

Planning to prevent loss of tax attributes at death

Dear Reader:

Based on our prior communications or from information gleaned from other sources, you no doubt are well aware of how proper planning during life can reduce or eliminate Federal or state estate taxes or state inheritance tax to the benefit of your heirs. But what you may not know and why I am writing this letter is to inform you that many important income tax considerations come into play in "planning for the inevitable." You need to understand how various income tax attributes are affected at death, steps you can take during life to use those tax attributes that would be lost at death, the factors involved in transferring tax attributes to your estate or beneficiaries where you have such choices, and other special rules that arise when a person dies.

In many cases, your executor or other personal representative will be in a position, after appropriate consultation with us or another professional advisor, to take actions that will save taxes on your final income tax return or save income taxes for your estate or beneficiaries. But, in other cases, the personal representative will be locked into choices you make during life and won't have the latitude to take actions that will save the most taxes for you, your estate or your beneficiaries. Therefore, it is imperative that you have at least a basic understanding of the various choices and the kinds of planning you can take during life to optimize savings for all parties involved. Here are the more widely applicable topics to consider:

Choice of executor. The primary duties of your executor or other personal representative will be to collect your assets, pay your creditors, and distribute the remaining assets to your heirs or other beneficiaries. The executor also will have to file various types of tax returns and make important choices on them. Therefore, it is imperative that you choose someone who is both trustworthy and competent to serve as your executor or personal representative.

Income in respect of a decedent (IRD). Income that was due to a person but wasn't paid before his or her death will be taxed to his or her estate or beneficiaries. With proper planning, charitable-minded clients can wipe out the income tax bite on IRD.

Partners and S shareholders. Clients in this category need to know how they will be taxed on their share of the entity's income in the year of death and how their successors will be taxed.

Tax-favored medical accounts. An individual who has a health saving account, Archer medical savings account, or Medicare Advantage medical savings account is in a position to choose whether the account's assets will be taxed in his final return or to a named beneficiary or will escape tax if he is married and names his spouse as beneficiary.

Holders of Series E or EE savings bonds. Choices can be made before and after death to minimize taxes on the interest on these bonds.

Compensatory options. Individuals who have received compensatory options, statutory or nonstatutory, face various issues with respect to transferring them at death and the ultimate tax consequences to beneficiaries who receive the options. For example, incentive stock options are accorded favorable tax treatment but this treatment is lost for disqualifying dispositions of the stock acquired on the option exercise. A transfer at death isn't a disqualifying disposition even though it might have been if made while alive.

IRAs and retirement plans. Owners of individual retirement accounts (IRAs) and participants in company-sponsored qualified retirement plans need to understand how their benefits will be taxed at and after death. For example, IRA distributions from an inherited traditional IRA are taxable to the beneficiary in the year received as IRD up to the IRA-owner-decedent's taxable IRA balance at death. If the estate is large enough, the IRA funds also will be subject to estate tax but the recipient of the IRA distributions will get a special income tax deduction for the estate tax attributable to the IRA.

Deductions. A host of issues come into play with respect to deductions at death. For example, unused net operating losses carryovers and capital loss carryovers expire if not used on an individual's final return—they can't be used on the estate's income tax return. Certain deductions may be allowed to recipients of IRD. Unpaid medical bills at death are subject to a special deduction choice for an executor.

This is just a sampling of the many different income tax rules that affect an individual at death. With proper planning during life, you can help to reduce taxes for the benefit of your heirs. You can also arm your executor with the key information he will need to make the best choices for them.

Please contact us if you would like to learn more about any of these items or other items that could impact your estate and your heirs.