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INCOME TAX MEMORANDUM

TO: CPAs, Clients & Associates

FROM: David L. Silverman, Esq.
Shirlee Aminoff, Esq.

DATE: April 2, 2010

RE: The Decedent's Final Income Tax Return

A decedent's final income tax return must be filed by the Executor by April 15 of the year following death. A joint return may be filed if the decedent's spouse did not remarry during the year. If no Executor has been appointed by the due date of the return, a joint return must be filed by the surviving spouse. In that case, the later appointed Executor may revoke the surviving spouse's election to file a joint return and file a separate return for the decedent's estate within one year from the due date of the return, including extensions. Liability issues may arise if a joint return is filed, since the executor and spouse become jointly and severally liable for any tax and penalties, unless otherwise agreed. Therefore, the executor should exercise caution before filing a joint return, even if fewer taes would arise by doing so.

Income tax liability of the decedent which arose before his death constitutes a bona fide debt of the estate. Accordingly, such income tax liability may be deducted on the estate tax return. However, if a joint return is filed, only that portion of the income tax attributable to income for which the decedent was liable may be deducted. Other expenses incurred by the decedent and paid before death, as well as certain other items, are deductible only on the decedent's final income tax return. Such expenses and items include (i) medical and other deductible expenses paid prior to death; (ii) capital loss carryovers; (iii) charitable contribution carryovers; and (iv) net operating loss carryovers. Medical expenses incurred before death but paid after death may be deducted either on the decedent's final income tax return (provided they are paid within one year of death) or on the estate tax return. To claim the deduction on the final income tax return, the executor must file a statement certifying that the expense was not claimed as a deduction on the estate tax return.

IRC §706(c)(2)(A) provides that the taxable year of a partnership closes with respect to a partner whose entire partnership interest terminates by reason of death. Therefore, the final return includes flow through items for the short year. Under the section 706 regulations, the allocation for the short year is made by effectuating an interim closing of the partnership's books at the decedent's death or, if all partners agree, on a pro rata basis based upon the number of days. A similar rule applies with respect to S corporation income. IRC §1377(a)(2). Allocating on a pro rata basis may be advantageous if it allows the use of carryovers that terminate with the decedent's death.

The executor may be held personally liable for taxes if a distribution results in an unpaid income or gift tax liability. Liability may exist for the period in which an assessment may be made, i.e., 3 years from the date payment is required, or six years if there is a "substantial omission" (i.e., 25%) of income. Liability may be imposed even if the executor had no actual knowledge of the tax liability. It is sufficient that the executor had knowledge of the facts which would cause a reasonably prudent person to be aware of the tax liability. Under IRC §6501(d), the executor may request prompt assessment of income and gift taxes attributable to prior returns filed by the decedent. This will shorten the statute of limitations for collection and may benefit the beneficiaries as well as the executor. The executor may also file a written application requesting release from personal liability for the decedent's income and gift taxes. If the IRS fails to notify the executor of any amount due within 9 months thereof, the executor will be released from liability.

The executor may also incur personal liability for estate taxes. The executor may request a release from liability with respect to any estate tax found to be due within 9 months of making the application if the application is made before the return is filed, or within 9 months of the due date of the return. IRC §2204(a). The executor may remain liable for tax liabilities if beneficiaries seek early distributions. In that case, the executor may seek to protect himself by funding an escrow agreement or reaching some other satisfactory arrangement with the beneficiaries.