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TAX AND BUSINESS Alert™

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Filing Options for Your Final Form 1040

Although we can't escape death or taxes, we may be able to minimize the federal income taxes due on our final Form 1040. Filing a tax return after we die (we are then known as the "decedent") is probably not something most of us think much about. But, a final Form 1040 generally must be filed for the year of our death and, just as in life, is typically due by April 15th of the following year. Normal tax accounting rules regarding the recognition of income and deductions generally apply for this final return. And, as is the case during life, tax planning opportunities are available both when death is imminent and after death. For instance, several decisions can affect the income or deductions reported on that final return. However, as we will discuss below, a major decision for married individuals concerns whether to file a joint return for the year of death.

When a married taxpayer dies and the surviving spouse does not remarry during the year, the spouse may file a joint return with the decedent for the year of death, but is not required to do so. The joint return will include income and deductions for the decedent prior to the date of death and the surviving spouse's income and deductions for the entire year. If the surviving spouse remarries before the close of the tax year that includes the date of death, the spouse may not file jointly with the decedent. Instead, a separate return must be prepared for the decedent. Listed below are some of the advantages and disadvantages for joint filers to consider when filing that final return.

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Advantages of Filing a Joint Return. Since the surviving spouse's tax year does not end upon the death of the decedent, it may be possible to reduce their combined income tax liability by accelerating or postponing income or deductions to maximize use of the joint tax rates. Some other benefits include, but are not limited to: (a) use of one spouse's excess deductions against the income of the other spouse (e.g., excess charitable contributions); (b) an increase in the IRA contribution limit (because of the

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Maximizing the Deduction for Start-up Expenses

Individuals starting a new business or acquiring the assets of an existing business often incur start-up expenses, which can be considerable, in the investigation and acquisition phase before actual business operations begin. Most start-up expenditures can be segregated into two broad categories: (a) investigatory expenses and (b) business preopening costs.

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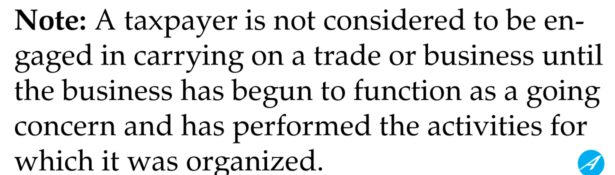
Taxpayers can immediately deduct up to $5,000 of start-up expenses in the year when active conduct of a business begins. However, the $5,000 instant deduction allowance is reduced dollar for dollar by cumulative start-up expenses in excess of $50,000 for the business in question. Start-up expenses that cannot be immediately deducted in the year a business begins must be capitalized and amortized over 180 months on a straight-line basis. In many cases, start-up expenses for small businesses will be modest enough to qualify for immediate deduction under the $5,000 instant deduction allowance in the year when active conduct of business commences.

Example: Claiming the deduction for start-up expenses.

Suzie (a calendar-year taxpayer) incurs $4,200 of start-up expenses in 2012 before opening her new car wash in November of 2012. Suzie's 2012 deduction is $4,200. Since her start-up expenses did not exceed $50,000, she can deduct the entire $4,200 in 2012.



Note: A taxpayer is not considered to be engaged in carrying on a trade or business until the business has begun to function as a going concern and has performed the activities for which it was organized.

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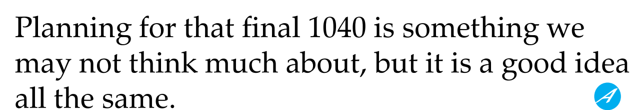
spousal IRA rules); and (c) the ability of the decedent's net operating loss (NOL), capital loss, and passive activity loss (subject to the limitation) carryovers to offset income of the surviving spouse. Note that any NOL or capital loss carryover of the decedent that is not used on the final return (whether separate or joint) will expire unused.

Disadvantages of Filing a Joint Return. Filing a joint return with the surviving spouse is not always the best option. One disadvantage of filing a joint return for the decedent's final tax year is that the decedent's estate and the surviving spouse are jointly and severally liable for any tax, interest, and penalties due on the joint return. In addition, when the surviving spouse is not the sole beneficiary of the estate, the decedent's personal representative may not be willing to expose the estate to potential unknown liabilities (e.g., tax on the surviving spouse's unreported income). Potentially, this exposure may be avoided because of the innocent spouse rules. Also, filing a joint return can negatively impact the amount of the decedent's deductions that are subject to adjusted gross income (AGI) limitations (e.g., medical, casualty, miscellaneous itemized) since AGI is based on joint income rather than separate income. Finally, the surviving spouse must cooperate with the decedent's personal representative by sharing the information necessary to prepare the return and by signing the return once it is prepared.



Planning for that final 1040 is something we may not think much about, but it is a good idea all the same.

Home Sale Gain Exclusion Restrictions for Second Homes

Many taxpayers bought a second home, such as a vacation home, with the intention of later converting the second home into their principal residence. Under pre-2008 Housing Act law, those taxpayers could have excluded up to $250,000 ($500,000 for certain joint filers) upon a later sale of that former vacation home as long as the ownership and use tests for the exclusion were satisfied. However, the Housing Act changed the method for recognizing post-2008 gain on the sale of a principal residence formerly used as a vacation or second home.

Specifically, the revised rule makes a portion of the gain from selling the residence—the non-qualified use period—ineligible for the gain exclusion privilege. A property's nonqualified use period equals the amount of time after 2008 during which the property is not used as the taxpayer's principal residence. However, periods of nonqualified use don't include temporary absences that aggregate to two years or less due to changes of employment, health conditions, or certain other unforeseen circumstances; certain time periods after use as a principal residence; or certain time periods while on qualified official extended duty.

Example 1: Nonqualified use leads to additional taxes.

Floyd bought a vacation home in an exclusive area on January 1, 2005. On January 1, 2011, he converts the property into his principal residence, and he and his wife live there for all of 2011 and 2012. On January 1, 2013, he sells the home for a $450,000 gain. Floyd's total ownership period is eight years (2005–2012). However, the two years of post-2008 use as a vacation home (2009–2010) count against him and result in a nonexcludable gain of $112,500 (2/8 × $450,000). Floyd must report the $112,500 as capital gain income on his 2013 federal tax return and pay the resulting income tax. If Floyd files jointly, he won't owe any federal income tax on the remaining $337,500 of gain ($450,000 – $112,500) because it's completely sheltered by the $500,000 exclusion.

Example 2: Nonqualified use has no impact.

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Sandy, a single person, bought a vacation home on January 1, 2001. On January 1, 2011, she converts the property into her principal residence and lives there for all of 2011 and 2012. On January 1, 2013, she sells the home for a $360,000 gain. Sandy's total ownership period is 12 years (2001–2012), but the two years of post-2008 use as a vacation home (2009–2010) result in a nonexcludable gain of $60,000 (2/12 × $360,000). Sandy can claim the $250,000 home sale gain exclusion against the remaining $300,000 ($360,000 – $60,000) gain, leaving a $50,000 taxable gain. The end result is that Sandy must report a total gain of $110,000 (the nonexcludable gain of $60,000, plus the $50,000 gain in excess of the home sale gain exclusion).

Even before the new nonexcludable gain rule, Sandy would have had to report taxable gain of $110,000 ($360,000 – $250,000). Since the $110,000 gain that she would have had to report anyway exceeds the $60,000 nonexcludable gain, the new nonexcludable gain rule has no impact on Sandy.

To minimize the amount of taxable gain from the sale of one of these homes, it is essential that taxpayers keep accurate records of all the money invested in home improvements (before and after it became the taxpayer's principal residence).

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Save Taxes Using a Partial Annuity Exchange

Variable annuity contract distributions generally contain two components, taxable income and nontaxable return of basis (investment). However, distributions received before the annuity starting date (nonannuity distributions) are likely to be less taxpayer-friendly. Initially, these nonannuity payments generally consist entirely of taxable income until all of the annuity contract's earnings have been distributed. Subsequent payments are considered to be a nontaxable return of basis. Because of this issue, when an annuity owner must take a nonannuity distribution, the tax impact can be onerous.

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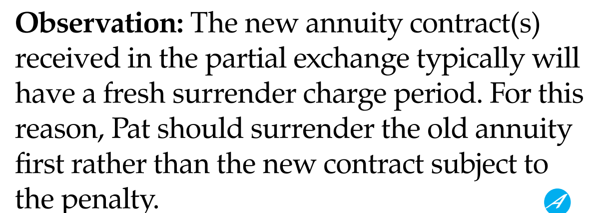
Internal Revenue Code Section 1035 has traditionally provided a federal tax-free mechanism to exchange one annuity contract for another annuity contract. This Section 1035 exchange, without recognition of gain or loss, is limited to cases where the person who is the insured or annuitant is the same in both contracts. Recent regulatory guidance offers a way to lessen the tax impact on nonannuity distributions using the Section 1035 exchange mechanism.

A person holding a highly appreciated annuity (one containing a large amount of built-up earnings) can lessen the tax bite using a two-step process. First, he or she makes a partial withdrawal from the original annuity by completing a partial exchange into another annuity. Next, he or she surrenders either annuity contract more than 180 days later to minimize the tax impact.

Example: Partial annuity exchange.

Pat originally invested $50,000 in an annuity, which has now grown to a fair market value of $200,000. If she withdraws $100,000 from this annuity, the funds will come first from her gain and will be taxed as ordinary income. So, instead, Pat makes a Section 1035 (tax-free) exchange with half of the original annuity into a second annuity worth $100,000. Her basis in each annuity is split proportionally. Accordingly, she has a $25,000 tax cost (basis) in each $100,000 annuity after the partial Section 1035 exchange. If Pat surrenders one of the annuities in full more than 180 days after the date of the Section 1035 exchange, she receives a $100,000 distribution that is considered to be $25,000 return of basis and $75,000 of ordinary income. This is a better result than receiving $100,000 of ordinary income without the partial Section 1035 exchange.



Observation: The new annuity contract(s) received in the partial exchange typically will have a fresh surrender charge period. For this reason, Pat should surrender the old annuity first rather than the new contract subject to the penalty.

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