

San Francisco Estate Planning Council

Pre and Post Mortem Planning for Income Tax Attributes

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- Understand income tax issues regarding tax attributes before and after death
- Planning with these attributes both before and after death

Polling Question

I have been practicing for:

- A) 1-5 years
- B) 5-10 years
- C) 10+ years

Income Tax Attributes at Death

Income Tax Attributes at Death

Rev. Rul. 74-175

- Specifically addressed capital losses and net operating losses at death
- In the absence of any express statutory language, only the taxpayer who sustains a loss is entitled to take the deduction. Citing, *Calvin v. United States*, 354 F. 2d 202 (10th Cir. 1965).

Income Tax Attributes at Death

NOL Carryovers

- NOL carryovers are lost if not used on the individual's final return.
- However, if NOL results from a net business loss on the final return, the net operating loss may be carried back to earlier years under the normal Sec. 172 rules.

Income Tax Attributes at Death

NOL Carryovers

- If filing joint return, NOL can be used by surviving spouse if used by year-end of year of spouse's death.
- If a joint return is filed, and if the spouses have different tax years solely because of the death of either spouse, the tax year of the deceased spouse covered by the joint return is deemed—for computing the tax for that joint return—to have ended with the end of the surviving spouse's tax year. Reg. Sec. 1.2-1(c).

Income Tax Attributes at Death

NOL Carryovers

- Consider generating taxable income
 - How???
- Be aware of different state rules

Income Tax Attributes at Death

Capital Loss Carryovers

- Are lost if not used on the final return.
- If joint filers, surviving spouse can use losses to offset gain before year-end in year of spouse's death.
- After year of death only losses attributed to surviving spouse continue.

Income Tax Attributes at Death

Unrealized Capital Losses

- Basis will be adjusted to date of death (or alternate valuation date) value. Sec. 1014.
- If loss property sold to a related party, loss is disallowed per Sec. 267(a).
 - However, if related person then sells property at a gain, that gain is recognized only to the extent it exceeds disallowed loss. Sec. 267(d)(1).
 - Rule only applies if sale or exchange.

Polling Question

Planning for tax attributes is:

- A) Often an area of focus
- B) Sometimes an area of focus
- C) Discovered when the taxpayer dies and it's too late....

Income Tax Attributes at Death

Charitable Contribution Carryovers

- Created due to Sec. 170 AGI limitations.
- Are lost if not used on the individual's final return. Reg. Sec. 1.170A-10(d)(4)(iii).
- For spouses can be allocated based on who contributed on proportionate basis per Reg. Sec. 1.170A-10(d)(4)(i).
- If individual has considerable carryovers and is planning to continue giving, consider using trusts to make contributions.
 - Also consider if carryover wouldn't be used in 5 years.

Income Tax Attributes at Death

Investment Interest Carryovers

- Are lost if not used on the individual's final return.
- Consider election under Sec. 163(d)(4)(B) if there gains.
- Consider **Higher** interest rate related party loans

Income Tax Attributes at Death

Foreign tax credit carryovers

- Can survive death in certain circumstances
 - Credit can pass to estate or beneficiary only if the recipient of asset assumes tax obligation for the income. Sec. 691(b)
- For current year foreign tax paid consider taking it as a deduction. Sec. 901(a).

Alternative minimum tax credits

- Are lost on death.
- Tax court in *Vichich*, 146 T.C. No. 12 (2016), ruled widow could not use AMT credit carryover on her separate return in year after husband's death.

Income Tax Attributes at Death

Passive Activity Losses (“PALs”)

- Under section 469(g)(2), “if a passive activity is transferred by reason of the taxpayer’s death, then suspended PALs can be deducted on the decedent’s final Form 1040 ‘to the extent such losses are greater than the excess (if any) of (i) the basis of such property in the hands of the transferee, over (ii) the adjusted basis of such property immediately before the death of the taxpayer.’”

Income Tax Attributes at Death

Passive Activity Losses (“PALs”)

- As such, the “freed up” PALs can offset other income on decedent’s final 1040.
- Any losses not in excess of this step-up in basis “shall not be allowed as a deduction for any taxable year.”

Income Tax Attributes at Death

Passive Activity Losses (“PALs”)

- Implication of PALs held in a defective grantor trust.
 - Assets in grantor trust not included in the decedent’s estate but deemed “owned” for income tax purposes.
 - Grantor trust rules prevent PALs being added to basis when gifted to trust under Sec. 469(j)(6).
 - During life PALs included on taxpayer’s Form 8582.
 - At death, presumably there is no basis step-up so application of Sec. 469(g)(2) results in 100% of PALs triggered on decedent’s final 1040.
 - IRS Agreed with result in FSA 200106018.
 - Planning with grantor trusts...

Income Tax Attributes at Death

Passive Activity and Capital Loss Carryovers

- Passive losses cannot be triggered if sold to related party. Sec. 469(g)(1)(B).
 - But, gain from a passive activity is passive income to offset passive losses, even if sold to related party.
- If PALs AND capital losses, could sell passive interest to related party and gain from sale could be considered passive for 469 purposes but also offset by capital loss.

Polling Question

At death passive actively losses are:

A) Lost

B) Continue

C) Can be taken on the final 1040 to the extent they are greater than the basis step-up

Income Tax Attributes in Trusts/Estates

Income Tax Attributes in Trusts/Estates

Deductions

- Excess expenses
 - Deductions in excess of gross income not generating a net operating loss will benefit beneficiaries only in the final year. IRC Sec. 642(h)(2).
 - In May IRS issued proposed regs (REG-113295-18) clarifying excess deductions are not miscellaneous itemized deductions.
 - Proposed Regs may be relied on beginning after 12/31/2017.
- Charitable contributions may not be included in the excess deduction contribution.

Income Tax Attributes in Trusts/Estates

Deduction

- Capital loss & Net Operating Losses (“NOLs”) –
 - An unused net operating loss carryover or capital loss carryover existing upon termination of the estate are allowed to the beneficiaries succeeding to the property of the estate. IRC Sec. 642(h)(1).
 - Capital gains & losses will be reported to the beneficiaries on the estate’s or trust’s final year K-1.
 - The treatment of these attributes are specially addressed by statute.

Income Tax Attributes in Trusts/Estates

Deductions

- PAL carryovers
 - Special Rule for Distributions by Estates or Trusts

If any interest in a passive activity is distributed by an estate or trust -

 - (A) the basis of such interest immediately before such distribution shall be increased by the amount of any passive activity losses allocable to such interest, and
 - (B) such losses shall not be allowable as a deduction for any taxable year. IRC Sec. 469(j)(12).

Income Tax Attributes in Trusts/Estates

Deductions

- PAL carryovers – Exception to general rule
 - If gain may be recognized on distribution of passive activity (for example if funding a pecuniary bequest), related party rules do not disallow loss recognition. Sec. 267(b)(13).
 - May be better to fund pecuniary bequest with passive activity.

Income Tax Attributes in Trusts/Estates

Deductions (Cont.)

- Other Carryovers
 - Attributes that disappear upon the termination of a trust/estate include:
 - Minimum tax credits
 - Foreign tax credits
 - Depletion credits
 - Investment interest expense
 - Note these attributes are considered lost because there is no specific statute addressing their treatment. With respect to investment interest expense carryover, some practitioners argue that because the investment interest limitation rules came into effect after the rules on final year distributions, there is a position that Congress would have allowed for distribution of the carryover.

Income Tax Attributes in Trusts/Estates

- What are the impacts of trust –
 - Decanting
 - No ruling list under rev. proc. 2020-3
 - Merging
 - Severance
 - Exercise of powers of appointment

Polling Question

Income tax attributes when an estate/trust is final are:

- A) Always lost
- B) Always continue with the beneficiaries
- C) Depends on the attribute



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Carl has significant experience with tax and financial matters affecting entrepreneurs, executives and other high-net-worth individuals. He has worked with numerous families and closely held businesses to

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Carl has been published and interviewed in *Trusts & Estates*, *The Estate Planning Journal*, *The Metropolitan Corporate Counsel* and *The Tax Stringer*, and is a frequent speaker on tax planning matters. Carl is also a co-author of the Andersen treatise, *Tax Economics of Charitable Giving*.

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Thank you

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