

Decedents



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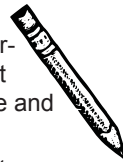
Quick Tax Briefing

Overview

Filing a return for the year an individual dies presents some unique filing and reporting rules. The decedent's final return includes income and deductions through the date of death, but certain elections, such as deducting medical costs paid after death, should be considered. It is the responsibility of the decedent's executor or personal representative to file the decedent's final Form 1040.

Tax highlights

- ✓ A decedent's tax year ends on the date of death, although the due date of the final Form 1040 return remains the same, typically April 15 of the following year.
- ✓ A joint return can be filed for a decedent and surviving spouse if the spouse has not remarried at the end of the tax year and the surviving spouse and estate representative agree to file jointly.
- ✓ The death of a partner closes the partnership's tax year for that partner but it generally does not close the partnership's tax year for the remaining partners.
- ✓ In the year of a S shareholder's death, the S corporation should prepare a separate Schedule K-1 reporting the decedent's proportionate share of the S corporation's pass-through income or loss for the portion of the corporation's tax year through the date of death (to be reported on the decedent's final Form 1040).
- ✓ Accrued, but unpaid, income as of the date of death is income in respect of a decedent (IRD). IRD is excluded from the decedent's final income tax return and taxed to the taxpayer, typically the estate or an heir, who actually or constructively collects the IRD.
- ✓ Medical costs paid by the decedent's estate within one year of the day following death can be deducted either on Schedule A of the decedent's final Form 1040 or on the estate tax return (Form 706), but not both.
- ✓ Net operating losses and capital losses allocable to the decedent cannot be carried over and used by his estate, nor can they be carried over and used in future tax years by a surviving spouse.
- ✓ A personal representative can shorten the time the IRS has to assess the decedent's estate with any additional income tax from three years to 18 months by requesting a prompt assessment of the decedent's income taxes.
- ✓ If there is no court-appointed representative and no surviving spouse, Form 1310 must be attached to the return to claim a refund.



IRS materials

- Pub. 559, *Survivors, Executors, and Administrators*.
- Form 56, *Notice Concerning Fiduciary Relationship*.
- Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer*.
- Form 4810, *Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)*.

Key Terms

Accelerated death benefits. Amounts received under a life insurance contract before the death of the insured individual. Also includes amounts received on the sale or assignment of the contract to a viatical settlement provider.

Constructive receipt. This doctrine requires a cash basis taxpayer to recognize income when an item is credited to the taxpayer's account or made available without restriction.

Decedent. An individual who has died.

Deductions in respect of a decedent (DRD). Items, such as business expenses, income-producing expenses, interest and taxes, for which the decedent was liable but that are not properly allowable as deductions on the decedent's final income tax return, generally because they are unpaid at death.

Income in respect of a decedent (IRD). Accrued, but unpaid, income as of the date of death for decedents who were cash basis taxpayers.

Letters testamentary. Documents issued by a court to the executor that provide evidence of the executor's authority to act on behalf of the estate; without them, third parties generally will not follow the executor's instructions.

Personal representative. An executor, administrator or anyone who is in charge of the decedent's property.

Prompt assessment of tax. A request by an executor to shorten the period the IRS can assess tax on the decedent's returns from the usual three years to an 18-month period beginning the date the IRS receives the request.

FILING REQUIREMENTS— YEAR OF DEATH

A decedent's tax year ends on the date of death, although the due date of the final Form 1040 remains the same (typically April 15 of the following year). In general, normal tax accounting rules apply regarding the recognition of income and deductions, including the doctrine of constructive receipt. The tax year of the estate's income tax return, Form 1041, begins the day after death and must terminate at a month-end no more than twelve months after the date of death. The estate may elect a fiscal tax year; it does not have to be a calendar year ending on December 31.

Return for preceding year. If an individual died after the close of the tax year, but before the return for that year was filed, the return for the year just closed will not be the final return. The return for that year will be a regular return, and the personal representative must file it.

Example: Eddie Jones died on March 21, 2015, before filing his 2014 tax return. His personal representative must file his 2014 return by April 15, 2015 or request an extension. Eddie's final tax return is his 2015 return (for the period January 1, 2015–March 21, 2015) and is due April 15, 2016.

Deceased Taxpayer—Tax Returns

Tax Return ¹	IRS Form	Due Date ²	Return required if:
Final Income Tax Return	1040	April 15 of the year following death. ³	<ul style="list-style-type: none"> The decedent's gross income from January 1 through the date of death exceeds the filing floor for the decedent's filing status and age determined on the date of death. The decedent meets any other filing requirements for individuals (such as having SE income). A return can be filed to claim a refund or refundable credit.
Income Tax Returns for Preceding Years	1040	April 15 of the year of death. ³	The decedent dies after the end of the year but before filing, and the decedent met any of the filing requirements for individuals. Original or amended returns for back years must also be filed if the decedent would have been required to file them. Amended returns may be filed to claim refunds.
Fiduciary Income Tax Return	1041	15th day of the fourth month following the close of the tax year.	<ul style="list-style-type: none"> Estate had gross income of \$600 or more in the tax year or Estate has a nonresident alien beneficiary. A return can be filed to pass deductions to beneficiaries in the estate's final year. Notes: <ul style="list-style-type: none"> Gross income includes proceeds from the sale of decedent's home or other capital asset if paid to the probate estate. If decedent was the grantor of a revocable trust, Form 1041 may be required to report trust income.
Estate Tax Return	706	Nine months after the date of death.	<ul style="list-style-type: none"> The decedent's gross estate at death, plus taxable lifetime gifts, exceeds the applicable exclusion amount (\$5.34 million for 2014). [IRC §6018(a)] Note: Gross estate includes amounts qualifying for the charitable and marital deductions. <ul style="list-style-type: none"> Executor elects to pass decedent's unused exclusion amount to surviving spouse.
Gift Tax Return	709	Earlier of: <ul style="list-style-type: none"> April 15 of the year following gift or Form 706 due date. 	<ul style="list-style-type: none"> The decedent made a taxable gift in the year of death. The decedent made a taxable gift in the year preceding death and died before filing. Returns for back years must be filed if the decedent failed to file a required return.

¹ See *Executor's Federal Tax Filings Checklist* on Page 3-13 for a list of other tax returns that may be required.

² Original return due date. Return may be extended.

³ For calendar-year taxpayers. The due date is the same date the decedent's return would have been due had death not occurred.

Who Should File the Return

Estate representative. If the decedent named an executor or a court appoints a personal representative or other estate administrator, that person must file for the decedent. A joint return can be filed for a decedent and a surviving spouse if the spouse has not remarried by the end of the tax year and the surviving spouse and estate representative agree to file jointly.



Surviving spouse. If there is no court-appointed representative by the deadline for the return, a spouse who does not remarry before the end of the tax year can file a joint return with the decedent [Reg. §1.6013-1(d)(3) and (4)]. A spouse can file a joint return even if he expects that an estate representative will be appointed. If the surviving spouse is the appointed representative, he files for the decedent as representative and not as surviving spouse.

Note: If a personal representative is later appointed, that person may disaffirm the joint return by filing a separate return for the decedent within one year of the due date (including extensions) of the spouse's (joint) return. [Reg. §1.6013-1(d)(5)]

Person in charge of decedent's property. If there is no court-appointed representative and no surviving spouse, a "person in charge of the decedent's property" must file the returns. This person may be anyone in actual or constructive possession of decedent's property; generally, one of the heirs is chosen informally by the others to act in this capacity.

Filing by a person in charge of the decedent's property should only be done for estates which will not require probate. If the return shows a refund, the "person" must verify on Form 1310 that a court has not and will not appoint a representative. The IRS uses the term *personal representative* throughout its publications and instructions to refer to both appointed representatives and persons in charge of the decedent's property.



Determining Whether to File MFJ

A final individual income tax return (Form 1040) must be filed for the year of a decedent's death. If the surviving spouse does not remarry during the year, the spouse may file a joint return with the decedent for the year of death, though they are not required to do so [IRC §6013(a)(3)]. The joint return will include income and deductions for the decedent prior to the date of death and the surviving spouse's income and deductions for the entire year. If the surviving spouse remarries before the close of the tax year that includes the date of death, a MFS return must be prepared for the decedent. [Reg. §1.6013-1(d)(2)]

Advantages and Disadvantages of Filing a Joint Return

Advantages	<ul style="list-style-type: none"> Ability to use one spouse's excess deductions against the income of the other spouse (for example, excess charitable contributions of a decedent who died before generating the income needed to offset the donations). Possible increase in the IRA contribution limit (because of the spousal IRA rules). Ability to use decedent's net operating loss (NOL), capital loss and passive activity loss carryovers to offset income of the surviving spouse. Certain deductions and credits are not allowed on an MFS return so filing joint return may allow these amounts.
Disadvantages	<ul style="list-style-type: none"> The decedent's estate and the surviving spouse are jointly and severally liable for any tax, interest and penalties due on the joint return [IRC §6013(d)(3)]. When the surviving spouse is not the sole beneficiary of the estate, the personal representative may not be willing to expose the estate to potential unknown liabilities (for example, tax on the surviving spouse's unreported income). This risk may be avoided because of the Section 6013(e) innocent spouse rules; however, it is not entirely clear that the rules apply in the case of the personal representative and the estate, nor will every situation meet the criteria for such relief. [Reg. §1.6013-5(a)] Possible scale-back of deductions that are subject to AGI limits (for example, deduction for personal exemption, itemized deductions and medical expenses) if joint AGI is higher than separate AGI.

INCOME IN YEAR OF DEATH

On the final return, the decedent's includible income is generally determined as if the person were still alive, only the taxable period ends on the date of death.

Decedent's Method of Accounting

The method of accounting regularly used by the decedent before death also determines the includible income on the final return.

Cash method. If the decedent accounted for income under the cash method, only those items actually or constructively received through date of death are included in the final return.

Constructive receipt. The doctrine of constructive receipt requires a cash basis taxpayer to recognize income when an item is credited to the taxpayer's account or made available without restriction. [Reg. §1.451-2(a)]

Example #1: Mary Smith died on July 5, 2014. She had bond interest coupons that matured and became payable on June 30, 2014, but she did not redeem them before she died. Though she did not cash the coupons, the interest income must be included on her 2014 (final) Form 1040 because it was available without restriction before she died. [Reg. §1.451-2(b)]

Example #2: Same facts as in Example 1. Mary also owned ABC Corp. stock, which mailed dividend checks to shareholders on July 1, 2014. Mary's dividend check arrived at her residence on July 6, the day after she died. Because the check did not arrive until after her death, Mary did not constructively receive it before her death. Therefore, the dividend is not included in her 2014 (final) Form 1040.

Accrual method. Generally, under an accrual method of accounting, income is reported when earned (not just when received). If the decedent used an accrual method, only the income items normally accrued before death are included in the final return.

Interest and Dividend Income

A Form 1099 should be received for the decedent reporting interest and dividends earned before death and included on the decedent's final return.

A separate Form 1099 should show the interest and dividends earned after the date of the decedent's death and paid to the estate or other recipient that must include those amounts on its return. Request corrected Forms 1099 from the payers if these forms do not properly reflect the correct recipient or amounts.

Observation: It's often difficult to get the payers of interest and dividends (for example, banks, brokerage firms, etc.) the information necessary for them to properly issue separate Forms 1099 in the year of death for income earned before death (and taxable to the decedent) and after death (taxable to the decedent's estate or other beneficiary). Therefore, a single Form 1099 may be received that includes all income for the year, before and after death. When that occurs, follow these return reporting guidelines: (IRS Pub. 559)

- 1) Report the total interest income shown on the Form 1099-INT on Schedule B (Form 1040).
- 2) Enter a subtotal of the interest shown on the Forms 1099, and the interest income reportable from other sources for which the decedent did not receive Form 1099s.
- 3) Show any interest (including any interest received as a nominee) belonging to another recipient (such as, the estate) separately and subtract it from the subtotal. Identify the amount of this adjustment as "Nominee Distribution" or another appropriate designation.
- 4) If the decedent received amounts as a nominee, a Form 1099-INT must be given to the actual owner under the nominee/middleman reporting rules (unless the owner is the decedent's

spouse). See the Form 1099 instructions on details for filing Form 1099 nominee/middleman returns.

Note: The same reporting procedures apply for dividend income received on Form 1099-DIV when a portion of the income is for the period after the decedent's death.

Partnership Income

The death of a partner closes the partnership's tax year for that partner, but it generally does not close the partnership's tax year for the remaining partners. [IRC §706(c)(2)]

- The decedent's distributive share of partnership items must be figured as if the partnership's tax year ended on the date the partner died.
- To avoid an interim closing of the partnership books, the partners can agree to estimate the decedent's distributive share by prorating the amounts the partner would have included for the entire partnership tax year. [Reg. §1.706-1(c)(2)]



On the decedent's final return, include the decedent's distributive share of partnership items for the following periods:

- 1) The partnership's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
- 2) The period, if any, from the end of the partnership's tax year in item 1 through the decedent's date of death.

Example: Gail Goodlow was a minority partner in Queen Partnership, a cash-method, calendar-year partnership. She died on September 1, 2014. The distributive share of partnership income allocable to Gail's interest for the entire year is \$12,000. If the partners agree, the partnership can estimate Gail's share of partnership income from January 1, 2014–September 1, 2014 to be \$8,000 ($\$12,000 \div 12 \times 8$). Gail's death causes the partnership year to close with respect to her interest. Accordingly, \$8,000 of income is included in her 2014 (final) Form 1040, and the remaining \$4,000 of income for the year is reported by the successor(s) in interest to Gail's partnership interest.

S Corporation Income

If the decedent was a shareholder in an S corporation, include on the final return the decedent's share of the S corporation's items of income, loss, deduction and credit for the following periods.

- 1) The corporation's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
- 2) The period, if any, from the end of the corporation's tax year in item 1 through the decedent's date of death.

Observation: In the year of a shareholder's death, the S corporation should prepare: (1) a Schedule K-1 for the decedent's proportionate share of the S corporation's pass-through income or loss for the portion of the corporation's tax year through the date of death (to be reported on the decedent's final Form 1040) and (2) a Schedule K-1 for each new shareholder (for example, the decedent's estate or heir) reporting pass-through income or loss for the remainder of the corporation's tax year.

Pass-through items generally are allocated to shareholders on a per-share, per-day basis [IRC §1377(a)(1)]. This general rule applies to the year a shareholder dies. However, the corporation can elect to close its books and use specific accounting to allocate income to the period through the date of death. If the election is made, shareholders affected by the stock transfer must consent. The executor or administrator of the decedent shareholder's estate consents to the election on behalf of a deceased shareholder [Reg. §1.1377-1(b)(5)(ii)]. The election is made by attaching a statement to Form 1120S.

Self-Employment Income

Include on the decedent's final Form 1040 self-employment (SE) income actually or constructively received through the date of death.

For SE tax purposes only, the decedent's SE income includes the decedent's distributive share of a partnership's income or loss through the end of the month in which death occurred. For this purpose, the partnership's income or loss is considered to be earned ratably over the partnership's tax year. [Reg. §1.1402(f)-1(a)]

Health Savings Accounts (HSAs) and Medical Savings Accounts (MSAs)

The treatment of an HSA, an Archer MSA or a Medicare Advantage MSA at the death of the account holder depends on who acquires the interest in the account. [IRC §220(f)(8) and 223(f)(8)]

- **Surviving spouse.** If the decedent's surviving spouse is the designated beneficiary, there are no income tax consequences at death and the account will be treated as the spouse's account.
- **Nonspouse beneficiary other than decedent's estate.** If an individual other than a surviving spouse is the beneficiary of the account (1) the account stops being an HSA (or MSA) and (2) the FMV of the HSA (or MSA) is taxable to the beneficiary in the year of the decedent's death.
 - 🔦 **Practice Tip:** The amount taxable to a nonspouse beneficiary other than the estate is reduced by any qualified medical expenses for the decedent that are paid by the beneficiary within one year after the date of death.
- **Estate.** If the decedent's estate is the beneficiary, the value is included in the decedent's final Form 1040.



Education Savings Accounts (ESAs)

Generally, the balance in a ESA must be distributed within 30 days after the individual for whom the account was established reaches age 30, or dies, whichever is earlier. [IRC §530(b)(1)(E)]

The treatment of the ESA at the death of an individual under age 30 depends on who acquires the interest in the account. [IRC §530(d)(7)]

- **Family member.** If a surviving spouse or other family member is the designated beneficiary and acquires the interest, the ESA retains its status. This means the spouse or other family member can treat the ESA as his own and does not need to withdraw the assets until he reaches age 30.
- **Nonfamily member.** If the ESA is transferred to any other person, the account ceases to be an ESA and the earnings portion of the distribution is includable in such person's income.
 - 🔦 **Practice Tip:** Any qualified education expenses incurred by the decedent before death and paid by the account recipient within one year after the date of death reduce the amount included in income. The 10% additional tax does not apply to taxable distributions made on account of death.
- **Estate.** If the decedent's estate acquires the interest, the earnings on the account must be included on the decedent's final Form 1040.



The age 30 limitation does not apply if the individual for whom the account was established or the beneficiary that acquires the account is an individual with special needs [IRC §530(b)(1)]. This includes an individual who, because of a physical, mental or emotional condition (including a learning disability), requires additional time to complete his education.

Accelerated Death Benefits

Accelerated death benefits are amounts received under a life insurance contract before the death of the insured individual. These benefits also include amounts received on the sale or assignment of the contract to a viatical settlement provider.

If the decedent received accelerated death benefits on his own life or on the life of another person, those benefits are not included in the decedent's income. However, this exclusion applies only if the insured was a terminally or chronically ill individual [IRC §101(g)]. See *Accelerated Death Benefits* on Page 4-6 for more information.

Income in Respect of a Decedent (IRD)

Accrued, but unpaid, income as of the date of death is income in respect of a decedent (IRD) for decedents who were cash basis taxpayers [IRC §691(a)]. IRD is excluded from the decedent's final income tax return and is taxed to the taxpayer, typically the estate or an heir, who actually or constructively collects the IRD.

Examples of Income in Respect of a Decedent	
Farm crops and livestock	Rent received by a cash-basis farmer in the form of crop shares or livestock that is owned at the time of death. The rent is reported in the year in which the crop shares or livestock are sold or otherwise disposed of. However, a farmer's growing crops and livestock at the date of death normally would not give rise to income in respect of a decedent or income to be included in the final return.
HSAs, MSAs and ESAs	Amounts taxed to a beneficiary in connection with the decedent's HSA, MSA or ESA [see <i>Education Savings Accounts (ESAs)</i> in the previous column].
Installment obligations	Deferred gain remaining on an installment note at the date of death.
Investment income	Income that has accrued at the date of death but is not included on the decedent's final Form 1040. The most common types of investment income that generate IRD include dividends, interest, rents and royalties.
Retirement plans	Distributions received by an estate or beneficiary from a decedent's IRA or qualified retirement plan account that would have been taxable to the decedent.
Wages	Salaries earned but unpaid at date of death.

Section 691 deduction. IRD items are not included in the decedent's final income tax return but are part of the decedent's gross estate. Therefore, while the decedent doesn't pay income tax on these items, they can increase the amount of estate tax paid. To account for the estate tax that may be attributable to these items, the estate or a beneficiary that pays income tax on the IRD is allowed a deduction for the estate tax, if any, paid with respect to the item [and after considering deductions in respect of a decedent—see *Deductions in Respect of a Decedent (DRD)* on Page 3-6]. See Section 691 and Publication 559 for more on computing the estate tax deduction that may be available when IRD items are reported in gross income.



Interest From U.S. Savings Bonds

The personal representative has three choices regarding the interest income on U.S. savings bonds if the decedent never elected to report the income as it accrued.

- 1) Report in the final return all interest earned before death (Rev. Rul. 68-145). If not reported, the interest is IRD and is not included in the decedent's final return.
- 2) Report interest earned prior to death on the estate's income tax return (Form 1041).
- 3) If the personal representative does nothing, the taxpayer who cashes in the savings bonds (the estate, an heir or an assignee) must report the interest income.

Reporting income under either items 1 or 2 requires that the personal representative make an election to report the bond's accrued interest income. Between these two, option 1 will most often result in tax savings because the 39.6% (for 2014) maximum income