V – HOW TO HANDLE TAXES

§ 5.01 – Introduction

An estate is an entity that is formed to hold a decedent's probated assets. If a decedent's assets are income generating (an example is stocks paying dividends) the estate is subject to an income tax. After the assets of an estate are distributed to the beneficiaries of the estate, the beneficiaries are responsible for the tax associated with the income generated by the assets.

Estate and gift taxes are associated with the transfer of wealth. While the gift tax rules apply only during an individual's lifetime, gifts made during a decedent's lifetime affect the tax rates applied to a taxable estate and the amount of the unused estate tax exclusion that can be transferred to a surviving spouse. The estate tax (transfer tax) is imposed on a decedent's estate. The beneficiaries of an estate are never subject to an estate tax or an income tax upon the receipt of the estate assets.

§ 5.02 Current Tax Laws, Rates, and Exemptions

The basic exclusion amount for federal estate and gift taxes and the exemption amount for purposes of the generation-skipping transfer is $11,400,000 for decedents dying in 2019.[1] [2] The exemption amounts are adjusted annually for inflation. A transfer tax of 18 to 40 percent is levied on the net taxable transfers in excess of the applicable exclusion amount. See § 5.07 for additional information.

§ 5.03 Tax Issues, Filing Requirements, and Deadlines

§ 5.03(a) When to File Form 1041

An estate must file an income tax return (Form 1041) annually if gross income is more than $600.[3] The filing requirement applies even if an estate is not liable for an income tax. The tax return is due by the fifteenth day of the fourth month after the end of the taxable year.[4] An automatic five-month extension of time to file can be obtained by filing form 7004 with the IRS on or before the due date of form 1041.

IRS form 56 (Notice Concerning Fiduciary Relationship) should be filed with the IRS by the person acting as a fiduciary for a decedent's estate. Form 56 should be filed when a fiduciary relationship with the estate is created or terminated.[5]

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[1] IRC § 2010(c)
[2] Rev. Proc. 2018-57
[3] IRC § 6012(a)(3)
[4] IRC § 6072(a)
[5] Reg. § 301.6903-1(b)

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§ 5.03 (b) Form 706

§ 5.03(b)(1) In general

The estate must file an estate tax return (Form 706) if the value of the decedent's gross estate, plus taxable gifts made by the decedent after 1976, exceeds the exclusion amount applicable in the decedent's year of death. The exclusion amount is $11,400,000 for decedents dying in 2019. The value of assets at the decedent's date of death is used to calculate the filing threshold. The alternative valuation election (the election to value an estate's assets six months after a decedent's date of death) is not used to calculate the filing threshold.[6]

The due date of an estate tax return is nine months after a decedent's death.[7] An automatic six-month extension of the time to file can be requested on form 4768. The extension must be requested by due date of the return.

The extension of time to file form 706 does not extend the time to pay the estate tax. An extension of time to pay the tax may be granted if an estate consists largely of an interest in a closely held business.[8] If the gross estate includes assets that will revert back to the estate in the future an extension of time to pay the tax is available under IRC § 6163.

§ 5.03(b)(2) Portability: Should You File Form 706.

The unused portion of a decedent's exclusion amount can be transferred to the surviving spouse.[9] The unused exclusion amount is based on the exclusion amount applicable in the year of the decedent's death. The portability election is made by filing a completed and timely form 706 (including Part 6 of the return that computes the unused exclusion amount). The portability election is irrevocable after the due date (including extensions) for filing form 706.[10]

The filing of form 706 is required to elect portability even if the decedent's gross estate is below the threshold for filing an estate tax return. A complete and properly prepared estate tax return (form 706) must be prepared to make an effective portability election.[11] [12]

§ 5.03(b)(3) Step-up in Basis and Basis Consistency Rules

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[6] Reg. § 20.6018-1(a)
[7] IRC 6075(a)
[8] IRC § 6166
[9] IRC § 2010(c)(2) and (4)
[10] Temp. Reg. § 20.2010-2T(a)(4)
[11] IRC § 2010(c)(5)(A)
[12] Reg. § 20.2010-2(a)(2)

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The basis of property acquired from a decedent is generally the fair market value on the decedent's date of death or the alternative valuation date.[13] The alternate valuation date is six months after the decedent's date of death.[14] Basis consistency rules apply to estate tax returns filed after July 31, 2015. The step up in basis on assets received by a decedent cannot exceed the fair market value reported on the decedent's estate income tax return. The executor of an estate is required to file form 8971 listing the value of each asset and the beneficiary's name and taxpayer identification number.

§ 5.03(c) Final Income Tax Return of Decedent

The death of a taxpayer terminates the decedent's tax year but the due date of the final Form 1040 is the same as if the taxpayer lived the entire year (generally April 15 of the following tax year).[15]

A six-month automatic extension of time is available for the filing of Form 1040 until October 15 of the following tax year.[16] The automatic extension of time to file does not require IRS approval and is obtained by filing Form 4868. The extension of time to file does not extend the time to pay taxes due on Form 1040. Interest and penalties maybe incurred if income taxes are not paid on or before the original due date of Form 1040.

§ 5.03(d) New Hampshire Taxes on Estates and Filing Requirements

§ 5.03(d)(1) Estate tax

New Hampshire does not impose an estate tax on a decedent's estate.

§ 5.03(d)(2) Interest and dividends tax

Estates are subject to the New Hampshire Interest and Dividends tax under NH RSA 77. The tax is levied on interest and dividends received by the estate of a decedent. The tax rate is five percent of interest and dividends received in excess of the $2,400 annual exclusion amount. The state tax is paid by filing form DP-10.

§ 5.03(d)(3) Business profits tax and business enterprises tax

An operating business held by an estate is subject to the New Hampshire business profits tax (NH RSA 77-A) and the New Hampshire business enterprise tax (NH RSA 77-E) if the business entity conducts business in New Hampshire. A business profits tax of 7.9 percent is imposed on the net income of a business held by an estate. An estate must file a business profits tax return (form NH-1041) if the gross receipts of the business exceed

[13] IRC § 1041(a)
[14] IRC § 2032
[15] Reg. § 1.6072-1(b)
[16] Reg. § 1.6081-4

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$50,000. A business enterprise tax is imposed at a rate of 0.675 percent of wages and interest paid by a business. An estate must file a business enterprise tax return (form BET) if the gross receipts of the business exceed $208,000 or the business enterprise tax base (total wages and interest paid by a business) exceeds $104,000.

§ 5.04 Post-Mortem Tax Planning – Basic Tips

§ 5.04(a) Selection of Estate Tax Year

The taxable year of an estate is a calendar year unless the estate chooses a fiscal year.[17] A tax year cannot be more than 12 months.[18] Therefore, the initial filing of the estate income tax return could be a short year return, based on the tax year selected.[19]

> *Planning note*: An estate may be able to lower its overall average tax rate by selecting a fiscal year that results in an initial short-tax year. Example: For an estate that is open for 18 months it is possible to have a short tax year the first year, a full year fiscal year return in the second year, and a short tax year in the final year. The lower tax brackets applied to taxable income are not prorated based on the number of months in a taxable year.

IRS form 56 (Notice Concerning Fiduciary Relationship) should be filed with the IRS by the person acting as a fiduciary for a decedent's estate. Form 56 should be filed when a fiduciary relationship with the estate is created or terminated.[20]

§ 5.04(b) Interest on Series E and EE Bonds

Generally, interest earned on series E or EE bonds is included in income when the bonds are redeemed. The executor of an estate can elect to include accrued interest on the final income tax return of a decedent.[21] Interest earned up until the date of death is included on the decedent's final Form 1040. If election to report accrued interest is made, accrued interest earned after the decedent's date of death is reported on the income tax return of the estate (form 1041).

The election to report accrued interest should be considered when a decedent died early in the tax year and otherwise wasted deductions such the standard deduction could be used to offset the income. The income tax rate of the beneficiaries as compared to the tax rates associated with a decedent's final income tax return should also be considered. If no election is made the beneficiary will report the accrued interest when the bonds are transferred.

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[17] IRC § 441
[18] Reg. § 1.441-1(b)(2)
[19] IRC § 443
[20] Reg. § 301.6903-1(b)
[21] Rev. Rul. 68-145

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§ 5.04(c) Election to File Joint Income Tax Return

A decedent can file a joint tax return with the surviving spouse so long as the surviving spouse did not marry before the end of the tax year.[22] The executor of an estate makes the decision to file jointly with the surviving spouse. If joint return is filed, then executor is jointly and severally liable for additional tax and penalties assessed under audit.

A joint return should be considered when one spouse's income does not fully absorb the lower tax brackets or if capital losses can be utilized. Separate tax returns should be considered if the income of one spouse is disproportionate to the amount of medical expenses associated with the spouse. Medical expenses in excess of 7.5 percent of a taxpayer's adjusted gross income are deductible (10 percent of adjusted gross income for tax years after 2018).

§5.05 Preparing the Decedent's Final Income Tax Return

§ 5.05(a) Form 1040

A taxpayer's tax year ends upon death.[23] Income accrued but not received before a decedent's death are included on the estate's income tax return under the IRD rules discussed in section 5.06.

Medical expenses that are unpaid at death but paid within one year of death are deductible on the decedent's final income tax return. No deduction is allowed on the estate's income tax return. An election can be made to deduct medical expense paid within one year of death on the estate tax return.[24] The deduction can be split between the decedent's final income tax return and the estate tax return.

> *Planning note:* Medical expenses are deducible on a decedent's final tax return to the extent that they exceed 10 percent of a decedent's adjusted gross income. Medical expenses are deductible on a decedent's estate tax return without limitation. The deduction limitation and the decedent's income tax rate should be compared with the value of the deduction on the estate tax return to optimize tax savings.

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[22] IRC § 7703(a)(1)
[23] Reg. § 1.6012-3(b)(1)
[24] IRC § 213(c)

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Capital losses and net operating losses not deductible on a decedent's final income tax return are lost. Capital losses and net operating losses not used on the decedent's final income tax return do not carryover to the estate income tax return.[25]

§ 5.05(b) Passive Activity Losses and Basis Adjustments

Generally, passive activity losses are allowed only to the extent of passive income.[26] Suspended losses associated with a particular passive activity are allowed in full upon the complete disposition of the activity. A passive activity is considered completely disposed of upon the death of a taxpayer.

Special rules apply to suspended passive activity losses upon the death of a taxpayer. The allowable passive activity loss deduction on a decedent's final income tax return is reduced by the amount of the basis step up to the fair market value of the activity at a taxpayer's date of death. Losses remaining after the basis step up reduction are deductible on a decedent's final income tax return.[27] If the step up in basis exceeds the suspended passive activity losses of an activity, no passive activity loss deduction is allowed for that activity on the decedent's final income tax return. The reduction of passive activity losses resulting from basis step ups are applied to each activity separately. This may result in a decrease in total suspended passive losses in an amount less than the aggregate basis step up of all passive activities owned by the decedent at death.

§ 5.06 Income Tax Return of an Estate

§ 5.06(a) Calculation of Estate Taxable Income

Generally, estates are subject to the same federal tax scheme as individuals.[28] There are differences that are discussed below.

Income in respect of a decedent (IRD) is included in the gross income of an estate.[29] IRD consists of income to which the decedent was entitled to on the date of death but not included on the decedent's final income tax return because of the decedent's method of accounting (generally the cash basis for individuals). IRD retains the same character on the estate's income tax return that it would have had if it were included on the decedent's

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[25] Rev. Rul. 74-175
[26] IRC § 469
[27] IRC § 469(g)(2)(A)
[28] Reg. §1.641(a)-1
[29] IRC § 691

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final income tax return.[30] Common examples of IRD are compensation payments related to salary, commissions, and sick and vacation pay.

A deceased partner's share of partnership income or losses is included on the final income tax return of the deceased and not on the return of the estate. A partner's tax year closes with respect to a partner on the partner's date of death.[31] Unrealized receivables (uncollected receivables with a zero basis) received after the death of a partner and received as part of the liquidation of a partnership interest are included on the tax return of the estate as IRD.[32]

The allowable exemption amount of an estate is $600.[33] Expenses of administration are fully deductible against the gross income of the estate.

Charitable contributions must be made from the estate's income to be deductible. If a charitable contribution is made out of the estate's income there is no limitation of the deduction based on an estate's AGI. (Generally, the charitable contribution deduction available to individuals is limited to 60 percent of AGI). A donation of property to a charity that was specifically bequeathed by a decedent is not deductible on the estate income tax return.[34] [35] An example is the donation of stock to a charitable organization. Charitable contributions related to dividends received by the estate on the account of the stock are deductible as a charitable contribution.

Estates may deduct distributions made to the estate beneficiaries. The deduction is limited to the amount of an estate's distributable net income.[36] Distributable net income is the taxable income of the estate with certain modifications.[37] An estate may elect to deduct distributions made within 65 days after the end of tax year on the estate's prior year return.[38] An election must be made each tax year on form 1041.

§ 5.06(b) Tax Implications of Sales of Property

§ 5.06(b)(1) In general

A decedent's estate will receive a step of in basis equal to the value of property on the date of the decedent's death (six-months after the date of death if the alternative valuation date is elected). Gain will be recognized only to the extent that property increases in value after the aforementioned valuation dates.

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[30] IRC § 691(a)(3)
[31] IRC § 706(c)(2)(A)
[32] Rev. Rul. 71-507
[33] IRC § 642(b)(1)
[34] IRC § 642(c)
[35] Crestar Bank v. IRS, 47 F. Supp. 2d 670 (E.D. Va. 1999)
[36] Reg. § 1.661(a)-2
[37] IRC § 643(a)
[38] IRC § 663(b)

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§ 5.06(b)(2) Holding periods for capital gains

Special long-term capital gains rates apply to capital assets held for more than one year. When an estate acquires property from a decedent the holding period is automatically deemed to be more than one year.[39] The holding period of property purchased by an estate and distributed to a beneficiary begins the day after the purchase of the property by the estate.[40]

§ 5.06(b)(3) Unused capital losses on decedent's final income tax return

Capital losses not deductible on a decedent's final income tax return are lost. Capital losses not used on the decedent's final income tax return do not carryover to the estate income tax return.[41] For assets that are expected to appreciate in value it maybe beneficial to sell the assets to the beneficiaries and use capital losses to shelter the gain from income tax. The beneficiaries would receive a basis equal to the purchase price and any increase in value after the date of sale would be excluded from a decedent's gross estate.

Assets transferred at death receive a step-up in basis equal to the fair market value on the date of death. This would result in a beneficiary recognizing a gain on the future sale of an asset only to the extent that the asset increased in value after the date of death of the decedent. The avoidance of income taxes on future sales should be compared with the potential increase in the estate tax related to holding assets expected to appreciate in value to determine the overall lowest tax consequence.

§ 5.06(c) Coordination of Deductions on Form 1041 with Deductions on Form 706

In general expenses cannot be deducted on both the estate income tax return (form 1041) and estate tax return (form 706).[42] Administrative expenses fall into this category. An estate may claim administrative expenses as an income tax deduction if a statement is filed with the Internal Revenue Service waiving the right to claim deduction against federal estate tax.[43]

> *Planning note:* The highest income tax rate (37 percent) is applied to an estate's taxable income in excess of $12,500 for taxable years beginning in 2018. The maximum estate tax rate of 40 percent does not apply until the taxable estate exceeds $1,000,000. The election to deduct administrative expenses on the estate's income tax return might result in overall tax savings.

The IRC § 642(g) double deduction rules do not apply to accrued expenses existing at a decedent's date of death. Accrued expense cannot be deducted on decedent's final

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[39] IRC § 1223(9)
[40] IRC § 643(e) and § 1223(2)
[41] Rev. Rul. 74-175
[42] IRC § 642(g)
[43] Reg. § 1.642(g)-1

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income tax return if not paid before death if a decedent uses the cash method of accounting. (Generally, individuals use the cash method of accounting to compute taxable income). Expenses included in this category are items such as taxes, mortgage interest, and business expenses.

§ 5.06(d) Calculation of Tax

The income tax rates applied to the taxable income of an estate range from 10 to 37 percent.[44] Estates are not subject to the self-employment tax on business income.[45] Estates are subject to the additional 3.8 percent Medicare tax on investment income[46] if the estate is in the highest tax bracket ($12,500 for tax years beginning in 2018). The alternative minimum tax is also applicable to estates.[47] The calculation is similar to the calculation for individuals and the alternative minimum tax rates are 26 and 28 percent.

The lower, maximum tax rates associated with long-term capital gains and dividends apply to estates.[48] The maximum tax rates are zero for estates in the 10 percent tax bracket, 15 percent for estates in the 24 and 35 percent tax brackets, and 20 percent for estates in the 37 percent tax bracket.

§ 5.07 Estate, Gift, and Generation-Skipping Transfer Taxes

§ 5.07(a) Estate Tax Return

An estate tax of 18 to 40 percent is levied on the net taxable estate in excess of the applicable exclusion amount. The exclusion amount is $11,400,000 for decedents dying in 2019.[49] [50] The exemption amounts are adjusted annually for inflation.

The applicable exclusion amount is reduced by the value of gifts made during a decedent's lifetime. Example: Assume "A" gifts $900,000 to "B" prior to his death in 2019. If "A" dies in 2019, the amount of the estate tax that can be sheltered by the exclusion amount in 2019 is $10,500,000 (calculated as $11,400,000 - $900,000).

Assets are included in the gross estate at the fair market value on the date of death of the decedent.[51] The estate may elect to use an alternative valuation date of six months after the decedent's date of death.[52] The estate is allowed deductions such as charitable

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[44] IRC § 1(e)
[45] Reg. § 1.1402(a)-2(b)

[46] IRC § 1411(a)(2)
[47] IRC § 55
[48] IRC § 1(h)
[49] IRC § 2010(c)
[50] Rev. Proc. 2018-57
[51] IRC § 2031(a)
[52] IRC § 2032

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contributions, debts and expenses accrued at death, and funeral costs. The estate may also deduct medical expenses (subject to the rules discussed at § 11.07(b)) and administrative expenses (subject to the rules discussed at § 11.07(a)(2)).

§ 5.07(b) Amounts Includible in the Gross Estate and Reported on Schedule G of Form 706

Gift taxes associated with gifts made by a decedent within three years of death are included in the gross estate of the decedent.[53] This rule prevents an overall reduction of the value of the gross estate on the transfer of appreciating assets made in anticipation of death. The transfer of life insurance, the release of general powers of appointment, and the release of retained life interests made with three years of the decedent's death are also included in the decedent's gross estate.[54]

Transfers made during a lifetime that are not completed gifts are included in the decedent's gross estate. Property that a decedent retained an interest in at death is included in the decedent's gross estate.[55] Property transfers that the decedent had a reversionary interest in at death and revocable transfers made by a decedent while living are includible in the decedent's gross estate. [56] [57]

§ 5.08 Sample Tax Forms and Charts

[53] IRC § 2035(b)
[54] IRC § 2035(a)
[55] IRC § 2036
[56] IRC § 2037
[57] IRC § 2038

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