Untaxingly Yours

Pre-Mortem Income Tax Planning

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By Brian T. Whitlock

Baseball Hall of Fame catcher and manager Yogi Berra is best remembered for his unintentional wit and malapropisms, commonly referred to as "Yogi-isms." In July 1973, Yogi's New York Mets trailed the Chicago Cubs by 9½ games. When asked about his team's chances, Yogi responded, "It ain't over until it's over." The New York Mets ultimately surpassed the Cubs and went on to play in the 1973 World Series. They lost to Oakland Athletics, but they never quit.

Many sports contests operate within the confines of a limited number of innings, periods, and/or time frames. Similar to the end of a game, we have some expectations about when an individual's life will end, but we rarely are given the opportunity to know that the end is imminent. Once in a while, we will be given an opportunity to consult with the family of a client who is facing a terminal illness or an end-of-life scenario. As trusted advisors, it is up to us to be prepared for such events and armed with actionable strategies that can turn a difficult time period into an opportunity to save the family money. Our responsibility is to be clear thinkers who can analyze the situation and respond appropriately.

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Death—The Gatekeeper

Tax attributes are specific economic benefits that taxpayers earn and carry with them from one period to the next. Capital assets held for more than one year are generally deemed to have been held long term. Capital losses may be offset against capital gains, but otherwise, they are limited. The unused portion of capital losses may be carried forward from one period to the next. Large charitable contributions may be limited under Code Sec. 170 if a taxpayer does not have sufficient Adjusted Gross Income, but unused charitable contributions may be carried forward.[1] Excess business losses disallowed under Code Sec. 461(l) are generally treated as Net Operating Losses under Code Sec. 172. If Net Operating Losses exceed gross income, then some or all of the excess may be eligible to be carried forward[2] and deducted in a future tax period. If passive losses exceed passive income, then some or all of the excess passive loss may be eligible to be carried forward[3] and deducted in a future tax period. Tax credits may be used to reduce the amount of tax that may be due. If the credits exceed the amount of tax in any one period, the excess credits may generally be carried forward to future tax periods.

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Death acts like a gatekeeper. Death closes the gate to post-mortem carryforwards. Unused charitable contribution deductions, unused Net Operating Losses, Capital Loss carryforwards, and tax credits terminate with the death of the taxpayer. The expired deductions and credits cannot be claimed by the decedent's estate or any of the decedent's heirs.

Absorb Carryforward and Credits before They Expire

Rather than permit deductions and credits to expire, taxpayers should consider accelerating various types of gross income into the final year of life. Ordinary income that is accelerated during a lifetime can be used to absorb Net Operating Losses and Income Tax Credits that might otherwise expire. Special attention should be paid to items that might otherwise be considered Income in Respect of a Decedent (IRD)[4] post-death. The most common items of IRD include wages receivable, accounts receivable held by a cash basis flow through trade or business, tax-deferred savings bonds and annuities, tax-deferred employee retirement benefits, tax-deferred employee stock options and equity, and certain capital assets that may not be otherwise eligible for a stepped-up basis at death.

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Factor Accounts Receivable

Accounts Receivables of a business enterprise can be accelerated through a process called "factoring." The holder of the receivable sells the receivables to a third party at a discount. Income is recognized at the time of sale. If the third-party collector is able to collect one-hundred cents on the dollar, then the amount they collected less the amount that they paid at a discount, divided by their original investment becomes their rate of return on their purchase of the receivables.

Accelerate the Recognition of Deferred Compensation

Individuals who work for start-up business enterprises and public companies will frequently receive restricted stock, stock options, or carried interests as compensation for their labor. This "sweat equity" is generally income tax deferred until the restrictions lapse or the equity "vests." Before the equity has fully vested, the employee can make an election under Code Sec. 83(b) and accelerate the recognition of the taxable income on restricted equity. The taxable income will generally be equal to the fair market value of the equity interest in excess of any exercise price on the date that the election is made.

Consider Withdrawals from Tax-Deferred Annuities

The tax-deferred income embedded in non-qualified annuities can be accelerated by taking a distribution from the annuity. If there is a potential for any tax penalties for early withdrawal under Code Sec. 72, or there are potential surrender fees charged that will be charged by the insurance company that issued the annuity, then those costs need to be weighed against the potential benefits generated by recognizing the income pre-mortem.

Convert IRAs to ROTH-IRAs

Terminally ill persons should consider converting Individual Retirement Accounts (IRAs) to ROTH-IRAs.[5] The conversion will accelerate the recognition of income so long as the conversion is made during the lifetime of the account owner. The conversion to ROTH-IRA will strip out all of the income tax obligations associated with the accounts in the future. The lifetime income that is recognized may be sheltered by charitable contribution carryovers, Net Operating Loss, and tax credits that are at risk of expiring.

If the terminally ill client does not have carryforwards that are at the risk of expiring at death, then consideration should still be given to triggering the additional income tax that may be due on the individual's final income tax return. Where the terminally ill person has a Gross Estate for either Federal or State death tax purposes that might be subject to the death tax, then the lifetime income tax liability created by the ROTH Conversion will be a debt of the decedent that will reduce the decedent's taxable estate.[6]

Post-mortem—Retro-Active Income Recognition

In very limited circumstances, tax elections can be made post-mortem with the filing of the decedent's individual income tax return that will accelerate the recognition of income. Many older individuals hold U.S. Savings Bonds. "The Greatest Generation" lived through World War II. In the 1940s, the U.S. economy was just coming out of the Depression. Government revenues were down, but the need to finance the war effort was significant.

The U.S. Government issued U.S. Government Savings Bonds to taxpayers as an attempt to raise the necessary funds. Workers would give the government 50% of the bond's face value in exchange for the promise that when the bond matured the government would pay the investor the full-face value. The interest income on the U.S. (Series E) Savings Bonds was tax deferred until the date that the bond was physically redeemed. Many taxpayers held these bonds long past their redemption date. If they did, the bond would continue to earn interest tax deferred for up to 40 years. The bonds never technically expired, but they did not earn interest after 40 years.

Workers continued to purchase U.S. (Series E) Savings Bonds for decades after the War. Frequently, they could purchase the bonds through their employers using a payroll deduction plan. The accumulation of savings bonds continued through the 1980s. When interest rates rose during the 1980s, the U.S. Government adjusted its bond issuance strategy. In order to induce individual investors to postpone redemption of their bonds, the government permitted individuals to roll over their Series E bonds into Series H bonds. In order to induce new individuals to invest, the government created a new Series I bond that would be issued at face value but earn tax-deferred interest at high levels. The interest paid on the Series I bonds generally "floats." Rather than pay a low fixed rate of interest, the I bonds will pay a rate of interest that increases as the rate of inflation increases.

Many older taxpayers hold large sums of tax-deferred Series E, Series EE, Series H, and Series I bonds. If they do not redeem the bonds or otherwise elect to pay tax on the tax-deferred interest during their lifetime, then their heirs will pay income tax on the tax-deferred interest. Under Code Sec. 454, a taxpayer can elect to include the accrued interest income on U.S. Savings Bonds prior to redemption by filing an election with their income tax return. Once the election is made under Code Sec. 454, the taxpayer agrees to pay tax on the accrued interest each year.

The executors and administrators of estates may find it beneficial to make an election under Code Sec. 454 on the final income tax return of the decedent. This election can be made post-mortem, and it will relate back to the last day of the taxable year of the deceased individual. The final Form 1040 will report the income earned up to the date of death. When the heir redeems the U.S. Savings Bond post-mortem, the bank will issue a Form 1099-INT to the heir for the full amount of the interest earned throughout the life of the bond, but the heir can subtract off the amount of the interest (on Form 1040, Schedule B) that was reported by the decedent on the final income tax return. The subtraction should list the name and the Social Security Number of the "nominee," and reference should be made in the description on Schedule B to the election made under Code Sec. 454.

Pre-Mortem—Recognition of Indirect Capital Gains

It would generally be imprudent to recommend the sale of appreciated capital assets when someone is terminally ill. Capital assets that are directly owned by the individual and are ultimately includable in their Gross Estate for Federal Estate Tax purposes will receive a tax-free "step-up in basis" under Code Sec. 1014 equal to the fair market value of the capital asset as of the taxpayer's date of death.[7] Selling a capital asset that is owned directly by a terminally ill taxpayer merely to absorb a capital loss carryforward would be open to criticism by the heirs since these capital gains will disappear at death with the adjustment made to basis under Code Sec. 1014. The focus should be on capital gains that will not disappear at death.

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There are three situations where the terminally ill taxpayer may have indirect capital gains or Income in Respect of a Decedent (Code Sec. 691) capital gains that will not disappear at death, which the family should consider accelerating.

S Corporation—Internal Capital Gains

First, if a taxpayer with capital loss carryforwards indirectly holds appreciated capital assets[8] (such as marketable securities or real estate) inside of a closely-held S Corporation, it may be advisable to accelerate the recognition of the capital gain by either selling the asset or distributing the appreciated asset to the shareholder. Unlike partnerships,[9] the step-up in basis

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of stock of an S Corporation at death may not be allocated to the assets inside the corporation. Under Code Sec. 311, if a corporation (whether it is taxed under Subchapter C or Subchapter S) distributes any property to shareholders (other than an obligation of the same corporation) and the fair market value of the property exceeds the adjusted basis of the property inside of the corporation, then the corporation will recognize gain on the amount of the differential. If an S Corporation recognizes a capital gain as a result of a transaction occurring inside of the corporation, then that capital gain (whether long term or short term) will retain its character in the hands of the shareholder. The capital gain, recognized as a result of Code Sec. 311, will flow through the S Corporation as a separately stated item on Internal Revenue Service (IRS) Form 1065, Schedule K-1, and the capital gain will be taxable to the shareholders in the same proportions that the shareholders own stock of the S Corporation. Where the terminally ill person holds nearly all of the outstanding S Corporation common stock, triggering the gain on assets held inside of the S Corporation will be beneficial to the family. The capital gain will increase the shareholder's Accumulated Adjustments Account (AAA) under Code Sec. 1366, and the gain will increase the shareholders' income tax basis in the S Corporation shares under Code Sec. 1367. The proportionate distribution of the asset to the shareholders (to the extent they all have an income tax basis) will not result in any additional income or capital gains being recognized by the shareholders.

The key to effective pre-mortem tax planning is developing a personal relationship with clients. If we can foster that close working relationship, then we will have the possibility of receiving notice of life-altering events before they happen, and we can help clients plan ahead.

Grantor-Type Trusts—Internal Capital Gains

The second type of indirect capital gain that should be considered by terminally ill taxpayers is any capital gain-related assets held inside of an Irrevocable Grantor-Type Trust. Some practitioners refer to these Grantor-Type trusts as Intentional Defective Grantor Trusts (IDGTs). I prefer the acronym IDIOT, an Intentionally Defective Income Only Trust.[10] Whether you prefer IDGT or IDIOT, the trust is generally an irrevocable trust created by the taxpayer during the lifetime and funded with gifts of certain assets. The drafter intentionally designs the trust to violate one or more of the powers under Code Sec. 674 or 675. The intentional violation of these powers will cause the Grantor (creator of the trust) to retain the obligation to pay the income tax on any income or capital gains generated inside of the trust. The trust is "Intentionally Defective" for income tax purposes. At the same time, the trust is quite effective for estate tax purposes, in as much as the drafters will avoid including any powers under Code Secs. 671–678 that might also cause the trust to be includable for estate tax purposes under Code Secs. 2035–2038. If the irrevocable trust is funded, then the gifted assets and the appreciation on those assets will be removed from the Grantor's Gross Estate for Federal Estate Tax purposes.

If the trust in fact does achieve the Federal Estate Tax objective, and the trust assets are effectively removed from Federal Estate taxation at the death of the Grantor, then the trust assets should not be eligible for a step-up in basis under Code Sec. 1014.[11] The Grantor in essence trades a potential 40% estate tax savings for a 20% capital gains tax (plus any Net Investment Income Tax).

If the trustee of the trust sells the appreciated assets during the lifetime of the terminally ill taxpayer, the recognized capital gains can be used to offset the capital loss carryforwards that the terminally ill client may have.

If the terminally ill client does not have capital loss carryforwards that are at the risk of expiring at death, then consideration should be given to triggering the gains inside of the trust for the purpose of reducing the Grantor's Gross Estate. Where the Grantor has a Gross Estate, that may be subject to either Federal or State death tax, then the lifetime income tax liability created by the recognition of gains inside of the Grantor Trust will be a debt of the decedent that will reduce the decedent's taxable estate.

If the terminally ill client does not have capital loss carryforwards and does not have a potential Taxable Estate for either Federal or State death taxes, then consideration should be given to exchanging (swapping) high-basis assets held by the terminally ill person with assets held inside the trust. This option may be available if the Grantor retained the power under Code Sec. 675(4)(d) to require the trust corpus by substituting other property of equivalent value. Following the rationale laid out in Rev. Rul. 85-13,[12] an exchange of assets between a Grantor that is treated as the owner of the trust under Code Secs. 671–678 will not be viewed as a sale for federal tax purposes. As a result, the

low-basis assets reacquired by the terminally ill Grantor will have a low carryover basis in the hands of the Grantor, and the high-basis assets transferred to the Grantor trust in the exchange will retain their high carryover basis. At death, the low-basis capital assets held by the terminally ill person will receive a step-up in basis under Code Sec. 1014(b).

CAUTION: Installment Note Sales to Grantor Trusts

Many practitioners leverage lifetime transfers to IDIOTs by selling assets to the IDIOT during the Grantor's lifetime. Frequently, Grantors will sell appreciating assets to the irrevocable trust in exchange for a promissory note payable from the trust to the Grantor. As discussed above, the sale or exchange of assets between a Grantor and its Grantor Trust does not result in any income tax consequences under the rationale of Rev. Rul. 85-13. The interest paid on the note is not deductible by the trust; the interest received by the Grantor is not taxable income; and any gain on the sale of an asset that may have been appreciated in the hands of the Grantor is not taxable if the principle is repaid during the Grantor's lifetime. The transaction is an installment sale.

Code Sec. 691 classifies the tax-deferred gain inherent in installment sales as IRD. As we have discussed, Code Sec. 1014 does not grant a step-up in basis to assets that are classified as IRD. As a result, the capital gain that is inherent in Installment Note Sales to Grantor Trust will be recognized post-mortem as the principal payments are recognized. If the trust can pay off the installment note during the terminally ill person's lifetime, then the IRD will be removed from consideration.

Take Advantage of Lower Income Tax Brackets, If Available

If the potential recognized income exceeds the available carryforwards, it may still be wise to accelerate the recognition of the income if the income will be taxed at tax rates on the decedent's Final Income Tax return that will be lower than the tax rates reflected on decedent's fiduciary income tax returns post-mortem estate or the individual income tax returns of the decedent's heirs.

Summary

The key to effective pre-mortem tax planning is developing a personal relationship with clients. We should know when major events are happening in their lives (*e.g.*, births, weddings, business start-ups, asset acquisitions, divorce, and terminal illnesses). If we can foster that close working relationship, then we will have the possibility of receiving notice of life-altering events before they happen, and we can help clients plan ahead.

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ENDNOTES

[1] Unused charitable contribution deductions may be carried forward by individuals for up to five years under Code Sec. 170(b)(1)(G)(ii).

[2] Net Operating Losses may be carried forwarded by individuals for up to 20 taxable years under Code Sec. 172(b)(1)(A)(ii)(I).

[3] Excess passive losses may be carried forwarded by individuals under Code Sec. 469.

[4] Code Sec. 691.

[5] Code Sec. 408(d)(3)(C).

[6] The author acknowledges that Code Sec. 691(c) permits an offset for the potential double taxation that may result if Income in Respect of a Decedent (IRD) is taxed for both Federal Estate Tax purpose and income tax purposes. The person that includes IRD in income is allowed a deduction for the Federal Estate Tax that may have been paid. Nevertheless, the author wishes to remind the reader of three facts. First, that the value of the deduction can be phased out and lost for certain taxpayers that itemize their deductions. Second, the federal deduction does not reduce state income taxes that may be due. Third, any State death tax that may have been paid by the inclusion of the IRD in the Gross Estate of the deceased is not deductible for Federal Income Tax purposes.

[7] Code Sec. 1014(a).

[8] Similarly, if the S Corporation holds real estate that has been significantly depreciated and the recapture of that depreciation would result in a capital gain under either Code Sec. 1245 or 1250, then triggering that gain during the lifetime of the terminally ill taxpayer may be beneficial.

[9] Code Sec. 754 permits an increase in the outside basis of a partnership interest (acquired via purchase or death) to be allocated to the assets held inside the partnership.

[10] Client's usually think that I am the idiot for recommending a trust that gives away all the benefits of income and appreciation but retains the obligation to pay tax on any of the income or capital gains recognized during the taxpayer's lifetime. Nevertheless, the benefits are enormous when you explain that the obligation to pay taxes on income and capital gains can be an additional tax-free gift to the beneficiaries of the trust. In fact, the trust will grow exponentially faster if it does not have to use its own assets to pay current income taxes.

[11] The IRS clarified earlier this year in Rev. Rul. 2023-2, IRB 2023-16, 658 (April 16, 2023) that the step-up in basis is only available under Code Sec. 1014(a) for property that is acquired or passed from a decedent. In order to qualify as a transfer under 1014(a), the transfer must be of one of the seven types listed in 1014(b). Property held by an irrevocable trust excluded from the decedent's gross estate under Chapter 11 (the Estate Tax) does not qualify merely because the decedent was taxable on the income under Chapter 1 (the Income Tax) by virtue of Code Secs. 671–678.

[12] Rev. Rul. 85-13, 1985-1 CB 184 (January 1, 1985).

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