JOURNAL OF ACCOUNTANCY

TAX / PERSONAL FINANCIAL PLANNING

The 10 most powerful postmortem planning pointers for trusts and estates

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MAY 2012

After a client passes away, there is much more to do than just prepare a final Form 1040, *U.S. Individual Income Tax Return*. Taking control of the postmortem planning process can be a powerful way to save tax dollars for the decedent's estate and family. Postmortem planning also applies to Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*; state death tax returns, if needed; and income tax returns for the estate and any revocable trusts set up during life.

Although many accountants routinely handle the preparation of the final personal return, fewer accountants acting as fiduciaries are as adept at taking advantage of the alternatives available to them when preparing Form 1041, *U.S. Income Tax Return for Estates and Trusts*. What follows are the most important tips for doing so:

1. Select a Fiscal Year End for the Estate

The assets that earned income during a client's lifetime will continue to do so after his or her death. Until the estate distributes those assets to beneficiaries, an estate income tax return will need to be filed each year, generating a Schedule K-1 to each residual beneficiary to the extent distributions are made. Using a fiscal year end can be a powerful tool to defer tax on that income and allow beneficiaries time to plan for its inclusion in their personal returns. Any of the 12 month-end dates that follow the decedent's death can be the fiscal year-end date, but the year cannot exceed 12 months.

For example, the maximum fiscal year for a decedent dying Oct. 5 is through Sept. 30 of the following year. The year can be shorter than 12 months, an effective choice if a large, income-producing transaction will occur in the months after the selected year end. Choose wisely for maximum income deferral. Estates do not have to make federal quarterly estimated tax payments for the first two years after the decedent's death.

2. Elect to Include Income Earned in the Decedent's Trust on the Estate's Income Tax Return

Trusts are required to use a calendar year end. However, a tax adviser can elect to include the income from a decedent's qualified revocable trust on the estate income tax return. Doing that provides an array of benefits not normally available to trusts, the most significant of which may be the ability to use the estate's fiscal year end for trust income. This election lasts two years beyond the decedent's date of death (longer if a Form 706 is required to be filed; consult the instructions to Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*), which is normally plenty of time to deal with closing out a trust. Known as a Sec. 645 election, it is made by filing Form 8855 with the Form 1041. This election can be made even if there are no income-producing probate assets in the estate.

3. Manage Distributions to Minimize Overall Tax

Estate and trust income taxes reach the highest tax bracket of 35% at $11,650 of taxable income for 2012. If residual beneficiaries are in lower brackets, it will save tax for the family overall to distribute income out of the estate to them in a timely fashion. The fiduciary has until 65 days after the end of the tax year to make distributions for that tax year. Capital gains stay at the Form 1041 level and are taxed there, except on a final return.

4. Prepare Form 1041 on the Accrual Basis

Excess deductions over income on an estate Form 1041 do not carry over to the next year and therefore are wasted (except on a final return; see below). If the fiduciary finds that the estate has paid large expenses without much income during the first year or, as is more often the case, the estate has ample income but will not pay related legal and administrative expenses until later, the fiduciary can prepare Form 1041 on the accrual basis and accrue the income or expenses into the current year.

5. Prepare a "First and Final" Return When Possible

Smaller estates often can be settled within a year plus 65 days. Then the fiduciary can file only one estate Form 1041 that is both an initial and a final return, saving the family money. Where possible, the fiduciary can make that happen by ensuring that timely distributions are made to beneficiaries and that any remaining assets are unlikely to generate the more than $600 of taxable gross receipts that would trigger an additional return filing requirement (by putting the remaining cash in a non–interest-bearing account, for example).

6. Update Basis of Assets

Capital gains are relatively rare on an estate Form 1041 because assets generally get a step-up in basis to date-of-death values. (However, executors of estates of 2010 decedents had until Jan. 17, 2012, to elect a modified carryover basis and holding period.) If the estate sells those assets quickly, there usually is not a lot of time for them to appreciate in value. Any asset acquired from a decedent generates long-term capital gain when it is sold, no matter how long the asset was held before or after the decedent's death. Stockbrokers often fail to adjust cost basis to date-of-death values before disposing of assets in an estate. It usually falls to the accountant to follow up on this issue and report the correct basis and long-term holding period for the sale and to provide brokers with a list of date-of-death values to update their basis for the remaining assets.

When an unmarried decedent owns a home at death and the estate sells it, there is no available exclusion from gain; however, because the basis in the residence will typically be the date-of-death value, the sale of the home will often generate a loss resulting from selling expenses, commissions, and repairs. Unlike a loss on a home sale during life, this loss is deductible.

7. Claim an Estate Tax Deduction for IRD

Not all assets get a step-up in basis. A category of assets known as income in respect of a decedent (IRD) does not. The beneficiary of such an asset or its income will "step into the shoes" of the decedent and report the income in the same way the decedent would have if he or she had lived to collect it. Common examples include wages earned but not yet paid when death occurs, installment notes receivable, dividends declared before death but paid later, traditional IRA accounts, and investments in annuities. Because the value of these assets is included on the decedent's balance sheet and is taxed for federal estate tax purposes, these assets are in essence double taxed when the money is collected and reported for income tax. If federal estate tax is paid on these assets, the entity that later reports the items for income tax is entitled to a deduction for the estate tax paid, known as the estate tax deduction for IRD. This may somewhat mitigate the double-taxation effect (Regs. Sec. 1.691(c)-2(a)(1)).

8. Claim DRD on Estate Tax Returns

Just as IRD is taxed twice, deductions in respect of a decedent (DRD) can be deducted twice: once for federal estate tax and once for income tax (Sec. 642(g)). Such items include business expenses, interest expense, taxes, expenses for production of income, depletion, and the foreign tax credit. Taxes are perhaps the most common, including state income taxes and real estate taxes. State death taxes, however, are not deductible anywhere except on Form 706.

9. Set Aside Income From Charitable Assets

If a decedent's estate will ultimately go to charity after all debts and expenses are paid, income earned while the estate is being settled need not be subject to income tax. An estate is allowed to set aside income from assets destined for charity (Sec. 642(c)). The mechanism to keep that income from being taxed on an estate Form 1041 is Form 1041-A, *U.S. Information Return, Trust Accumulation of Charitable Amounts*, a separate return filed to set aside this income. If a decedent's trust will ultimately go to charity, there is no set-aside for the income earned in the trust. However, a trust can take a charitable contribution deduction for its income. As long as that income actually is paid to the charity by the end of the following year, there will be no income tax on it. An election statement must be filed with the Form 1041 when this mechanism is used. The details of what should be included in this election statement can be found in the 2011 Form 1041 instructions at page 25.

10. Allocate Estimated Taxes From the Final Return

In a final return, all income tax liability, even on capital gains, rests with the beneficiaries of the estate. The final Schedules K-1 will carry out all the income. For this reason, there is no need to make any estimated tax payments if the fiduciary knows that the year or partial year will be the final time Form 1041 will be needed. If estimated tax payments are required or inadvertently made, they can be allocated to the beneficiaries for use on their personal returns by filing Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, within 65 days of the end of the estate's tax year. Deductions in excess of income in the final year are also allocated on Schedule K-1 and are available to beneficiaries as a miscellaneous itemized deduction on their personal returns. Any capital loss carryovers not used by the estate are also passed through to the beneficiaries.

EXECUTIVE SUMMARY

- **Tax planning has just begun when** Form 1040 is filed.
- **Choosing a fiscal year end** for the estate can maximize tax deferral.
- **The estate should make distributions** to minimize the overall tax burden.
- **Use of the accrual basis** will allow expenses to be matched with income for lower taxes.
- **Be sure to update the basis of assets** that are destined for charity so the estate can avoid paying income taxes on those earnings.

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