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**DEATH AND TAXES:  
SELECTED INCOME TAX ISSUES  
FOR DECEDENTS AND THEIR  
FAMILIES**

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**Overview**

- We will cover three main topics:
  - Returns and filing obligations
  - Income tax attributes affected by death
    - Basis
    - Home ownership
    - Other attributes
  - Some special problems for owners and transferees of partnerships and S corporations
    - Basis adjustments at death
    - New partnership audit rules.

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**Return Obligations**

- Civil Penalty structures for failing to meet filing and payment are likely familiar.
  - Failure to timely file and pay taxes. (6651)
    - (Also note failure to pay estimated taxes (6654))
  - Excused if due to “reasonable cause and not due to willful neglect”
- That all sounds simple enough, but what does it mean to file?

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### Filing

- Three basic requirements for a valid return:
  - Return or statement according to forms and regulations prescribed by the IRS
  - Signature
  - Execution under penalties of perjury
- No signature means no valid return
  - Good news: an invalid return cannot trigger a fraud penalty
  - Bad news: an invalid return is not a return at all for other purposes, including penalties

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### Joint Return Signatures

- Riefler (TCM 2015-199) illustrates one problem.
- H signed the joint return, but W failed to sign before the return was mailed. IRS rejected the return, triggering late submission of properly signed return.
  - On audit, IRS imposed late filing penalties of \$900K
  - Tax Court upheld: no signature differs from purported signature, which is presumptively valid.
  - Note: an invalid return remains invalid if the IRS accepts and processes it!

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### Returns by agents

- An agent can act on your behalf. Treas. Reg. 1.6012-1(a)(5).
- Form 2848 is sufficient to designate POA, but only if valid reasons for designating agent.
  - Absence from US for 60 days before due date of return
  - Disease or injury, or other reasons
  - Query how electronic signing affects this framework? (More on electronic signatures below).

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### Agents: Married Taxpayers

- A spouse may also sign for one who is physically unable, based on oral consent, without the need for Form 2848.
- Regulations prescribe formalities (see outline)
- If disability affects ability to make a signature, what about an electronic signature?
  - Still requires Form 8879 for taxpayers each year (vs. 3 year life of POA).
  - Return preparers should keep declaration required in regulations for Form 8879, which is not given to IRS.

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### Returns for Fiduciaries

- A fiduciary may also have return obligations on behalf of others.
  - Note broader authority than authorized representative under POA: fiduciary assumes powers, rights, duties and privileges of the other person; not limited to those enumerated in POA.
- Living persons: minors, guardianships, etc.
  - Form 56 filed with return to notify of status.

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### Fiduciaries

- Options for decedents with a surviving spouse:
  - Fiduciary option: Executor files final return of decedent, with short period ending on date of death.
    - Separate from estate's return
    - Separate Form 56 filed with return in each case.
  - Joint return with surviving spouse: (who survives the taxable year).
    - Report decedent's income on joint return
    - Avoids allocating income between periods and taxpayers
    - Expanded tax brackets will likely lower taxes due, even without income from deceased spouse

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### Fiduciaries

- Further issues with joint return.
  - Fiduciary cooperation required with surviving spouse.
  - Fiduciary can disaffirm joint return of surviving spouse
    - But this means, decedent failed to timely file.
    - Why do this? Joint and several liability fears? And maybe spite against surviving spouse?
  - Note: remarriage during the taxable year means no joint return with deceased spouse.
  - Potential to continue joint return treatment with deceased spouse for next two years if conditions are met, including household with dependent children.

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### Relief for Disability

- What happens if no one intervenes to file a return on behalf of one with a disability?
- Reasonable cause/not willful neglect
  - Burden on taxpayer to make affirmative showing
  - “ordinary business care and prudence”
- So what works?
  - Lack of access to information? Not if you can use estimates. Though some authorities may give relief where recalcitrant spouse is involved.
  - Not even incarceration constitutes reasonable cause!

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### Relief for Disability

- Illness or disability of taxpayer or close family member can be considered.
  - Emotional distress can be a form of disability
  - Must be sufficiently continuous and significant; must file when disability is removed.
  - Doing other significant things (like working) suggests emotional distress is not sufficient.
- Note that one spouse’s temporary disability is likely not an excuse to delay the joint return, unless care of the disabled spouse causes disability.

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**Refund Claims:  
Special Problems of Disability**

- The 3-year limitation period for refund claims may also be implicated if disability prevents timely claim filing. "Financial disability" was codified as an exception in 1998, after the SCT had ruled that "equitable tolling" was not applicable.
- A strict proof requirement applies. See Rev. Proc. 99-21.
- Potential action by a spouse, agent, or fiduciary makes one ineligible for relief.

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**Innocent Spouse Relief**

- Married couples may have a "bonus" or "penalty" associated with a joint return, but joint and several liability can become an undue penalty for a spouse.
- The Outline contains significant rules governing relief, which could apply to either spouse.

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**Innocent Spouse**

- Some strategic considerations:
  - Don't file a joint return if you are worried about joint and several liability.
  - Even if innocent spouse relief is granted, this does not negate transferee liability.
    - Ex. H dies and his executor distributes assets to W. If the IRS assesses a deficiency attributed to H's tax attributes, W may seek innocent spouse relief.
    - If relief is granted, W may still be liable as a transferee for assets she received from the estate.

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### Innocent Spouse

- Other strategic considerations: Statute of Limitations
  - Filing a request for relief provides an automatic stay against levy or collection proceedings.
  - But it also suspends the limitations period. If you are close to the end, should you file the request for relief?

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### Some Recent Case Studies

- Evans (TC Memo 2016-7)
  - IRS rejected emotional distress from daughter’s death as basis for excusing return filing obligations.
  - TP’s loss of motivation for filing tax returns contrasted with ability to maintain employment in managing real estate projects.
  - Compare situation where one continuously attends to dying child during period preceding return filing obligation – which provided basis for relief.

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### Some Recent Case Studies

- Estate of Stuller v. United States, 811 F.3d 890 (7<sup>th</sup> Cir. 2016)
  - Death of husband, destruction of home, personal health problems and depression, ruled insufficient.
  - W continued to manage business and to attend and compete in horse shows.
  - Missing records in destroyed home also failed – you could have gotten duplicates from the bank.

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### Some Recent Case Studies

- Estate of Rubenstein, 119 Fed. Cl. 658 (2015), appeal filed (Fed. Cir. April 1, 2015).
  - Decedent prepared own returns with help of son. After falling out, he made estimated payments but did not file returns.
  - Son discovers errors after his death, files amended returns with refund claim from overpayments (D-4) and some underpayments (D-3).
  - Refund claims barred by S/L; underpayments not subject to S/L. No relief based on “financial disability”

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### Some recent case studies

- Estate of Rubenstein, 119 Fed. Cl. 658 (2015), appeal filed (Fed. Cir. April 1, 2015).
  - Important object lessons regarding elderly clients
  - Clients may be able to do some complex things, but their tax compliance may fall short.
  - Overpayment of estimated taxes may be worse than underpayment due to S/L considerations.
  - Conflicting medical testimony here: not impaired for purposes of driving, but for impaired purposes of filing tax returns?

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### Tax Attributes

- Basis is likely the most significant tax attributed affected by death.
  - 1014(a)(1) adjustments present significant income tax effects, including effects on gifts, charitable donations, gain or loss, depreciation, etc.
  - As covered in detail in the outline, recently enacted basis reporting rules affecting certain taxable estates require consistent basis reporting for income and estate tax purposes.

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### Tax Attributes

- The basis reporting rules present numerous complexities and uncertainties for executors charged with compliance.
- But those rules affect a relatively narrow class of taxpayers – a fraction of the total property passing from decedents.
- Other taxpayers remain subject to the need to determine FMV independently.
  - Inheritance tax valuation: determination or presumption? (See page 19 of the outline).
  - Also note the interesting oddity of the tax treatment of options (page 19-20).

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### Tax Attributes: Home Ownership

- Home ownership presents a special set of problems due to the intersection of sections 1014 and 121.
- Joint tenancy presents enigmatic qualities, discussed in the outline at pages 20-21.
  - For married couples, the “qualified joint interest” results in half the property being included in the decedent’s estate.
  - Other joint tenancies are not so clear.

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### Tax Attributes: Home Ownership

- In a community property state, the section 1014 basis in community property produces a significantly different outcome: the entire property gets a step-up in basis, not just half.
  - That is a big tax advantage.
  - All community property is affected.
  - Caron & Soled (2016) found no empirical evidence of migration to community property states. (But query if the population was defined with sufficient clarity – two spouses of similar age may not achieve the same tax benefit as a “May-December” marriage.)

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### Home Ownership

- Section 121 presents requirements for a \$250K (single) or \$500K (married filing joint) exclusion. These generally include:
  - Owned by either spouse.
  - Both used as principal residence for 2 of last 5 years preceding the sale (with lesser benefits if there was some nonqualified use during that period)
  - Neither spouse accessed exclusion in the past 2 years.

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### Home Ownership: Examples

- A & B are unmarried. They buy a house together for \$100K, held in joint tenancy. A pays \$20K down, and thereafter makes all mortgage payments from A's separate bank account.
  - If A predeceases B when the home is worth \$150K, B likely takes a basis of \$150K.
  - If instead B predeceases A, A likely continues to have a basis of \$100K in the home.

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### Home Ownership: Examples

- If A & B continue to own the home and then sell it, the tax basis may depend on whether A intended a gift to B, adding other complexities.
- B and A could each independently satisfy the \$250K exclusion under section 121 for their portion of the home upon the sale, assuming requirements are met.
- Note that A and B may get greater benefits than a married couple under section 163(h), at least in the 9<sup>th</sup> Circuit. (See page 23 of outline).

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### Home Ownership: Examples

- H & W buy the same house as A and B, under the same terms (\$100K purchase price, \$20K down payment).
- If H predeceases W when the house is worth \$150K, W now has a basis of \$125K in the house.
- If instead W predeceases H, H gets the same basis in the house.
- If they continue to live in the house and sell it two years later, they can exclude up to \$500K under section 121.

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### Home Ownership: Examples

- H buys a home for \$100K and begins living there. Two years later, he married W. At this time, the house is worth \$600K. He retitles the home to joint tenancy. H dies on the honeymoon. W never lives in the house. She sells it one month after the funeral.
  - W's basis is \$350K (i.e., her half plus his half at FMV on the date of death).
  - W could get the \$500K exclusion here. She is deemed to meet the ownership and usage requirements through her husband. (A better deal than if the couple had sold the house while H was still living.)

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### Home Ownership Examples

- Same example as above, except H and W owned the property as community property.
  - W would have a basis of \$600K at death.
  - Note that this is the same result as if H kept the property titled in his name in the common law state, in which case W would take a basis of \$600K if she inherited the property.

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### Other Tax Attributes

- Some general rules about marriage (see *Vichich*, 146 T.C. No. 12 (2016)).
  - Two taxpayers become one taxable unit, but not one taxpayer.
  - Marriage “does not create a new tax personality”
  - Joint filing “generally does not permit either spouse to inherit or otherwise retain after the marriage ends a tax benefit that was originally conferred upon the other spouse.”

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### Other Tax Attributes: Examples

- H has NOL before marriage to W. H may not use NOL to offset W’s income after marriage.
- H has NOL during marriage to W; the couple may use it to offset taxable income earned by W in a joint return.
- W incurs NOL after H’s death. She may not carry these back to offset H’s income reported on joint returns filed during their marriage.
  - Note different result if W and H operated business together.
- NOL from business operations are deductible on the decedent’s final return, but not by decedent’s estate (ditto, capital losses).

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### Other Tax Attributes: Examples

- Rules regarding charitable contribution carryovers are covered in detail in the outline at pages 26-27.
  - Excess deduction carryovers perish with the donor. But with a married couple, who is the donor?
  - As long as the couple survives, it does not matter, but when one dies this issue deserves attention given the tax attribute treatment outlined above.

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### Other Tax Attributes: Examples

- Capital loss carryforwards: H has CLCF of \$100K before his death. W files joint return with H, potentially allowing only \$3K deduction under § 1211(b) unless she has offsetting gains. Otherwise, \$97K of CLCF expire.
- If W can sell some of the couple's property to trigger gains, she could utilize the CLCF. Note that wash sale rules don't apply for gain property, potentially allowing reacquisition. (See IRC 1091, but also worry about substance of sale.)
- Passive activities, credits, also affected (see outline).

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### Special Problems: S and K

- Tax attributes of an S corporation are sometimes treated as though they are attributable to the owner, despite the fact that the corporation is a separate legal person and tax reporting entity.
  - See IRC 1367(b)(4)(A) (requiring IRD to be taken into account as if the decedent had held the item of income).
  - See IRC 1367(b)(4)(B) (preventing basis adjustment by 1014 for IRD amount)

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### Special Problems: S and K

- Shareholder death affects the basis in his S corporation stock, as well as the allocation of pre- and post-death income between the decedent and his transferee on account of disposition of the stock.
  - Income allocations affect basis, see § 1367(a), but the transferee's basis is affected by § 1014 (step up or down, depending on the FMV as adjusted for any IRD).
  - Loss allocations affect basis, too. See § 1367(b). As with other tax attributes, suspended losses perish with the decedent if not used on the decedent's final return.

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### Special Problems: S and K

- Income allocations can potentially be affected by a decision to close the tax year, perhaps providing some assistance in utilizing a suspended loss.
- The inflexibility of the per-share, per-day allocation method, coupled with flexibility of using a pro rata vs. segmented reporting, may provide advantages in this context.

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### Special Problems: S and K

- E.g., A dies on 6/30/x1, holding 50% of ACME stock. A has \$50K of suspended losses. ACME owns an asset with a FMV of \$200 and a basis of \$0. During the first half of year x1, ACME has no taxable income; in the second half, it sells the asset and realizes \$200 of gain.
  - If a pro-rata allocation is used for the entire year, A gets \$50K of income, thus allowing suspended losses to be used on his final return.
  - If ACME closes the tax year at 6/30/x1, A's K-1 will show income of zero and the suspended loss perishes with him.

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### Special Problems: S and K

- Note that in the prior example, the closing election can be made by "affected shareholders". If A's heir, A', acquired the interest, A' would have to consent.
  - A' would presumably desire this outcome, as it would allocate income away from A' and toward A, thus reducing A's taxable income.
  - A' would have a basis reflecting FMV at A's death, to which A would add any income allocated from the sale. (See below – this basis adjustment may be cold comfort for A').

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### Special Problems: S and K

- As shown above, death of a shareholder does not affect the corporation's basis in its assets. In the above example, ACME retained a basis of zero in the assets it holds at death. Section 1014 only affects the asset held by the decedent, i.e., stock.
- Assume in the example above, A' has a basis under section 1014 of \$100 in the stock. If A' has \$100K of income allocated from the sale of ACME's only asset, A' would increase her basis to \$200 under section 1367. But she would still have to pay tax on that \$100 gain, unless somehow she could sell her stock or otherwise liquidate the corporation in a manner that would trigger an offsetting loss. (And characterization restrictions would apply.)

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### Special Problems: S and K

- A partnership presents similar issues but slightly different rules. See the outline at pages 32-36.
- Significantly, subchapter K provides a potential form of relief for the transferee due to the optional § 754 election.
- In the example above, if ACME was a partnership, ACME would adjust its basis in the asset to \$100, reflecting the increase in outside basis under section 1014 if it elected under section 754.
  - This would prevent A' from recognizing that gain upon the sale of the asset.
  - It would also prevent A' from seeking to recognize offsetting losses from a sale or liquidation.

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### Special Problems: S and K

- As discussed in the outline, Subchapter K treats the partner's suspended loss similarly to an S corporation shareholder's suspended loss: both terminate unless used.
- The income allocation rules under Subchapter K present segmentation of the partnership year as the approach when variations in ownership interests occur, albeit with a potential for a special allocation of an extraordinary income.

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### Final Topic: Partnership Audit Rules

- Large partnerships present considerable complexity in tax administration.
  - Partnership items generally must be determined in partnership level proceedings following a partnership audit, following the so-called “TEFRA” rules first enacted in 1982 to streamline partnership tax administration.
  - Partners generally report consistently with the partnership, unless they inform the IRS otherwise. See IRC 6222.
  - Audit adjustments from prior years then must be collected from partners, not partnership, adding to the IRS burden.

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### Final Topic: Partnership Audit Rules

- Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat 584 (Nov. 2, 2015), enacted a new regime, replacing the TEFRA rules effective for tax years beginning after 12/31/17, unless the partnership elects earlier application.
- The new rules are mandatory, but certain small partnerships may be eligible to elect out of them. Commentators advise to do so.

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### Partnership Audit Rules

- The audit rules are significant because they potentially turn the partnership into a taxpaying entity with regard to an audit adjustment, unless the partnership elects to pass through the adjustments to partners.
- If there is an “imputed underpayment”, the partnership may owe tax based on applying “the highest rate of tax in effect for the reviewed year under section 1 or 11” to the audit adjustment.

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**Partnership Audit Rules**

- This means the partnership must ultimately pay the tax in a later year than the year under audit.
- Changes in ownership could result in mismatching of tax benefits and burdens between time periods, potentially affecting current partners and their transferees.
- These effects create new complexity in the planning environment for owners of partnership interests.

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**Partnership Audit Rules**

- Alternative avenues for audit adjustments:
  - Partnership may elect to send the bill to its current partners, but they still pay it in the year the adjustment is made, not the tax year under audit. (Note that the underpayment rate is increased in this options)
  - Individual partners may elect to file amended returns for the affected years, thereby reducing the partnership tax due.
  - Many uncertainties exist here, some of which are identified in the outline.

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**Partnership Audit Rules**

- Some estate planning concerns:
  - Valuation effects from partnership audits.
  - Uncertainties created by potential elections, affecting the current partners and former partners.
  - Fiduciary conflicts: which heirs are benefitted by an election to file an amended return and pay tax; which are burdened by failing to do so?
  - Strategic partnership exits to avoid tax?
  - Preferences for termination and winding up, rather than continuation, to avoid liability shift?

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