposes, meaning the settlor is the deemed owner of the trust assets and reports income earned thereon on his/her Form 1040 and pays the associated tax. Upon the settlor's death, a revocable trust becomes irrevocable and, therefore, a non-grantor trust for federal income tax purposes. A non-grantor trust is generally taxed as a simple or complex trust depending on the terms of the trust agreement.

Where a revocable trust is funded during life, the trust will likely have its own income tax filing requirement upon the settlor's death, in addition to the estate's own filing requirement. To simplify reporting in this situation, the fiduciary may make a "645 election" that permits a decedent's "qualified revocable trust" to be treated as part of the decedent's estate for federal income tax purposes. This election permits the trust and estate to report their income on one Form 1041. Additionally, by treating the trust as part of the estate, the trust is eligible for advantages to which it would not otherwise be entitled, such as reporting income on the estate's fiscal year, which may defer income to a future tax year and taking a charitable deduction for amounts permanently set aside under Internal Revenue Code (IRC) § 642(c).

During life, a revocable trust is treated as the settlor's "grantor trust" for federal income tax purposes ...

The 645 election is irrevocable and must be made on Form 8855 no later than the due date of the estate's first income tax return. The election is effective for up to two years after the decedent's death if no estate tax return is required to be filed, or six months after the date of final determination of the estate tax liability if an estate tax return is required.

The tax reporting is more complicated where a married couple funded a revocable trust during life. Assuming the spouses transferred community property, one-half of the trust remains a revocable grantor trust with respect to the surviving spouse's transferred assets and the other half of the trust becomes an irrevocable non-grantor trust with respect to the deceased spouse's transferred assets. One-half of the trust income, therefore, is reportable by the surviving spouse on his/her Form 1040 and the other is reportable by the newly irrevocable non-grantor trust (again, either a simple or complex trust) on a Form 1041.

What Happens to a Decedent's Irrevocable Grantor Trust?

Irrevocable grantor trusts, also called intentionally defective grantor trusts, are a powerful tool in the estate planner's toolbox. If structured properly, the settlor is the deemed owner of the trust assets for federal income tax purposes, but the trust assets are not includable in the settlor's gross estate for estate tax purposes. A common grantor trust power is the settlor's right to reacquire trust assets by substituting other assets of equivalent value.

Because the trust is a grantor trust, the settlor reports, and pays the tax on, the trust income. This permits the assets of the trust to grow income tax-free outside of the settlor's gross estate for estate tax purposes and, importantly, the settlor's payment of the trust's income tax does not result in a taxable gift to the trust.

Upon the death of the settlor, a grantor trust that continues after death becomes a non-grantor trust for federal income tax purposes and must obtain a new EIN, regardless of whether the trust previously obtained an EIN during the settlor's life. The concept here is the trust assets have a new owner for federal income tax purposes (i.e., from the settlor to the trust) and, therefore, needs a new EIN. If the trustee used the traditional reporting method of filing a "skeleton" Form 1041 with an attached statement of the items of income, deduction and credit, the grantor trust should file a final Form 1041 as a grantor trust and an initial Form 1041 as a non-grantor trust. The grantor trust's final Form 1041 for the short year ending with the settlor's death is due on the same day the decedent's final Form 1040 is due.

A grantor trust with two settlors poses additional complications, but the reporting answer is analogous to a dual settlor revocable trust. During life, each spouse is treated as the grantor for federal income tax purposes with respect to one-half of the trust. On the death of the first spouse, the one-half of the trust treated as the deceased spouse's grantor trust becomes a non-grantor trust and the one-half of the trust treated as the surviving spouse's grantor trust remains a grantor trust. In this scenario, the trust continues to report under the EIN previously used by the trust, provided that the portion of the trust treated as being owned by the deceased spouse remains part of the original trust and the other portion continues to be treated as being owned by the surviving spouse.

TXCPA OFFERS A NUMBER OF CPE PROGRAMS THAT COVER ESTATE PLANNING ISSUES. OPTIONS ARE AVAILABLE FOR LIVE PROGRAMMING, WEBCAST AND ON DEMAND. VISIT THE EDUCATION AREA OF OUR WEBSITE AT TSCPA.ORG TO FIND CPE, LEARN MORE AND REGISTER.

What Happens to S Corporation Stock?

S corporation stock, whether owned individually or by a trust, merits special attention upon death. Congress presumably did not want a shareholder's death to terminate an S election, so an estate of a deceased S corporation shareholder is a permitted shareholder during the period of administration. If the executor transfers the S corporation stock to a trust, the trust will need to qualify as a permitted shareholder, generally requiring an election as a qualified Subchapter S trust (QSST) or an electing small business trust (ESBT).

A QSST is a permitted shareholder of an S corporation during the life of the income beneficiary. If the death of the beneficiary causes the trust to fail to qualify as a QSST, it may still continue to hold the S corporation stock for a two-year period following the beneficiary's death. If, after the two-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election will terminate.

A grantor trust is a permitted shareholder of an S corporation during the life of the deemed owner of the trust. Upon the death of the deemed owner, the trust may continue to be a permitted shareholder for the two-year period following the deemed owner's death. After this two-year period, the trust will need to make a QSST or ESBT election to prevent the termination of the corporation's S election.

Finally, suspended losses with respect to S corporation stock expire upon the shareholder's death because suspended loss carryovers are personal to the shareholder and cannot be transferred. With respect to a grantor trust, the deemed owner is treated as the shareholder. Accordingly, a grantor trust's suspended losses expire upon the death of the deemed owner. For a dual settlor grantor trust, the result should be that one-half of the suspended losses with respect to the deceased deemed owner expires on death and the remaining one-half with respect to the surviving deemed owner should continue.

What is the New Basis of a Decedent's Assets Upon Death?

The income tax basis of property acquired from a decedent is adjusted to the fair market value as of the decedent's death. This basis is, thus, "stepped-up" where an asset's fair market value exceeds the decedent's tax basis, or "stepped-down" where basis exceeds fair market value. With a community property asset, both halves of the community (i.e., the estate's and the surviving spouse's) are adjusted to fair market value. Assets held in a revocable trust and a qualified terminable interest property (QTIP) trust, as well as property over which the decedent possessed a general power of appointment, also receive a basis adjustment on death of the settlor, spousal beneficiary and powerholder, respectively.

If a near-death client owns loss property (i.e., basis exceeds fair market value), it may be advisable to sell the property, recognize a loss and thereby avoid a basis step-down on death. Alternatively, a married taxpayer may gift the loss property to his/her spouse, who will take a carry-over basis in the gifted property. This is an exception to the general rule that the basis of gifted loss property in the donee's hands equals the property's lower fair market value, rather than the donor's higher basis.

Should I Make a 754 Election for a Decedent's Partnership Interest?

If a client dies owning an interest in a partnership or limited liability company taxed as a partnership, be sure to analyze whether an IRC § 754 election (754 election) should be made to increase the deceased partner's share of the inside basis of the partnership assets to match the newly adjusted outside basis in the partnership interest pursuant to IRC § 743 (743 adjustment). A partnership must make a 743 adjustment, even if it does not have a 754 election in place, if its assets have a "substantial built-in loss" immediately after a transfer of a partner's interest at death. A partnership has substantial built-in loss if the adjusted bases of its assets exceed the fair market value by more than $250,000.

The mechanics of the 743 adjustment are beyond the scope of this article, but in short, the benefit of an upward adjustment – which applies only to the transferee partner and not the other partners of the partnership – is a higher income tax basis in the partnership assets for calculation of capital gain and depreciation deductions allocated to that partner.

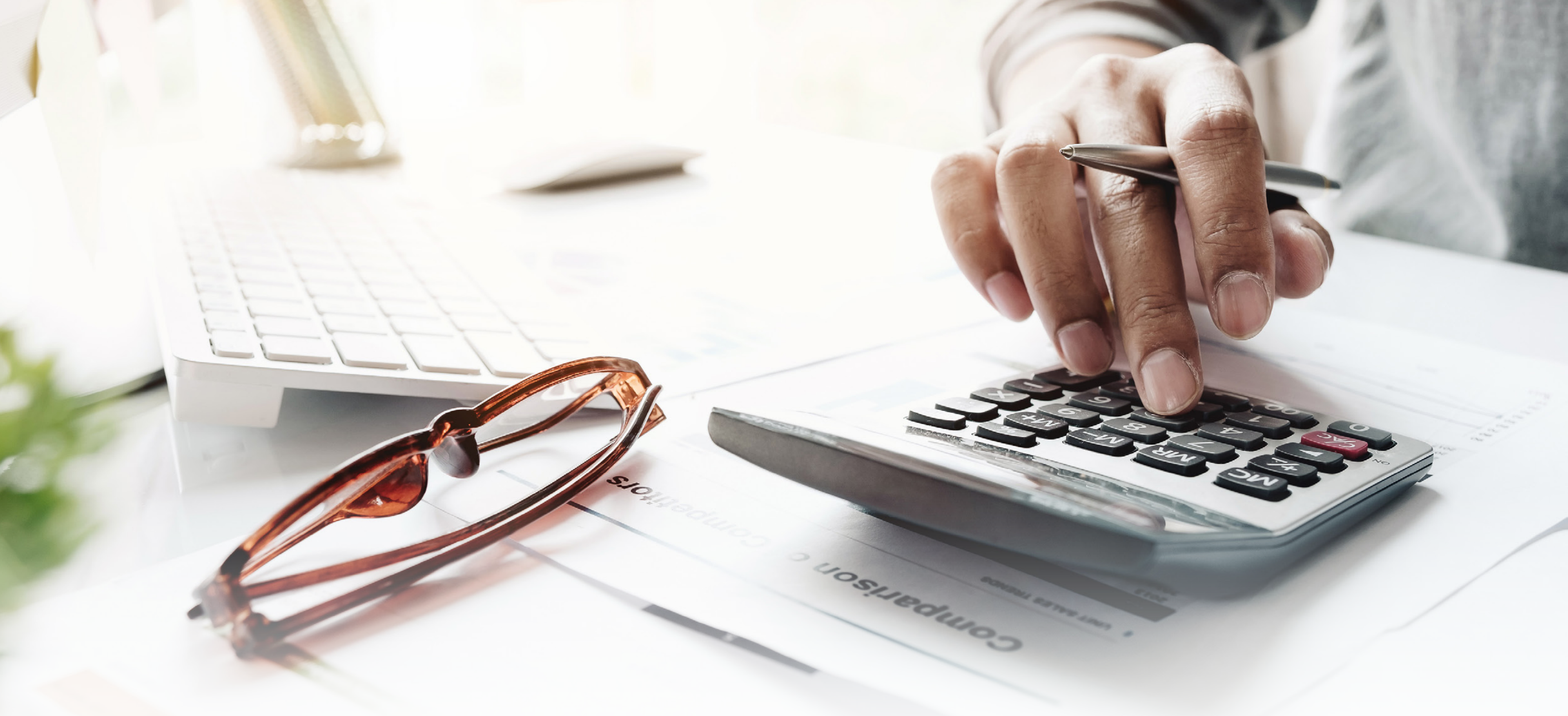
When to File a Form 706

An estate tax return (Form 706) must be filed if the value of the gross estate exceeds the basic exclusion amount for the year of death, even if no estate tax is due. For 2019, the basic exclusion amount is $11,400,000. Thus, if the estate of a decedent dying in 2019 has a value of $15,000,000 and passes to the surviving spouse under the marital deduction, no estate tax is due, but the executor must still file a Form 706.

Even if the value of the decedent's estate does not exceed the filing threshold, the executor may still want to file a Form 706 to elect portability of the decedent's deceased spousal unused exclusion (DSUE). Portability is not automatic; the executor must timely file a Form 706 to "port" the DSUE to the surviving spouse, who may then use the DSUE during life against gift tax or at death against the estate tax. To ease the administrative burden of making a portability election, estates below the filing threshold have relaxed reporting requirements for certain marital deduction and charitable deduction property. The cost of filing a Form 706 solely for portability purposes must be weighed against the potential for estate tax at the surviving spouse's death, which is affected by the spouse's age, remaining assets, growth and consumption of those assets, and the basic exclusion amount available on his/her death.

If a Form 706 will be filed, the executor will need to decide whether the CPA or the probate lawyer will prepare the return. The CPA, if preparing the return, should discuss the decedent's estate plan with the probate lawyer and offer to review the return before filing, depending on the CPA's comfort level and experience, particularly with regard to GST allocations made on Schedule R of the Form 706.

Regardless of who prepares the return, the CPA and probate lawyer should have open communication during this time, as both parties have unique knowledge of the client's tax, accounting and legal history. As a final preparer tip, while there is no replacement for reviewing the Code and Regs, the Form 706 instructions are surprisingly thorough and helpful, as well as the PPC 706/709 Deskbook.



What is the (Relatively) New Form 8971?

The IRS introduced Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, for estate tax returns filed after July 31, 2015, in accordance with the basis consistency provisions in IRC §§ 1014(f) and 6035(a). Within 30 days of filing the Form 706, the executor must file Form 8971 with the IRS and provide the accompanying Schedules A to the beneficiaries. The executor, however, does not need to file this form if there was no estate tax return filing requirement, such as when the Form 706 is filed for portability purposes only. Potentially severe penalties apply for failure to correctly and timely file the Form 8971 and furnish a Schedule A.

How Do I Request an Estate Tax Closing Letter?

An estate tax closing letter confirms if the Form 706 has been accepted by the IRS as filed or has been selected for examination. The IRS no longer automatically issues a closing letter; instead, an executor may request one six months after filing the return via telephone or fax.

Alternatively, an executor may request an account transcript in lieu of a closing letter, again at least six months after filing the return. The account transcript reflects transactions, including the acceptance of the Form 706 and completion of an examination. You must first register with the e-Services Transcript Delivery Service (TDS) and have a Form 2848 or Form 8821 for the estate already on file.

ABOUT THE AUTHOR:

Christopher C. Weeg, J.D., LL.M, CPA, is an associate at Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P. With a focus on tax and estate planning, his law practice includes drafting wills and trusts; advising on income, gift, estate and GST tax issues; forming business and nonprofit entities; and probating estates. Contact him at cweeg@meadowscollier.com.

SOURCES

[1]Texas Estates Code § 22.012.
[2]Texas Family Code § 3.002.
[3]Texas Estates Code § 360.253.
[4]IRC § 641(b).
[5]Treas. Reg. § 1.6012-3(b)(1).
[6]Treas. Reg. § 1.443-1(a)(2).
[7]Treas. Reg. § 1.451-1(b)(1).
[8]IRC § 691(a)(1).
[9]IRC § 6013(c).
[10]IRC § 676(a).
[11]A "qualified revocable trust" means a trust treated as a decedent's grantor trust under IRC § 676. IRC § 645(b)(1).
[12]IRC § 645(a).
[13]IRC § 645(c).
[14]IRC § 645(b)(2).
[15]IRC § 675(4).
[16]Rev. Rul. 2004-64, 2004-27 IRB 7.
[17]Treas. Reg. § 1.671-4(h)(2).
[18]Treas. Reg. § 1.671-4(a); IRS Form 1041 Instructions.
[19]Treas. Reg. § 1.671-4(h)(3)(i).
[20]Treas. Reg. §§ 1.671-4(h)(3)(i), 1.6072-1(a)(2).
[21]Treas. Reg. § 1.671-4(h).
[22]Treas. Reg. § 301.6109-1(a)(3)(i)(B).
[23]IRC § 1361(b)(1)(B).
[24]IRC § 1361(c)(2).
[25]IRC § 1361(d)(1).
[26]Treas. Reg. § 1.1361-1(j)(7)(ii).
[27]Id.
[28]IRC § 1361(c)(2)(A)(i).
[29]IRC § 1361(c)(2)(A)(ii).
[30]Treas. Reg. § 1.1366-2(a)(6)(i); Treas. Reg. Preamble, T.D. 8852, 2000-2 I.R.B. 253.
[31]IRC § 1361(c)(2)(B)(i).
[32]IRC § 1014(a).
[33]IRC § 1014(b)(6).
[34]IRC §§ 1014(b)(2) (revocable trust), 1014(b)(10) (QTIP trust), 2041(a)(2) (general power of appointment).
[35]IRC § 1015(e).
[36]IRC § 1015(a).
[37]IRC § 743(b).
[38]IRC § 743(d).
[39]IRC § 6018(a)(1).
[40]Rev. Proc. 2018-57, 2018-49 IRB.
[41]IRC § 2010(c)(5).
[42]Treas. Reg. §§ 25.2505-2(a) (gift tax), 20.2010-3(a) (estate tax).
[43]Treas. Reg. § 20.2010-2(a)(7)(ii)(A).
[44]IRC § 6035(a)(3); Prop. Treas. Reg. § 1.6035-1(d).
[45]IRC § 6035(a)(1).
[46]Prop. Treas. Reg. § 1.6035-1(h); IRS Form 8971 Instructions.
[47]Frequently Asked Questions on Estate Taxes, IRS website, https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-estate-taxes#1
[48]Transcripts in Lieu of Estate Tax Closing Letters, IRS website, https://www.irs.gov/businesses/small-businesses-self-employed/transcripts-in-lieu-of-estate-tax-closing-letters