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Income Tax Planning for Clients with Shorter Life Expectancies

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Jimi Hendrix made an insightful comment: "*Life is pleasant. Death is peaceful. It's the Transition that's Troublesome."* This article will address some of the practical income tax planning opportunities and traps for clients with shorter live expectancies.

The Changing Environment. Estate planning is undergoing a radical transformation which will continue for decades. There are at least four major drivers of this changing environment.

First, the Baby Boomer bubble is starting to burst. The current average life expectancy is around age 79. In the next 40 years, Baby Boomer Americans will age, become incapacitated and die at an increasing rate. Approximately 2.5 million US residents will die in 2014 (up from 1.7 million in 1960). A 2008 Census Bureau report projected the following future annual deaths:

Year	Total Deaths
2020	2,867,000
2030	3,316,000
2040	3,881,000
2050	4,249,000

Wondering about your client's life expectancy? Try these websites, but do not expect them to agree:

- www.deathclock.com
- http://gosset.wharton.upenn.edu/mortality/perl/CalcForm.html
- http://www.socialsecurity.gov/OACT/population/longevity.html
- http://media.nmfn.com/tnetwork/lifespan/

Second, Americans are living longer. Many are moving into a lengthy incapacity. According to a February 14, 2013 report from Alzheimer's Association, by 2050, the number of Americans subject to Alzheimer's and other types of dementia will increase by 300% to 13.8 million, with costs increasing by 500% to $1.1 trillion. The report *"65+ in the United States, Current Population Reports,"* (issued December 2005) provided the following projections on the number of Americans over age 65:

Year	Total Age 65 or Over
2000	35.0 million
2010	40.2 million
2020	54.6 million
2030	71.5 million
2040	80.0 million
2050	86.7 million

Third, a massive passage of wealth is occurring. A 2003 Boston College report (that updated a 1999 report) projected that the largest intergenerational wealth transfer in history would occur by the year 2052, with a total transfer of approximately $41 trillion.

Finally, for the vast majority of Americans, income tax planning trumps federal estate tax avoidance. A Congressional Research Service report entitled "*The Estate and Gift Tax Provisions of the American Taxpayer Relief Act of 2012*," (issued on February 15, 2013) noted that less than 0.2% of all estates will be taxable. The high transfer tax exemptions adopted in the American Taxpayer Relief Act of 2012, coupled with the recent significant income tax increases (particularly for estates and trusts), are bringing income tax planning into the forefront of estate planning. While the imposition of transfer taxes has been substantially reduced, the reality is that the annual compounded cost of state and federal income taxes could take substantially more assets than the estate tax ever took and the tax hits taxpayers at lower thresholds. Moreover, the government does not have to wait until death to get their "fair share." The income tax has effectively replaced the estate tax as the confiscation tax of most concern to moderately affluent taxpayers.

This article will focus on income tax planning issues for clients who are facing a looming demise - primarily the terminally or chronically ill. Many of the issues in this article also apply to those facing a looming incapacity, such as dementia or Alzheimer's. We will also provide a few estate tax savings approaches for the terminally ill client.

<u>Preliminary Review</u>. The starting point for planning for a terminally ill client is to quickly gather all of the relevant information about their planning and assets, including (but certainly not limited do):

- Review the client's existing documents and make sure they:
  - Clearly reflect the client's wishes,
  - Minimize points of conflict (e.g., don't use Co-Fiduciaries who despise each other),
  - Minimize the income taxes paid by the client, heirs, estate and/or trusts,
  - Provide flexibility, including the ability to change the estate plan during the life of the client,
  - Designate the correct decision makers (e.g., Power Holders, Personal Representatives, Trustees), and
  - Provide legal protection to the people who will be making legal decisions for the client.
- Check the client's beneficiary designations, pay on death designations and ownership of assets to make sure assets are not passing in unexpected or tax-costly ways (e.g., no beneficiary of an IRA, passing a retirement plan to the estate; jointly held accounts with dad's third wife).
- Determine if a spouse, particularly a second or third spouse has an elective share against the client's estate and determine if there are methods under applicable state law to reduce that elective share, particularly if the dying spouse wants the assets to pass in another manner - but be careful about conflicts of interest (e.g., you previously prepared estate planning documents for both spouses).
- Obtain a current list of the client's assets and any assets that are held in trusts and estates that are commonly controlled with the client or other family members.
  - Run an analysis of how assets will pass under the documents and discuss that passage with the client.
  - Determine the tax basis of all assets and look for planning opportunities like those discussed

in this article (e.g., gifting assets with unrealized losses).

- Review the client's federal and state income tax returns and see if there are tax carry-forwards (e.g., net operating losses, capital loss carry forwards, and charitable carry-forwards) that will expire with the client's passing, and examine tax matters for the most recent period for which an income tax return has not yet been filed.
- Determine the relative income tax brackets and estate tax inclusion of the client, any trusts, any spouse and heirs.

Gifting by the Terminally Ill. In general, the donee of a gifted asset obtains the tax basis of the donor. IRC section 1015(a) provides: *If the property was acquired by gift ..., the basis shall be the same as it would be in the hands of the donor ... except that if such basis ... is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value*. The result of this rule is that the donor's appreciation on the gifted asset will normally be taxed to the donee, but any unrealized tax loss on a gifted asset may be lost as an income tax benefit for the donee.

> ***Example*:** Assume a client owns marketable stock she purchased for $14,000 which is now worth $10,000. If the stock is gifted to a child and the child sells it for $10,000, the $4,000 capital loss is effectively lost. Instead, have the client sell the asset for $10,000 and take a $4,000 capital loss. The $10,000 in cash proceeds could then be gifted to the child.

If the donor client intends to gift an asset with significant unrealized gain, it may make more sense to have the donor sell the asset and then gift the cash to heirs or trusts. The payment of the capital gain tax and any ordinary income taxes reduces the taxable estate of the donor for state and federal death tax purposes. Moreover, if the donee has the responsibility for the payment of the tax on the appreciated gain, it effectively wastes a part of the donor's transfer tax exemption or annual exclusion.

> ***Example***: A donor wants to give $2.1 million in marketable securities to her children in 2014. The stocks have a basis of $100,000. The donor's and donees' effective state and federal capital gain tax rate is 30%. If the donor sells the stock, her taxable estate is reduced by the $600,000 paid in income taxes. At a 40% estate tax rate, this saves the heirs $240,000. If the donor gifts the stock, the donees will pay the $600,000 in income taxes, making the effective after-tax benefit of the gift only $1.5 million, not the $2.1 million value of the asset. However, if the donor client held the asset until death, no one would be liable for the income taxes from the sale because of the step-up in basis.

> ***Perspective***: With the shrinkage in the difference in tax rates for gift taxes and income taxes (including capital gains taxes), advisors who are recommending gifts of low basis assets should calculate when the potential transfer tax savings of the gift overcomes the expected income tax cost of a carryover basis. If the donor dies proximate to the time of the gift with a non-taxable estate, the donees may question the loss of a step-up in basis that would have occurred at the donor's death.

At first blush, it would appear that gifting by or to a terminally ill client would not be advisable, but this is not necessarily the case. Gifting may still make sense in a number of situations. For example, clients with potentially taxable estates should consider annual exclusion gifts and non-taxable gifts using their gift exemptions as long as the gifts do not create significant basis problems. Gifting of assets with unrealized losses can make sense.

> ***Planning Opportunity*:** Assume a terminally ill married client owns an asset with a basis of $500,000 and a fair market value of $200,000. If the client dies, the asset's basis will step down to its fair market value, resulting in the termination of any tax benefit of the unrealized loss in the asset. Instead, the terminally ill client could gift the asset to either:
> (1) A spouse. If the spouse subsequently sells the asset the spouse will receive the same gain or loss as the donor would have received during life. See section 1041.
> (2) To non-spousal family members or a trust for their benefit. If the donee subsequently sells the asset between $200,000 and $500,000, no tax would be incurred. See section 1015(a).

For the terminally ill client, paying gift taxes rarely makes sense because death within three years of the gift will bring the gift taxes back into the gross estate. See Code section 2035(b).

> ***Planning Opportunity***: Even if the donor is not expected to survive for three years, making a taxable gift may still make sense with a rapidly appreciating asset. For example, assume a taxpayer has an asset worth $2.0 million which expects to grow at 25% per year. The client has already given away an amount equal to their gift tax exemption. Assume further that the taxpayer is in a 40% transfer tax bracket when she dies. If taxpayer has a life expectancy of two years, the gift would remove almost $1,125,000 (i.e., $2,000,000 at an annual compounded rate of 25% grows to almost $3,125,000) in appreciation from the taxable estate, saving up to $450,000 (i.e., $1,125,000 X 40%) in transfer taxes, but at a cost of a loss of basis step-up to heirs. Any analysis needs to include a review of the tax basis impact of the gift when the heirs sell the asset.

<u>Gifting to the Terminally Ill</u>. With the right fact pattern, gifting to a terminally ill family member can make sense.

> ***Planning Opportunity*:** Assume a client owns a tract of land that has a fair market value of $2.1 million, a basis of $200,000 and secured debt of $1.5 million. If the client sells the property, the recognized gain is $1.9 million. The first $1.5 million of sales proceeds pays off the mortgage. Assuming a state and federal effective income tax rate of 30%, the taxes on the sale are $570,000, leaving the client with $30,000 before the sales commission is paid.
>
> But assume the client's husband was terminally ill. The client gifts the property directly to the husband, who specifically passes the real property to a trust for the benefit of the couple's children. Not giving any beneficial interest in the trust to the donor/wife avoids any possible application of section 1014(e). The gift to the husband does not create a taxable event to the wife, even though the liability on the asset exceeded its basis. When the husband passes away, the tax basis increases to $2.1 million. Assume the property is sold. The trust would have no recognized gain from the sale, netting $600,000 (less closing costs and commissions) for the children's trust, after payment of the mortgage. See PLR 9615026 and Treasury Regulation 1.1041-1T(d), Question 12 on the non-recognition of the liability in excess of basis for the spousal transfer.

In the alternative, the wife could have a beneficial interest in the trust and if the husband dies within a year of the gift to the husband, the wife could disclaim any interest to that trust to avoid the application of section 1014(e). See the discussion of section 1014(e) later in this article.

Code Section 1014(e) When dealing with gifts to a terminally ill client, give careful consideration to Code section 1014(e). Code section 1014(e) provides an exception to the step-up in basis rule of Code section 1014(a), designed to eliminate gifts to dying taxpayers to obtain a step-up in basis for the donor.

Since section 1014(e) was enacted, the IRS has provided little information on how to apply section 1014(e). Even though 1014(e) was adopted 33 years ago by the Economic Recovery Tax Act of 1981, to date the IRS has not issued any Treasury Regulations with respect to section 1014(e). In IRS News Release 86-167, the IRS announced that it was closing its project to create regulations interpreting section 1014(e). No Revenue Rulings or Revenue Procedures have ever referenced section 1014(e). Four IRS rulings have provided some limited guidance on the IRS's view of the application of section 1014(e)(1). See: PLRs 200210051, 200101021, 9026036 and TAM 9308002. There are no court decisions interpreting section 1014(e), other than a concurring judge's opinion that did not provide any insight.

There are four triggers to the application of section 1014(e). The first trigger requires an appreciated asset at the time of the gift. For non-readily marketable assets, this probably necessitates obtaining an independent appraisal, if the donee dies within one year of the gift and makes a bequest back to the donor.

The second trigger is whether the gift of an appreciated asset occurred within a year of the donee's death.

The third trigger is whether the asset was reacquired by the donor. This is where the confusion generally begins, particularly when you start dealing with an indirect reacquisition (e.g., beneficial interests in trusts) and try to determine the reach of "indirect" benefits to the transferor. Unfortunately, there are few definitive answers.

The fourth trigger is activated when there is a sale by a trust or estate of the appreciated asset "*to the extent*" the donor is "*entitled*" to sales proceeds. Unfortunately, there are no definitions for the operative words in section 1014(e)(2)(B). There is not a single PLR, TAM, Revenue Ruling, court decision or Treasury Regulation that even mentions section 1014(e)(2)(B). That makes it a bit hard to know how it applies to particular fact patterns. However, Section 1014(e)(2)(B) is, in many ways, more dangerous for taxpayers than 1014(e)(1). Why? Because its application is not triggered until a sale of the appreciated property occurs and a determination is made of whether the original donor was entitled to any of the sales proceeds. As long as the appreciated property remains in the donee's trust or estate, the donor/beneficiary remains alive and the donor beneficiary has not renounced or otherwise lost an interest in the trust, section 1014(e)(2)(B) remains in the shadows, patiently waiting to be retroactively applied.

The lack of substantive authority on section 1014(e) and its imprecise language makes it virtually impossible to determine the reach of 1014(e). How far do the 1014(e) phrases "*acquired from the* *decedent*" and "*entitled to the proceeds*" reach? How are "*indirect*" transfers to the donor to be treated? While we can logically speculate, no one really knows.

Planning Opportunity: A donor gifts $1.0 million in cash into an income defective grantor trust in which the donor is the deemed grantor and the donor's dying spouse is the sole lifetime beneficiary. The donee/spouse holds a testamentary general power of appointment over the entire trust and exercises the power of appointment in favor of the donor or a trust for the donor's benefit. Property owned by the grantor is sold into the trust during the spouse's lifetime. As a result:

- The sale by the grantor to the grantor trust is not recognized for income tax purposes. See Revenue Ruling 85-13.
- 1014(e) would not apply because the gifted cash was not "appreciated."
- The entire trust fund would be included in the donee/spouse's estate pursuant to Code section 2041(a)(2).
- Pursuant to Code section 1014(b)(9) a step-up in basis would be allowed because the trust assets were included in the donee/spouse's estate. Because the donor did not retain any powers over the trust which would cause the gift to be incomplete for transfer tax purposes, Code section 1014(e) would not apply.

Research Sources:

- Scroggin, "*Understanding Section 1014(e) and Tax Basis Planning,*" LISI Estate Planning Newsletter #2192 (February 6, 2014)
- Scroggin, "*Section 1014(e) and JESTs,*" LISI Estate Planning Newsletter (March 2014)

<u>Charitable Gifts</u>**.** Many clients provide for charitable bequests, but there is generally no income tax benefit obtained by the charitable bequest, except perhaps the avoidance of any IRD that is allocated to the charitable bequest.

Planning Opportunity: To obtain income tax benefits, consider making the charitable gift before the client's death and take advantage of the charitable income tax deduction to reduce the client's income taxes. Part of this plan might include accelerating income (e.g., assets that would constitute IRD in the estate) into the client's final income tax return to take advantage of the charitable contribution. Replacing a $50,000 charitable bequest with a gift could save up to $21,700 in federal income taxes (i.e., $50,000 times a 43.4% top federal income tax rate in 2014).

Traps: Make sure the dispositive documents are changed to remove the charitable bequests, or the charity might have a claim against the estate. Also make sure the client can fully use the charitable income tax deduction, because charitable deduction limitations, AMT or itemized deduction limits could reduce the tax benefit.

Research Source: Horwood, "Imagine the Possibilities: Opportunities for Non-Cash Donors," BNA Estates, Gifts and Trusts Journal, January 12, 2012. The article provides an excellent overview of the rules governing charitable deductions of non-cash assets and includes a helpful table.

Estate Basis Planning. Basis planning (in the absence of a taxable estate tax) takes on a new significance. While in the past the primary focus in estate tax driven valuations has been to minimize the value of the bequeathed or gifted asset, now, driving up the value of assets may make more sense. Practitioners may adopt the valuation arguments of the IRS ("*you know dad retained too much control over the FLP so, under 2036 we have pulled the entire FLP value into his estate*"). Meanwhile, the IRS may use tax practitioners' previous arguments supporting a lower value. And then we may all go back to our old positions whenever Congress changes the rules again

> ***Planning Opportunity***: Assume that in 2014, a terminally ill unmarried client owns 40% of a business having a fair market value of $4.0 million. The estimated valuation adjustments for minority interest and lack of marketability are 30%. The client's sole heir owns the remaining 60% of the business. The client's remaining assets are $500,000. When the client dies, the tax basis in the 40% business interest would become $1,120,000. Assume instead, the client obtained a 15% minority interest from the heir. At the client's death, his 55% interest is worth at least $2.2 million (perhaps more if a control premium is applied). The client's assets would produce a non-taxable estate of $2,700,000, while providing a step up in basis for the 55% interest to $2.2 million. Assuming the heir sold the business after the client's death, the new step-up in basis would save up to $324,000 in income taxes, assuming a 30% state and federal effective tax rate**.**

Does it make sense to bust strategies that were designed to discount values if the client has a non-taxable estate?

> ***Planning Opportunity***: A client created an FLP a number of years ago. The document has not been reviewed or revised since its execution. The client has been giving away limited partnership units of the FLP for years to family members. Unfortunately, the client's control over the FLP clearly violates the current case law and could result in the gifted assets being included in the donor's taxable estate pursuant to IRC section 2036. Assume the client's total estate, plus the current value of the gifted assets is well below $5.34 million. In preparing the federal estate tax return, the advisor might show that the retained control violated IRC section 2036 and pull the gifted FLP units into the taxable estate. Why? Because the basis of the gifted FLP units will step-up to their fair market value and the basis of assets in the FLP assets can also step-up.

Defective Grantor Trusts. Defective grantor trusts have been an effective estate planning tool for decades. Most grantor trusts are defective for income tax purposes, but not for transfer tax purposes. Therefore, the assets of the trust will not be included in the grantor's taxable estate. But in many cases, the asset held in the defective grantor trust has significant unrealized gain.

> ***Planning Opportunity:*** If the trust instrument uses a power of substitution to create the defective effect, then a grantor whose passing many be more imminent should consider replacing the appreciated asset with a higher basis assets, such as cash.

Estate & Trust Income Taxes. With the passage of the American Taxpayer Relief Act of 2012, trusts and estates are taxed at the top federal income tax rates when there is only $12,150 (in 2014) of taxable income (adjusted annually).

	2012	2014
Top Federal Income Rate	35%	39.6%
Health Care Surtax	0%	3.8%
Top Federal Ordinary Tax Rate	**35%**	**43.4%**
Dividend and Capital Gain Rate	15%	20%
Health Care Surtax	0%	3.8%
Top Federal Ordinary Tax Rate	**15%**	**23.8%**

State Income Tax Rates: **0%** to **11%**
Top Potential Rate: 54.4%+

Among the issues which the planner should look for are:

- Do trusts permit discretionary spraying of income among a class of heirs (e.g., "all my descendants")? If there is only one income beneficiary of the trust, the ability to reduce income taxes by spraying income to heirs in lower tax brackets is lost. Note that certain kinds of trusts mandate only one lifetime income beneficiary of the trust (e.g., marital trusts and QSSTs).
- Examine the assets of any trusts and determine if the investments can be changed to capital gain driven assets as opposed to ordinary income investments to reduce the trust's income tax cost of accumulating income or the tax cost to heirs who receive trust distributions.
- Does the terminally ill client (or anyone else) hold a power of appointment to change the terms of a trust that does not have sufficient flexibility to reduce the income taxes on heirs?
- Is the any requirement that the trust accumulate income? If so, clients need to quantify the tax cost of such accumulations. The income tax cost for trust asset protection increased substantially in 2013.
- Determine what discretionary distributions powers the trustees have and see if those powers can be used to increase the basis of assets that will pass when the terminally ill client dies.

Planning Opportunity: A client is a beneficiary of a trust that will not be included in her estate when she passes but which provides for broad Trustee discretionary distribution powers. The trust owns assets with a significant unrealized gains. If it does not create exposure to a state or federal death tax, consider making discretionary principal distributions to the dying client of the appreciated assets. Leave the assets with unrealized losses in the trust to avoid a sep-down in basis.. If the gifts come from a non-grantor trust, they should not be subject to Code section 1014(e), permitting a step-up in basis under section 1014(a) as a result of their inclusion in the decedent's estate.

Trap: In the above example, if the trust making the distribution is a grantor trust and the distributed asset will pass directly or indirectly back to the grantor, section 1014(e) might deny a step-up in basis. It might be possible for the grantor to renounce any defective grantor powers before the distribution and avoid the application of 1014(e).

Planning Opportunity: A terminally ill client is the beneficiary of a marital trust with substantial unrealized losses in the trust assets. Upon the client's death, the assets will step down to their lower fair market value. However, if the trust sells the assets before the spousal/beneficiary's death, the losses can be preserved for remainder beneficiaries. See IRC section 642(h).

Planning Opportunity: The income taxation of grantors, trusts, and beneficiaries varies widely from state to state. Even though the tax rate in most states is relatively low, the long-term imposition of a state income tax can amount to substantial tax dollars, especially in states that do not provide any tax break for capital gains. Moreover, the income tax rates on estates and trusts range from zero (e.g., Alaska, Florida) to 11% (e.g., Oregon, Hawaii). Local income taxes (e.g., New York City income taxes) could drive the rates even higher. Consequently, clients who are creating trusts (especially trusts that are intended to accumulate dollars) should consider establishing the trusts in a jurisdiction that minimizes state and local income taxes.

Perspective: Early in the process of planning for a terminally ill client, all of the client's existing documents should be examined to see if changes are necessary to provide for flexibility, particularly if the client should become incapacitated before the planning is completed (e.g., broad powers in the client's general power of attorney)

<u>Look for IRD and Remove it</u>. The post-2012 increase in income tax rates, especially on fiduciary taxable income, can significantly increase the income taxes imposed on IRD assets. Advisors should determine if a client's estate is expected to have IRD and examine ways to reduce its impact. For example:

- Making lifetime charitable gifts of the IRD assets to reduce the decedent's or heirs' income taxes.
- Because of the potentially high tax rate on income accumulated in an estate or trust:
  - Determining if it is advisable to distribute IRD assets to heirs after death to use the heirs' lower marginal income tax brackets, recognizing that such distributions may not be the best choice for immature beneficiaries.
  - Accelerating income into the client's lifetime taxable income to take advantage of the client's lower marginal income tax rates (e.g., doing a ROTH conversion before death).
  - Particularly in a second marriage, specifically allocate IRD assets to a surviving spouse with the expectation that the assets will dissipate over the spouse's lifetime using the spouse's income tax brackets. Meanwhile, other assets could be allocated to an Exemption Trust with the expectation that the trust income is either paid to heirs or accumulated (particularly if invested in capital gain assets).

<u>Retirement Plans</u>. Many clients have significant assets in retirement plans.

Planning Opportunity: Clients with taxable estates should evaluate the tax cost of taking distributions from retirement plans (particularly if they are in low income tax brackets), paying the related income tax and then gifting or bequeathing cash to donees before they pass.

Clients with a limited life expectancy (particularly those with a taxable estate) should consider converting existing IRAs and retirement plan accounts to Roth IRAs.

Planning Opportunity: A terminally ill client has a $500,000 IRA. The client could convert the

IRA to a ROTH IRA and pass the ROTH to heirs, who can make future tax exempt withdrawals. While the conversion will create an immediate income tax cost to the IRA owner, the tax cost is not paid from the ROTH account. If the client has a taxable estate, the owner's income liability effectively reduces the taxable estate.

Research Sources:

- Keebler, "Roth Conversions in 2012: Now's the Time to Convert," LISI Employee Benefits and Retirement Planning Newsletter #591 (January 19, 2012).
- Keebler, "What Every Lawyer Should Know About Roth Conversions – Beyond the Numbers," LISI Employee Benefits and Retirement Planning Newsletter #502 (November 2, 2009).

Net Unrealized Appreciation. Code section 402(e)(4) provides that when a qualified plan distributes employer stock in a lump sum to a plan participant, the employee is only taxed on the retirement plan's cost in the stock. The "*net unrealized appreciation*" (often called "NUA") in the employer stock upon distribution to the plan participant is not subject to tax.

The plan participant who does not rollover the employer stock can receive capital gains treatment when the stock is sold. IRS Notice 98-24, 1998-1 CB 929(issued April 10, 1998) provides that the "*Amount of net unrealized appreciation which isn't included in basis of securities in hands of distributee at time of distribution is considered gain from sale of capital asset held for more than 18 months to extent that appreciation is realized in later taxable transaction*." (emphasis added) The 18 months referenced in the notice was the required capital gain holding period in 1998.

Tax Trap**:** If the employee/participant rolls the entire retirement plan distribution into an IRA, the benefit of section 402(e)(4) rule is effectively eliminated. See PLR 200442032 where the IRS refused to let a plan participant retroactively rescind a rollover to take advantage of the section 402(e)(4) NUA rules.

Planning Opportunity: Section 402(e)(4)(B) permits the plan participant to elect to have the NUA taxable at the time of distribution. A plan participant is terminally ill and has a loss carry-forward that will expire at the participant's death. By electing to be taxable on the NUA, the loss carry-forward may reduce or eliminate the taxable income from the election. Moreover, no portion of the stock is treated as IRD when the participant dies.

Planning Opportunity: If the NUA is treated as IRD, how do you reduce the tax on the gain? If the stock is a "qualified appreciated stock" as defined in Code section 170(e)(5) the owner could use the stock to fund charitable contributions. The unrealized gain is generally not recognized in such contributions and the donor receives a charitable deduction equal to the fair market value of the contributed marketable security. See PLR 199919039.

Similarly, if the donor had charitable bequests in his or her will, a special allocation of the NUA qualified appreciated stock to the charity could wipe out the adverse IRD cost of the stock.

Research Source*:* Maldonado, "*Basis Issues Complicate Qualified Plan Distributions of*

Employer Securities," Journal of Taxation, December 1992.

Plan for Loss Carry-Forwards. A pivotal part of the planning for any terminally ill client starts with examining their most recent federal income tax returns, and other transactions that are not yet reflected on an income tax return and the unrealized losses in the current assets of the client's estate.

The unused tax loss carry-forwards of a decedent are not carried over to the estate or to heirs. See Rev. Rul. 74-175, 1974-1 CB 52. Instead, they simply vanish. There are at least three ways that expiring losses could be used. First, the client (or persons holding a general power of attorney) could take actions to use any expiring losses (e.g., accelerating taxable income). Second, in the case of a married client who files a joint return, the spouse might take pre-mortem actions to create taxable income to offset the soon-to-expire losses. Third, a surviving spouse who is entitled to file a joint return in the decedent's year of death could take year-of-death, postmortem steps (e.g., accelerating income) to offset the losses. See section 6013(a).

Planning Opportunity: If the decedent was married at the time of passing, the surviving spouse can use the decedent's expiring tax carry-forwards on the couple's final joint income tax return to offset gains and income of the surviving spouse. For example, assume the deceased Husband left a $400,000 NOL from his failing business. In the year of the Husband's death, the Wife could convert $400,000 of her IRA to a ROTH IRA to take advantage of the expiring NOL.

Post-Mortem Income Tax Planning. While most post-mortem tax planning has traditionally focused on achieving estate tax savings, reducing the income taxes of the estate and its heirs has become more important. For example, consider the following post-mortem strategies:

- While a trust is generally required to use a calendar year, Section 645(a) permits an estate to elect any calendar or fiscal year of not more than 12 months. By selectively choosing a fiscal year, the planner can effectively lower the overall income taxes of heirs and the estate. For example, assume that a client dies in October and the estate has considerable income before the calendar year-end. The personal representative could elect to use a January 31 year-end for the estate. With proper planning for any underpayment penalty, the taxes on the income that is distributed to beneficiaries would not be taxable until the April 15 of the next year.
- Pursuant to section 645,the trustee of a "qualified revocable trust" and an executor have the right to elect to treat such a trust as part of the estate. This election can provide living trusts with the unique tax benefits of estates, such as the use of a fiscal year, the limited right of an estate to own S corporation stock, and the two-year waiver of the passive loss rules. See Dennett and Moseley, "*Maximizing the Benefits of the Section 645 Election*," 31 ETPL 546 (Nov. 2004).

- Similar planning decisions must be addressed in determining when the estate is to be closed. The analysis should include examining the income tax impact to the beneficiaries. For instance, assume that most of the estate administration has been completed in November, but the tax year of the estate ends in February. If the estate administration is not completed until the following January, the distributable net income ("DNI") of the estate from March through

January will not be reported on an heir's tax return until April 15 of the year after the estate was closed. In contrast, if the estate were to be closed in November, two years of the estate's DNI could be reported on the heirs' tax returns (i.e., for the tax year ending in February and that ending upon the closing of the estate in November).

- It is important to consider not only the tax years of the estate, but also the tax brackets of heirs when making estate or trust distributions. For example, assume in the previous example that an heir was closing the sale of his business in January. The increased taxable income anticipated upon the sale of the business might make it more advantageous to close the estate in November.

- Because of broad variations in state income taxes, planners should also take into account the relative state income tax brackets of the grantor, the estate or trust, and the beneficiaries. For instance, assume an estate is opened in a state with a fiduciary income tax, but the beneficiaries are all Florida residents. By making income distributions from the estate each year, the potential state income tax might be reduced or eliminated, dependeing upon state law.

- If an estate anticipated having large income tax deductions early in its first year, the estate might consider using a longer fiscal year to allow the estate to earn sufficient income to offset the early deductions.

- The timing of payment of deductible expenses is also a critical income tax planning issue. Most estate administration deductible expenses are not considered business expenses. Therefore, they cannot generate an NOL for the estate. Consequently, to the extent that such deductions exceed income, they are not carried over to future years.

- However, Code section 642(h) provides that to the extent estate deductions exceed the estate's income in the final year of the estate, the excess deductions can be carried over to the estate beneficiaries. Hence, personal representatives of cash basis estates with substantial deductible expenses (such as commissions and legal fees) should consider delaying the payment of non-business deductions until the final year of the estate, so that heirs can receive the benefit of the pass-through of the excess deduction. Personal representatives should also be careful about paying too many non-business expenses in any year in which the estate has insufficient income to offset the deduction of such expenses.

- The bases of depreciable estate assets are generally stepped up to FMV at the time of death. Because the estate is a new taxpayer, the estate can elect whatever new depreciation method it deems appropriate to reduce income taxes. The estate is not bound by the depreciation methods that the decedent used.

- If an estate or trust sells an asset, receives an installment note, and then distributes the note to a beneficiary, the distribution of the note may trigger recognition of the inherent gain in the note, resulting in income taxation to the distributing trust or estate. If a distribution to heirs proximate in time to the sale is anticipated, and the sale is expected to result in a significant recognized gain, it would be far better to distribute the asset to the beneficiary prior to signing a sales contract, permitting deferral of the gain over the term of the note.

- If the installment note was obtained by the holder before death and was transferred as a result of the death of the holder, a non-sale transfer is not a taxable disposition. See Section 453B(c). However, if the note is returned to the obligor of the note, the estate is taxable on the remaining gain. See Section 691(a)(5).

- Traditionally, the use of disclaimers in post-mortem planning has focused primarily on minimizing estate taxes. Now that federal estate taxes are less of an issue, tax planning will refocus on using disclaimers to minimize income taxes.

  Planning example. A grandparent dies with an IRA worth $50,000. The sole heir has a daughter who is getting married. The child is in a 10% income tax bracket, while the parent is in a 40% income tax bracket. If the parent took the IRA funds and used them for the wedding, the parent would generate $20,000 in income taxes. If the parent disclaimed the IRA and it passed to the daughter, the tax would be only $5,000, saving $15,000 to help cover the cost of the wedding and honeymoon.

Conclusion. The hardest part of this planning is not the tax rules – it is the understandably low priority given to tax planning by clients and their families who are facing the tragedy of the looming death of a loved one. It often seems unseemly to discuss tax planning when death sits outside the door. The unfortunate reality is that it is not the deceased who will suffer the legacy of poor planning, it is the survivors.

Practical Checklist. A practical checklist on planning for the terminally ill can be found at the author's website: *www.scrogginlaw.com*.

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