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# Planning opportunities for the final tax return

Final arrangements should include many tax considerations for the decedent and his or her survivors.

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Several tax attributes and related tax planning opportunities are lost when a taxpayer dies. However, careful and thoughtful planning for clients who are elderly or nearing death can result in substantial tax savings. It is important to recognize and discuss planning ideas with clients in advance to provide adequate time to implement and take complete advantage of the tax savings strategies available for these tax attributes.

Tax practitioners need to be alert to tax planning opportunities when they are aware that a client is approaching death.

### PASSIVE ACTIVITY LOSSES

A decedent's suspended passive activity losses are allowed on the final income tax return, subject to certain limitations. Sec. 469(g)(2)(A) limits the deductible loss. The amount of the suspended loss allowed as a deduction on the final income tax return is reduced by the step-up in basis for the related asset to fair market value (FMV) under Sec. 1014. Sec. 469(g)(2)(B) disallows the excess losses as a deduction for any future tax year.

> ***Example:*** The taxpayer owns a rental property. The building has an adjusted basis of $500,000, an FMV of $550,000, and passive suspended losses of $75,000. The taxpayer does not have any other passive income. If the taxpayer dies during the tax year, the deductible suspended passive loss on the taxpayer's final income tax return will be limited to $25,000 ($75,000 – $50,000 step-up in basis). The deductible loss can offset other income such as interest, dividends, and earned income. The remaining $50,000 of passive loss will be permanently lost as a tax deduction.

In the example, if the property has declined in value and the taxpayer is not required to file a federal estate tax return, a practitioner should consider advising the taxpayer to gift the building before the taxpayer's death. The suspended passive activity loss of $75,000 would be added to the donee's basis in the property under Sec. 469(j)(6). Although the donee will not be able to use the suspended passive loss currently, none of the passive loss will be permanently lost as a tax deduction, as is the case on the decedent's final tax return. If the decedent retained the depreciated property until death, the heirs would have a stepped-down basis in the property equal to the date-of-death FMV

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rather than the original cost basis. The lower basis in the hands of the heirs would create a larger tax liability when they later sell the property.

### CAPITAL LOSS CARRYOVERS

Rev. Rul. 74-175 provides that capital loss carryovers expire upon a taxpayer's death and cannot be used on the estate's income tax return. The decedent cannot transfer a capital loss carryover to the estate because the decedent and estate are separate tax entities. A taxpayer's capital loss carryovers also cannot be transferred to the surviving spouse.

A practitioner who is aware that a married taxpayer is in failing health should look for opportunities for the taxpayer to sell assets generating capital gain income to offset capital loss carryovers. After the taxpayer dies, the spouse can continue to generate capital gain income during the remainder of the tax year to offset the decedent's capital loss carryovers. Because the wash-sale rules apply only to securities sold at a loss, the surviving spouse can immediately buy back any securities sold if he or she deems them to be worthy investments. Any remaining capital losses are lost, and the estate or the heirs cannot deduct them.

If a taxpayer in failing health is holding property that would generate capital loss if sold, consideration should be given to gifting the asset to the spouse before death. This strategy will preserve any capital loss that would have been lost had the taxpayer died holding the asset. Sec. 1015(e) and Sec. 1041(b)(2) provide that the cost basis of property gifted to a spouse is its original cost even when the FMV of the gifted property has dropped below its original cost.

Practitioners should advise taxpayers in failing health holding capital assets with an FMV less than the cost basis to sell the property before death if the capital loss can offset capital gains on the final income tax return. If the taxpayer dies holding the depreciated property, the cost basis will be stepped down at death, and the unrealized loss will disappear and cannot be deducted in the future.

### SEC. 1245 AND SEC. 1250 PROPERTY

Regs. Sec. 1.1245-2(c)(1)(iv) and Regs. Sec. 1.1250-3(b)(2)(i) provide that Sec. 1245 and Sec. 1250 property transferred by reason of death receives a basis equal to FMV at the date of death under Sec. 1014(a) and loses its character as recapture property. Regs. Sec. 1.1245-2(c)(3) and Regs. Sec. 1.1250-3(b)(2)(ii) provide an exception for Sec. 1245 and Sec. 1250 property that was gifted before death and depreciated by the transferee.

The difference in tax treatment—depending on whether the taxpayer retains the depreciable property until death or gifts the depreciable property before death—provides planning opportunities for the practitioner.

If the Sec. 1245 or Sec. 1250 property has appreciated, the recapture would be significant, and the decedent is not required to file a federal estate tax return, then it may be advantageous for the taxpayer to retain the property until death. The heirs who inherit the property will receive a basis equal to FMV at death and escape ordinary income recapture when they eventually sell the property, which will result in significant tax savings.

If the decedent is expected to have a taxable federal estate, the property is expected to appreciate

## IN BRIEF

- Because tax attributes can be lost when the taxpayer dies, CPAs can help their tax clients who are elderly or facing death with planning ideas for taking advantage of opportunities to use or pass on these tax attributes.
- One such attribute is a suspended passive activity loss, which is allowed on the taxpayer's final return. But if the loss would be limited by the taxpayer's gross income in the year of death, or if the fair market value of property giving rise to the loss is less than its basis, the taxpayer may benefit from instead gifting the property prior to death.
- Similarly, capital loss property may be more advantageously gifted, including to a surviving spouse. There may also be opportunities to absorb capital loss carryovers, which otherwise would be lost upon the taxpayer's death, with capital gains realized in the year of death.
- Other attributes and types of property that may call for planning strategies include Sec. 1245 and Sec. 1250 property, net operating losses, excess charitable contributions, timing of recognition of U.S. savings bond interest, and business credit carryovers.

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rapidly, and the recapture amount is minimal, then it may be beneficial for the decedent to gift the property before death to a person other than a spouse. This plan provides an opportunity for the appreciation to escape federal estate tax.

## NET OPERATING LOSSES

Rev. Rul. 74-175 also limits the deductibility of net operating losses (NOLs) specifically attributable to the decedent to the final income tax return. The NOLs are not deductible on the federal estate tax return, and a surviving spouse cannot deduct the losses on future income tax returns. An NOL resulting from a business loss incurred on the decedent's final tax return may be carried back to earlier years under Sec. 172.

The practitioner should evaluate the NOLs of a decedent filing a joint tax return to determine if any of the NOLs are attributable to the surviving spouse. In *Rose*, T.C. Memo. 1973-207, the Tax Court held that one-half of the NOLs incurred during the marriage were attributable to the surviving spouse.

In *Rose*, the taxpayers participated equally in a business activity that generated NOLs. The court held that the surviving spouse was entitled to carry forward one-half of the business's NOLs that were a direct result of her participation in the activity.

In *Zeeman*, 395 F.2d 861 (2d Cir. 1968), the surviving spouse reported a substantial passthrough loss from a limited partnership in the year after her husband died. Regs. Sec. 1.172-7(f) provides that the NOL of one spouse may be carried back or forward against the combined taxable income of both spouses in any tax year in which the couple filed or will be able to file a joint income tax return. Regs. Sec. 1.172-7(b) allows the NOL to be used against the income of both spouses even when separate returns are filed in the year the NOL occurs. However, the regulations apply only where a couple had the option of filing jointly or separately in the NOL year.

Since the surviving spouse in *Zeeman* was unable to file a joint return in the year she incurred the loss, the court disallowed an NOL carryback against income reported on a joint tax return with her deceased husband in prior years. The court found that none of the income in the carryback years was attributable to the surviving spouse.

If NOLs cannot be attributed to the surviving spouse, the practitioner has a window of planning opportunity for the surviving spouse to generate additional income during the remainder of the tax year after the decedent dies. Any income generated by the surviving spouse after the decedent's death but before the end of the year can be used to offset the decedent's NOL. The surviving spouse should also consider delaying tax deductions to the following year.

Planning examples include selling appreciated property; advising the spouse to accelerate IRA or pension distributions; electing out of bonus depreciation; and delaying payment of state, local, and property taxes. If the taxpayer's death is imminent, the practitioner may advise the taxpayer to withdraw additional IRA funds to offset the NOL. The IRA distribution will not be subject to taxation because the NOL will offset it. This plan avoids the inherited IRA's being taxed to the heirs at a higher tax rate. Any unused NOLs attributed to the decedent will expire and cannot be carried forward to future tax years.

## CHARITABLE CONTRIBUTIONS

Regs. Sec. 1.170A-10(d)(4)(iii) provides that charitable contributions made directly by the decedent in excess of the current-year income limitation cannot be carried forward to future tax years by the surviving spouse.

However, in the year of death, the decedent's excess charitable contributions can be used against the income of the surviving spouse. The surviving spouse has an opportunity to generate extra income before the end of the tax year and use the excess charitable contributions made by the decedent. The surviving spouse can consider creating extra ▶

income such as capital gains by selling securities or withdrawing additional IRA funds before year end.

If the decedent has excess charitable contributions in the form of capital gain property, Sec. 170(b)(1)(C)(iii) and Regs. Sec. 1.170A-8(d)(2) allow a taxpayer to make an election to limit the contribution deduction for appreciated capital gain property to the tax basis of the property in exchange for increasing the charitable deduction for the property from 30% to 50% of adjusted gross income (AGI).

Regs. Sec. 1.170A-8(d)(2) further provides that the election may be made for contributions of 30% capital gain property carried over to the current tax year, even if the taxpayer did not make any contributions of 30% capital gain property in the current year. This election may be beneficial if 30% of the deceased taxpayer's AGI in the year of death is less than the charitable contribution of appreciated property and a portion of the charitable contribution would remain unused and unable to be carried forward to future tax years.

The election is made by attaching a statement to the decedent's final tax return. The election is irrevocable and applies to all gifts of appreciated property that are subject to the 30%-of-AGI limitation made for the tax year of death, as well as any carryovers.

### SAVINGS BOND INTEREST

Rev. Rul. 68-145 provides that a decedent's executor can elect under Sec. 454(a) to report the increase in the redemption price of Series E or EE U.S. savings bonds as income currently on the decedent's final income tax return rather than reporting the income when the bonds are redeemed. This election is beneficial when a decedent dies early in the tax year or otherwise has nominal income or excess deductions on the final income tax return. In a case where the taxpayer does not have excess deductions, the election provides an opportunity to use the decedent's lower income tax brackets that would otherwise go unused.

### BUSINESS CREDIT CARRYOVERS

Business credit carryovers cannot be used on the decedent's estate tax return. Sec. 196(b) provides for a deduction of unused "qualified business credits" on the decedent's final income tax return under regulations prescribed by the IRS. However, the IRS has not yet issued regulations to provide for this deduction.

### TAXES AND FINAL ARRANGEMENTS

Tax practitioners need to be alert to tax planning opportunities related to tax attributes and make plans for the final income tax return when they are aware that a client is approaching death. Although these issues may be difficult to address with a family during this emotional time, the tax planning opportunities can result in substantial income tax savings for clients and their heirs. ■

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