When the taxpayer ends, the estate begins (or does it?)

When a person dies with a revocable trust, a new independent taxable entity is created.

By David Ellis, CPA
Guest Contributor

Many taxpayers upon their final exit will leave behind trusts or estates that are subject to income tax reporting and/or payment on Form 1041, U.S. Income Tax Return for Estates and Trusts. The fiduciary for a domestic estate must file Form 1041 for a domestic estate that has any of the following:[1]

- Gross income for the tax year of $600 or more;
- A beneficiary who is a nonresident alien; or
- Has held a qualified investment in a Qualified Opportunity Fund (QOF) at any time during the year.

The fiduciary for a domestic nongrantor trust must file if the trust has any of the following:[2]

- Any taxable income for the year;
- Gross income of $600 or more (regardless of taxable income);
- A beneficiary who is a nonresident alien; or
- If the trust held a qualified investment in a Qualified Opportunity Fund (QOF) at any time during the year.

Practitioners and fiduciaries should keep in mind that when a person dies with a revocable trust, such trust generally converts to an irrevocable nongrantor trust, and a new independent taxable entity is created, which is subject to the taxable and gross income filing requirement stated. This is an exceedingly common occurrence for decedents who have done even minimal estate planning. Thus, it happens that most practitioners will at some point be faced with filing a Form 1041 for a dearly departed client, or on behalf of a client who has the unenviable task of being the executor of an estate or trustee of a trust.

Get the dates straight

The first item that must be determined is on what day did the taxpayer end and the estate begin, and Treas. Regs. §1.451-1(d)(1) states that a taxpayer's taxable year ends on the date of death. The regulation further refers the reader to IRC §443(a)(2) and paragraph (a)(2) of Treas. Regs. §1.443-1.

IRC §443(a)(2) is not much help here, as it merely states that "a return for a period of less than 12 months shall be made …[when] the taxpayer is in existence during only what would otherwise be his taxable year." In other words, when the taxpayer dies, you must file a short-year tax return, but the regulation does not state on what date the short-year ends.

Paragraph (a)(2) of Treas. Regs. §1.443-1, however, turns out to be more satisfying by indicating that a taxpayer's final tax year includes the day of death, by stating as follows:

"Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and <u>ending with the date of his death</u> [emphasis added] the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year." Treas. Regs. §1.691(a)-1b similarly states:

"In general, the term income in respect of a decedent refers to those amounts to which a decedent was entitled as gross income, but which were not properly includible in computing his taxable income for the taxable year <u>ending with the date of his death</u> [emphasis added] or previous taxable year." Since the regulations clearly do not exclude the day of death from the taxpayer's final taxable year, it therefore logically follows that the taxpayer's last taxable year includes the day of death. Likewise, it stands to reason that the estate's year will begin the day <u>after</u> the taxpayer dies.

The difference one day can make

In the experience of this author, most practitioners will report the beginning date of the estate as the date of the taxpayer's death and the ending date of the final personal tax return likewise.

In most cases, except for those of us suffering from Obsessive Compulsive Tax Syndrome, this one-day overlap will be of little consequence. However, there could be instances in which the exact day matters. For example, suppose that a cash basis taxpayer receives income on the date of his death but reports such income on the estate tax return instead of the personal tax return. Depending on the circumstances, the highly compressed tax rates to which estates are subject could result in significantly more tax being erroneously paid.

Another example of the difference one day makes is when the decedent dies on the last day of the month. Suppose the taxpayer dies on June 30, 2021. If the executor elects a fiscal year for the estate, the correct starting date would be July 1, 2021, with an ending date of June 30, 2022. However, if the executor elected a fiscal year and wrongly used the date of death as the starting date for the estate's tax year, the estate would start on

June 30, 2021, and end on May 31, 2022, throwing the estate's accounting period off by an entire month for the life of the estate. The implications of this are potentially disastrous in terms of revenue recognition, filing deadlines, and tax payment due dates. This may not be such an unlikely event as one might think, for in any given month, the odds of dying on the last day are approximately 1 in 30, so a fair number of us will make our final exit at the end of the month.

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[1] Instructions to Form 1041

[2] Instructions to 2020 Form 1041