

Preparing The Decedent's Final Income Tax Return

By Yahne Miorini, LL.M.

The decedent's final federal income tax return is due like any other individual income tax returns, on April 15 of the following year. The same income tax rules apply to the Virginia individual income tax return, which is due a month later.

1. Assessing the Income to be Reported

The income to be reported is the income earned by the decedent until his/her death. The 1099s received may not reflex accurately the income received prior and after death because financial institution may not have been contacted immediately after the death or because the administrative procedure to rename the accounts or assets into the name of the estate. I recommend that you create a spreadsheet where you allocate the income received prior and after death. See attached a sample of a spreadsheet. In my sample spreadsheet the decedent died on

August 15, 2007. The portion of the income received after August 15, 2007 needs to be included in the fiduciary income tax returns.

2. Obligation to Report

The trustees or executors should contact the IRS to notify of his/her fiduciary capacity by completing and filing Form 56, "Notice Concerning Fiduciary Relationship." (See attached.) By filing this form with the IRS, the fiduciary will receive any notices sent by the IRS to the decedent. Mail forwarded by the Post Office may be insufficient because the Post Office forwards the mail for only six months.

If the decedent did not file any returns for the prior years, you may have to file them. For instance, if the decedent dies in March 2008, he/she certainly hasn't filed his/her income tax returns for 2007, which are due April 15, 2008 or later. I prepared 10 years of income tax returns for one of my clients. The three years statute of

limitation for the IRS audit runs only for income tax returns filed. If the decedent did not file any return for a given year, there is no statute of limitation. It is not unusual that the decedent who was of advanced age and died from a debilitating illness will be behind his/her filing of income tax.

Please be aware that the IRS has a separate account per individual but also for each year. You will need to ask the same questions and obtain a copy of the account for each year you may have some concerns.

An automatic extension is available by filing Form 4868, but this extension does not extend the time for actual payment of any tax due. If the tax is not paid when the extension application is filed, interest will be charged at 0.5 percent per month unless at least 90 percent of the actual tax liability was paid prior to the due date through estimated payments,

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withholding, or payment submitted with the Form 4868.

Even if the decedent had no taxable income for the tax year, a return must be filed. If the deceased owed any taxes or is entitled to a refund of overpayment or estimated income taxes. There is a special form that the fiduciary has to complete in order to collect the income tax refund due to the decedent: Form 1310, "Statement of Person Claiming Refund Due a Deceased Taxpayer."

If the decedent's taxable year is shortened, there may be no need to file a federal income tax return. For instance, the death occurred in January and the total of the decedent's gross income is under a certain minimum amount, which varies dependent of the filing status of the decedent¹. For instance, in 2006, the minimum income amount, over which individuals had to file a federal income tax return

varied, from \$3,500 to \$15,460 depending on the filing status.

When filing any return for the decedent, you should add after the name of the decedent the word "deceased," followed by the date of death.

3. Obligation to Pay Tax

The tax for the decedent's final tax year must generally be paid in full by the due date of the final return (excluding extensions). However, if the executor elects to have the tax computed by the IRS, the payment is due within 30 days after the IRS sends a notice of the amount due. Extensions of time for payment of up to six months may be granted by the IRS on request.

4. When there is a Surviving Spouse

When there is a surviving spouse, the executor or trustee has the choice of filing a joint return with the spouse or filing a

separate return for the decedent. Filing joint return may produce substantial tax savings if it permits the surviving spouse to offset income by the decedent. These deductions might otherwise be lost if the decedent did not have enough income to take advantage of them. However, the executor or trustee will not be able to file a joint return when the following occurs:

- The surviving spouse remarries during the decedent's taxable year.
- When the surviving spouse or the decedent were nonresident alien.
- When the surviving spouse or the decedent had a short taxable year by virtue of a change in the accounting period.

In order to file a joint return, the surviving spouse and the executor or trustee will have to consent to the return. The surviving spouse can make the

¹ See chart A on page 6 of the 2007 IRS instructions for Form 1040.

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final unilateral decision in the following situations:

- The decedent has not already filed a return for the taxable year
- No executor has been appointed by the time the joint return is filed
- No executor has been appointed before the due date for the surviving spouse to file his/her own return

However, the executor can later disaffirm the joint return by filing a separate return for the decedent's final tax year within a period of one year after the due date (including extensions) for filing the surviving spouse's return.

The executor has the responsibility for the filing of a joint return unless the return is filed before the executor has been appointed, in which case the surviving spouse can file it and sign the return "filing as surviving spouse." If the

surviving spouse has remarried before the end of the year of the decedent's death, the status of the decedent's return must be "married filing separately."

A surviving spouse who files a joint return qualified for special tax rates for two years following the death of the first spouse.

5. Exemption and Deductions

Most of the deductions allowed on the decedent's final income tax return are the same as those allowed on any return.

5.1. Medical Expenses. Medical expenses have a special tax status. They qualify for deduction on the estate tax return under the regular rules for deducting debts and claims. The executor can instead deduct them on the income tax return of the decedent for the year in which they were incurred. However, an income tax deduction on the decedent's

return is allowed only if the expenses are paid out of the estate within one year after his death. So medical expenses which exceed 7.5 percent of the adjusted gross income can be taken as deductions either from the income tax return or from the federal estate tax but not from both. When the estate is taxable, the executor may prefer to report the medical expenses on the estate tax return because medical expenses will not be reduced by the 7.5 percent adjustment out of gross income.

5.2. Savings bonds. Interest on the decedent's Series E or EE savings bonds is not reportable until the bonds are redeemed. A taxpayer could, however, elect to report the income as it accrues. If the executor elects to report the interest, then all interest previously deferred must also be reported. Such an election may be used to absorb deductions if the decedent had large deductions but little income. Since income tax paid on the

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accrued interest is deductible as an expense for estate tax purpose, this election is recommended.

5.3. Sale of the Residence. When the decedent had contracted to sell his/her residence, but dies before the sale, the executor can make the election to take the exclusion under Code Section 121. The election should be made on the decedent's final income tax return.

5.4. Contribution of IRA. A taxpayer's right to make contributions for his or her IRA ceases at death. No one can make further contributions to the IRA after the taxpayer's death. However, the surviving spouse can claim/make a spousal IRA contribution, when the decedent had earned enough to make a spousal IRA contribution but didn't make the contribution prior to death.

5.5. Moving Expenses. The decedent keeps the right of deduction of moving expenses

when the decedent moved in connection with the start of work at a new location. The test of 39-week (for employee) or 78-week (for self-employed) doesn't apply when the decedent died before completing the minimum period of employment requirement.

5.6. Statutory Stock Options. Upon the death of an individual who hold unexercised incentive stock options (ISOs) or options issued under an employee stock purchase plan, the individual's estate or others who take as a result of death, may exercise the options if the terms of the options permit. If the estate, etc., exercises the options, the holding period requirements normally applicable to stock acquired on the exercise of statutory options don't apply.

5.6.1. Any transfer by an estate of stock acquired by the estate's exercise under an employee stock purchase plan is treated as a disposition of the stock for purposes of the

rules that treat a portion of the gain on disposition as ordinary income.

5.6.2. Where an individual exercises an ISO before death, death isn't a disqualifying disposition that causes a loss of ISO treatment.

5.6.3. Where an individual exercises an option under an employee stock purchase plan before death, the gain is treated as ordinary income.

6. Refund of Tax

If the decedent is entitled to a tax refund, the executor should claim it on behalf of the estate. When the tax return was filed jointly, there is a presumption that the estate owns half of the refund.

On the tax return, the executor should claim the refund. If the income tax return for the year for which the refund is due has been filed, the refund should

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be claimed on Form 1040. Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must also be completed by the executor and filed with the refund claim.

7. Gift Tax Returns

The executor will have to file any gift tax returns, which are required for transfers made by the decedent before his death and not filed by the decedent. The return covering gifts made during the calendar year in which the decedent dies is due no later than the due date, including extensions, of the estate tax return.

If the decedent died before filing the gift tax returns for gifts made the prior year, the executor will have to file these as well. In such case, the due date is April 15 following the year of the gift, or the due date for the federal estate tax return (9 months after the death) which ever due date comes first.

If gifts were made to the decedent before his/her death and the donor failed to pay the gift tax, the estate of the decedent (donee) may have to pay the tax.

If the decedent was married, the executor of the estate can consent to gift splitting for gifts made while both spouses were alive. The consent must be indicated on a timely filed gift tax return, or in the case of late returns, on the first return filed.

For a gift tax refund, the claim may be made on an amended return or on Form 843, Claim for Refund and Request for Abatement.