Tax Considerations: Terminal Illness and Death

Anywhere Legal - The Virtual Law Firm
Bruce Glassman, JD, CPA/PFS
Attorney at Law
Jacksonville, FL
(904) 254-0504
webresponse@anywherelegal.com
http://www.anywherelegal.com

October 28, 2009

Table of Contents

Tax Considerations: Terminal Illness and Death 6

What are the tax considerations associated with terminal illness and death? 6

What should you know about income tax planning for the terminally ill? 6

How might the death of a family member impact tax return responsibilities? 6

What should you know about income in respect of a decedent (IRD)? 6

Income Tax Planning for the Terminally Ill 7

What is income tax planning for the terminally ill? 7

What are some of the income and deduction issues that may be of particular concern to the terminally ill? 7

Which insurance issues are of particular interest to the terminally ill? 8

What should you know about retirement plan distributions? 9

How does estate planning impact your income taxes? 10

Death of a Family Member 11

How might the death of your family member impact income tax return responsibilities? 11

What should you know about filing and signing income tax returns incident to a death? 11

What are some filing status considerations in the year of death? 11

What is the procedure for obtaining and cashing refund checks for a decedent? 12

Filing a Final Income Tax Return 14

Who should file the return? 14

Declaring income in the year of death 14

Deductions, personal exemption, and credits 14

Headings and signing the forms 15

Documents needed to claim a refund 16

Early filing 16

Income in Respect of a Decedent 17

What is income in respect of a decedent (IRD)? 17

Examples of IRD 17

Income tax deduction for estate taxes paid 17

Tax Planning Tips: Life Insurance 18
- Life insurance contracts must meet IRS requirements 18
- Keep in mind that you can't deduct your premiums on your federal income tax return 18
- Employer-paid life insurance may have a tax cost 18
- You should determine whether your premiums were paid with pre- or after-tax dollars 18
- Your life insurance beneficiary probably won't have to pay income tax on death benefit received 18
- In some cases, insurance proceeds may be included in your taxable estate 19
- If your policy has a cash value component, that part will accumulate tax deferred 19
- You usually aren't taxed on dividends paid 19
- Watch out for cash withdrawals in excess of basis--they're taxable 19
- You probably won't have to pay taxes on loans taken against your policy 20
- You can't deduct interest you've paid on policy loans 20
- The surrender of your policy may result in taxable gain 20
- You may be able to exchange one policy for another without triggering tax liability 20
- When in doubt, consult a professional 20

Tax Planning Tips: Disability Insurance 21
- Individual disability income insurance 21
- Employer-sponsored group disability insurance 21
- Benefits under a cafeteria plan 21
- Group association disability insurance 22
- Government disability insurance 22
- Is it wiser to buy disability coverage with pretax or after-tax dollars? 22

Tax Tips: Health Insurance 23
- You don't include employer-paid premiums in your income 23
- What if your employer reimburses you for your premiums? 23
- In most cases, you won't be able to deduct the premiums you pay 23
- If you're self-employed, special deduction rules may apply 23
- Your health insurance benefits typically aren't taxable 24

Viatical Settlements 25

Who can sell a life insurance policy? ... 25

Who can buy a life insurance policy? ... 25

How much will you receive for your policy? ... 25

How do you choose a viatical settlement company or provider? ... 25

Should you sell your life insurance policy? ... 26

Income tax considerations ... 26

Gift and Estate Taxes ... 27

Federal gift tax and federal estate tax--background ... 27

Federal gift tax ... 27

Federal estate tax ... 27

Federal generation-skipping transfer tax ... 28

State death taxes ... 28

Life Insurance and Charitable Giving ... 29

Why use life insurance for charitable giving? ... 29

What are the disadvantages of using life insurance for charitable giving? ... 29

Ways to give life insurance to charity ... 29

Choosing an Income Tax Filing Status ... 31

The five filing statuses and how they affect your tax liability ... 31

You're unmarried if you're unmarried or legally separated from your spouse on the last day of the year 31

Married filing jointly often results in tax savings for married couples ... 31

You don't have to be separated to choose married filing separately ... 32

Head of household status offers certain income tax advantages ... 32

Qualifying widow(er) with dependent child offers the advantages of a joint return ... 32

Organizing Your Finances When Your Spouse Has Died ... 34

Notify others ... 34

Get advice ... 34

Locate important documents and financial records ... 34

Set up a filing system ... 34

Set up a phone and mail system ... 34

Evaluate short-term income and expenses 35

Avoid hasty decisions 35

How will estate taxes be paid if I leave no provision in my will? 36

Is it possible to name a charity as the beneficiary of my life insurance policy? 37

Will my beneficiaries have to pay taxes on the proceeds of my life insurance policy? 38

My spouse passed away this year. When I file my taxes, what filing status should I claim? 39

Tax Considerations: Terminal Illness and Death

What are the tax considerations associated with terminal illness and death?

When the terminal illness of a family member is newly discovered, or in those cases where the death of a family member has just occurred, federal income tax liability certainly isn't a primary concern; indeed, it may seem utterly insignificant. Emotional upheaval is likely, and pressing matters must be considered first. Nevertheless, income taxes must be dealt with at some point. And in the case of the terminally ill, tax planning may be essential for several reasons. Sufficient cash must be on hand to subsidize increased medical bills, finances and retirement assets must be positioned in the most advantageous ways, and estate planning should be considered. In all of these instances, income tax planning can play a key role.

If the death of a family member has recently occurred, other tax issues become important. In particular, you'll need to learn the proper procedure for filing and signing the decedent's final income tax return, you'll need to review the applicable filing status rules, and you'll probably need to learn how to obtain and cash any refund check to which the deceased may have been entitled.

What should you know about income tax planning for the terminally ill?

Increased medical expenses and decreased ability to earn income often accompany terminal illness. As a result, you may be required to deplete or liquidate all or a portion of your investments, retirement accounts, or insurance vehicles. You need to know how best to increase your liquidity, and you need to understand the tax consequences when you access each of these classes of assets. Income tax planning for the terminally ill also often involves learning how to take advantage of medical deductions, charitable deductions, and gifting to loved ones. Along with income tax planning, you'll want to think about estate planning as well.

How might the death of a family member impact tax return responsibilities?

The death of one of your family members, particularly the death of your spouse, may create certain federal income tax tasks and responsibilities for you. In particular, you'll need to learn the proper procedure for filing and signing the decedent's final income tax return; you'll need to review the applicable filing status rules; and you'll probably need to learn how to obtain and cash any refund check to which the deceased may have been entitled.

What should you know about income in respect of a decedent (IRD)?

Income in respect of a decedent (IRD) involves gross income that a decedent would have received had death not occurred, that is not properly includable on the decedent's final income tax return. Instead, the IRD is reported on the recipient's income tax return in the year received, or, if paid to the decedent's estate, the IRD is reported on the estate's income tax return. If you are filing a final income tax return for a deceased loved one, it is important for you to understand the concept of IRD.

Income Tax Planning for the Terminally Ill

What is income tax planning for the terminally ill?

Terminal illness changes your financial outlook. It may be that you require more current income due to increased medical expenses or a change in lifestyle. Or perhaps transferring assets to your loved ones and engaging in estate planning is foremost on your mind. In either case, minimizing your payment of federal income taxes is likely to be one aspect of your general tax planning if you are terminally ill.

Unfortunately, terminal illness often prohibits continued employment. Consequently, depleting or liquidating investment funds, retirement plans, and insurance policies may become necessary to generate sufficient cash. It is important to understand the tax ramifications of your financial decisions. It is also important to understand the extent to which your medical expenses may be deducted on your federal income tax return.

Income tax planning for the terminally ill involves four general areas: general income and deduction issues, insurance considerations, retirement planning, and the income tax consequences of estate planning.

What are some of the income and deduction issues that may be of particular concern to the terminally ill?

In general, terminal illness results in a drastic lifestyle change. An illness often limits your ability to earn money. Further, your medical expenses frequently increase. In each case, significant income tax implications are involved. Depending upon a number of factors, the manner in which you liquidate your assets may impact the amount of income tax you will pay. In addition, you should be aware that the medical expense deduction is broader than most people realize. This deduction can be used to reduce your tax liability.

Need for increased income

If you are terminally ill, you will probably need to increase your income in order to offset expenses associated with your illness. In addition, if you can no longer work, you will need additional funds to cover your living expenses. You may have to liquidate your investment, retirement, or insurance assets. Since you generally control when you recognize income or gain, you generally can control when you incur income tax liability. If you have a diversified and varied investment portfolio, you can liquidate loss and long-term capital gain assets first.

Unfortunately, some of your assets will create ordinary income, rather than the more favorable capital gain income. Indeed, for many people, a retirement plan will hold the bulk of their investment assets. Be aware that withdrawals from a retirement plan will result in ordinary income.

Deduction of medical expenses

Medical expenses are deductible to the extent that they exceed 7.5 percent of your adjusted gross income. These deductions reduce your ordinary income. The medical expense deduction, however, is limited to unreimbursed medical expenses.

It is important to keep detailed records of your medical expenses. The need for extra income during a terminal illness is often associated with the need for medical care. Medical expenses include such disbursements as transportation to and from your physician for medical treatment, long-term home care, and insurance premiums. Improvements to your residence necessitated by your disability are also deductible to the extent they exceed any increase in value to your home.

Medical expenses in the year of death may be used as either an income tax deduction or an estate tax deduction, but not as both.

Capital losses

Generally, capital loss carryforwards are lost upon death. If sufficient loss carryforwards exist during your lifetime, an increased need for income would best be served by recognizing capital gain income, which can be sheltered by your loss carryforwards.

> **Tip:** Depending on filing status, your surviving spouse may be able to use your loss carryforwards after your death.

Which insurance issues are of particular interest to the terminally ill?

In some cases, insurance policies may provide a source of cash for the terminally ill. For instance, you may be able to access life insurance benefits by selling your life insurance policy to investors. (This transaction is commonly known as a viatical settlement.) In addition, you may have access to payments from disability, health, or accident insurance provided by your employer. Income tax planning for the terminally ill seeks the best after-tax return on these insurance vehicles. This approach is twofold. First, the taxation of insurance proceeds must be considered. Second, you need to compare the after-tax return available on all your investments.

Viatical settlements and accelerated death benefits

Viatical settlements involve the sale of your insurance policy benefits to investors. Under a recent change in the tax law, amounts received from a life insurance contract on the life of a terminally ill or chronically ill person are excluded from gross income if certain requirements are satisfied. In addition, the sale or assignment of a life insurance contract to a viatical settlement provider is not taxed if certain requirements are satisfied. Accelerated death benefits and viatical settlements allow you to gain access to the death benefit while you are still alive. The return to the viatical settlement provider is the difference between the discounted value paid for the policy and the full value of the policy upon your death. This return to the viatical settlement provider can also be viewed as your transaction cost, in a sense; it is the amount that would otherwise go to your beneficiaries. The cost can be as high as 25 percent.

Viatical settlement companies buy almost any type of life insurance policy (including term, universal, whole, and group). The policy must be in good standing, it can contain no prohibition against assignment, and it generally must have been in force for at least two years. Typically, you must produce a medical certificate attesting to imminent death. Payment is usually made in the form of a lump sum. The primary risk to the company involves determining life expectancy. Note, however, that a viatical settlement might jeopardize your eligibility for Medicaid or welfare benefits.

Viatical settlements vs. liquidation of other investments

Viatical settlements are not taxed if certain requirements are met; nevertheless, they might not represent the best approach for you. After considering your financial needs and specific goals, you should compare the consequences of a viatical settlement with the total cost associated with liquidating some or all of your other investment assets. Viatical settlements can provide access to cash that you might not otherwise have. However, if you have a variety of different investments, the tax and transaction costs of liquidating investments such as retirement accounts or investments may be lower then the total cost of a viatical settlement. Bear in mind that medical expense deductions may be wasted if you do not generate sufficient taxable income.

- **Example(s):** Assume you are terminally ill and expect to live another 6-12 months. You need $50,000 to replace a lost income stream and $50,000 to pay additional expenses related to your illness. Half of your additional expenses will qualify as deductible medical expenses. In addition, you would like to leave loved ones at least $100,000. At present, you have the following assets:Stocks worth $50,000 with a built-in gain of $25,000. The gain is long-term capital gain.

- A life insurance policy worth $120,000.

- A qualified retirement plan with a balance of $50,000. (Distributions would be taxed at

ordinary income tax rates.)

First, assume that you decide to liquidate the insurance to pay your various expenses. The market cost of your viatical settlement comes to $20,000. (Assume that the settlement meets the requirements for tax-free treatment.) Upon your death, the stock will receive a step-up in basis. Thus, this asset will not result in any tax to your beneficiaries. When you die, the retirement plan assets will be taxed at ordinary income tax rates. Thus, the beneficiaries will get less than $100,000. The total cost of this approach equals the cost of the viatical settlement of $20,000, plus taxation of the retirement benefits when distributed to the beneficiaries.

Assume, instead, that you decided to liquidate your stock and retirement plan first. You would then sell only a portion of the insurance to make up any shortfall. The tax cost of the sale of stock is $5,000 (20 percent of $25,000 gain). The tax cost of the retirement distribution is approximately $5,000 (after taking into account the medical expense deduction). You then liquidate the insurance policy to the extent necessary to make up the $10,000 shortfall. Assume a transaction cost of $2,500. In this case, you are able to leave over $100,000, tax free, to your loved ones. Your total cost amounts to approximately $12,500. Comparatively, liquidation of the insurance policy--while without tax cost--is less favorable. (Of course, liquidation of the insurance policy may very well prove more beneficial under a different set of facts. It is important, however, to assess the costs of each possible transaction.)

Disability insurance

Disability insurance policies typically pay a percentage of your income if you become sick or disabled and unable to work at your occupation. If you pay the disability premiums, the benefits are not taxable. If disability insurance is provided through your employer, the benefits may be taxable if your employer paid the premiums and the premiums were not considered taxable income for you. However, the disability benefits will not be taxable if they represent merely a reimbursement of your medical expenses, permanent loss or loss of the use of part of the body, or disfigurement. In general, you cannot deduct the premiums.

What should you know about retirement plan distributions?

Retirement plan distributions are often necessary to maintain the standard of living for the terminally ill. But this creates two problems: first, distributions from qualified retirement plans are taxed at ordinary income tax rates; and second, taking such distributions sacrifices tax-deferred growth.

Retirement distributions and tax liability

The good news is that the terminally ill are not subject to the 10 percent early distribution penalty, because they are treated as disabled. The bad news is that distributions from qualified retirement plans are taxed at ordinary income tax rates. Since our tax system is progressive, large annual distributions can increase your marginal tax rate for the year in which distributions are received. Thus, the tax cost of accessing these funds can be significantly higher. However, increased deductions from your medical expenses or through charitable giving may offset part of an increase in your tax liability. A strategy that liquidates loss investments or long-term gain assets may actually be preferable.

Transfer of your tax-deferred retirement funds into a Roth IRA may provide a number of tax benefits, also. Distributions from a Roth IRA are tax free. Thus, Roth IRAs can help you to increase your income stream without increasing your tax liability. Of course, the transfer of funds to a Roth IRA may be taxable. Given an abbreviated life span, this is probably not a beneficial strategy. However, taxpayers with significant deductions may want to consider a shift of retirement assets into the Roth IRA.

Taxation of retirement distributions after your death

The creation of tax-deferred growth is one of the major benefits of a qualified retirement plan. With appropriate planning, this tax-deferred growth can be passed on to beneficiaries of your estate. But to the extent that you take distributions while you are alive, you sacrifice some of this tax benefit.

How does estate planning impact your income taxes?

Retirement planning can certainly have an impact on your income tax position. In addition, your estate planning goals should be coordinated with your income tax planning.

Gifting

Gifting can be used to eliminate or reduce assets that generate ordinary income. Why would you give away income producing assets when you need a greater income stream? Well, you might wish to spend down retirement assets and pass on investment securities to loved ones. Accomplishing this task prior to your death reduces your taxable income. Furthermore, you are not taxed on the built-in gain in an asset when you give it away. Unfortunately, this type of gift has income tax implications for the gift beneficiary, since he or she will have to pay tax on the built-in gain if and when the asset is sold.

Charitable giving

Charitable giving may also offer you several tax saving opportunities. The charitable contribution is tax deductible (subject to certain limitations), so it can reduce your taxable income. Giving an unproductive asset away while increasing your income stream allows you to reduce your tax liability. Further, you can give away a partial interest in property. For instance, certain arrangements permit you to retain the use of property, such as your home, while currently making a gift of the value of the remainder interest. This strategy ensures use of a residence until your death, yet it also provides a deduction against current income. Your beneficiaries will not get the property when you die, but your current use of the property is not diminished.

Death of a Family Member

How might the death of your family member impact income tax return responsibilities?

The death of one of your family members--particularly the death of your spouse--may create certain federal income tax tasks and responsibilities for you. In particular, you'll need to learn the proper procedure for filing and signing the decedent's final income tax return, you'll need to review the applicable filing status rules, and you'll probably need to learn how to obtain and cash any refund check to which the deceased may have been entitled.

What should you know about filing and signing income tax returns incident to a death?

Specific procedures must be followed if you are filing and/or signing a decedent's final income tax return.

Filing the return

The same filing requirements that apply to individuals determine whether a final income tax return must be filed for your deceased family member ("the decedent"). In other words, if the decedent's level of income during the year was so low that he or she would not normally be obligated to file an income tax return, then an income tax return need not be filed for the year of death.

When you file a return for the decedent, either as the personal representative (i.e., the executor or administrator) or as the surviving spouse, the return must be completed according to some specific rules. For instance, you must write "DECEASED" across the top of the decedent's tax return, along with the decedent's name and date of death.

- If you are the surviving spouse and are filing a joint return with the decedent, you should also write the names and addresses of both parties (you and the decedent) in the regular name and address space on the return, or use the peel-off label
- If a joint return is not being filed, write the decedent's name in the name space in care of the personal representative, along with the personal representative's address

Signing the return

Specific rules also govern procedure for signing the return. If a personal representative such as an executor or administrator has been appointed, the personal representative must sign the return. If a joint return is filed, the surviving spouse must also sign the return. If no personal representative has been appointed by the due date for filing the return, the surviving spouse (on a joint return) should sign the return and write "Filing as Surviving Spouse," in the signature area. If no personal representative has been appointed and if there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as "Personal Representative."

Other important rules

There are many other rules that come into play when filing a final return for a decedent. For instance, you should know that the date of death determines the amount of income and deductions that will be reported on the tax return.

What are some filing status considerations in the year of death?

In general, marital status is determined on the last day of the tax year (December 31). However, special rules

apply when a married taxpayer dies; married filing jointly status is generally allowed for that tax year, even if the death occurred on January 1. If the decedent was married, however, it is important for you to calculate whether the tax on a joint return would be less than the total tax owed on two separate returns. Bear in mind that although a joint return will include all of the income and deductions of the survivor for the entire year, it will include only the income and deductions of the decedent up until the date of the death.

> **Tip:** If certain property was not owned jointly with the surviving spouse but passed to the decedent's estate at death, the subsequent income on that property would be reported on the income tax return for the estate, not on the joint income tax return.

Filing status for surviving spouse

For the surviving spouse, any of a number of filing statuses may be appropriate. These can range from married filing jointly, to married filing separately, to qualifying widow(er), to head of household.

Married filing jointly

In the year of a spouse's death, the surviving spouse generally is considered married for the entire year, for tax purposes. Therefore, the surviving spouse can generally file a joint return for that year. This rule also applies if both spouses die during the same tax year. Generally, a joint return can be made only with the cooperation of the executor or administrator of the decedent's estate. However, the surviving spouse, acting alone, can file a joint return with the deceased spouse under the following conditions:

- The decedent had not filed a tax return (as married filing separately) for his or her year of death, prior to death
- No executor or administrator has been appointed at or before the filing of the joint return or before the last day prescribed by law for filing the return of the surviving spouse (including extensions)

Married filing separately

In general, a surviving spouse should calculate taxes both according to the married filing jointly status and the married filing separately status in order to determine the most advantageous approach. If the surviving spouse remarries before the end of the year, married filing separately status must be used for the decedent's final return.

Qualifying widow(er)

Although a joint return cannot be filed with the deceased spouse for a tax year after the year of death, the surviving spouse can use the married filing jointly tax rates and standard deduction amount by filing as a " qualified widow(er) " in each of the following two years. The surviving spouse must be unmarried and pay more than half the cost of maintaining the principal home for the entire year of a child who qualifies for a dependency exemption on the surviving spouse's return.

Head of household status

If you are not eligible to file jointly or as a qualified surviving spouse, head of household filing status is the best alternative to minimize tax (assuming that you qualify). This is because the tax rates are lower and the standard deduction higher than if you file single or married filing separately. It's possible that you may qualify for head of household status if you provide support for a grandchild, sibling, or other relative, and meet all applicable conditions.

What is the procedure for obtaining and cashing refund checks for a decedent?

Generally, a person who is filing a return for a decedent and claiming a refund must file IRS Form 1310, with the return. However, there are some exceptions:

Surviving spouse

If you are a surviving spouse filing a joint return with the decedent and claiming a refund, you do not have to file Form 1310.

Appointed personal representative

If you are a court appointed or certified personal representative, you also do not have to file Form 1310, but you must attach a copy of the court certificate showing your appointment to the return. However, if you are claiming a refund on an amended return (Form 1040X), then you must attach Form 1310.

> **Tip:** To make sure that refunds are not delayed, it is recommended that Form 1310 be attached to any return being filed for a decedent on which a refund is being claimed.

Filing a Final Income Tax Return

Who should file the return?

Estate representative

If a court has appointed a personal representative or other estate administrator, that individual is required to file returns for the decedent. If the decedent was married at the time of death, the representative and surviving spouse, if they both agree, may file a joint tax return. If the surviving spouse remarries before the end of the tax year, however, the representative must file for the decedent as married filing separately.

Surviving spouse

If a court hasn't appointed an estate representative by the deadline for the return, the surviving spouse alone can file a joint return as long as he or she hasn't remarried before the end of the tax year. A spouse can file a joint return even if the appointment of an estate representative is expected. The representative may, once appointed, revoke the election to file jointly, though.

> **Technical Note:** If the surviving spouse is appointed representative, he or she files for the decedent as representative and not as surviving spouse.

Person in charge of decedent's property

If there is no court-appointed representative and no surviving spouse, a "person in charge of the decedent's property" must file the return. This "person" may be anyone in actual or constructive possession of the decedent's property. Generally, the heirs informally designate one person among the beneficiaries to act in this capacity. A person in charge of the decedent's property should only file the return if the estate won't require probate. If the return shows a refund, the person is required to verify on Form 1310 that a court hasn't and won't appoint a representative.

Declaring income in the year of death

The items you include in the final federal income tax return depend on whether the decedent was a cash or accrual method taxpayer. If the decedent used the cash method of accounting, you include items of income received before death, and deduct those expenses that the decedent paid before death. If he or she used the accrual method, then you include items accrued before death. You report any income after death on the estate's income tax return or on the tax return of the beneficiary who received it directly.

An incorrect Form 1099

If the decedent's Form 1099 reflects income both prior to and after death, you should request and obtain a corrected 1099. If you cannot obtain one, report the income as nominee interest or dividends. List the entire income from the 1099 on Schedule B. On a separate line, subtract the amount attributable to the estate or other beneficiary. Label this subtraction "Nominee Distribution." Then, issue a Form 1099-INT or 1099-DIV to the estate or beneficiaries. Also, file Forms 1099 and 1096 with the IRS.

Deductions, personal exemption, and credits

Itemized deductions

The general rule is that you handle deductions for a decedent the same way you handle them for living individuals. Deductions are allowed for items paid before the decedent's death that would have been deductible by the decedent as of the date of death (accrued before death for accrual method taxpayers). The following exceptions apply:

- Medical costs paid by decedent's estate within one year of death--These medical costs can be deducted either on Schedule A of the decedent's Form 1040 or on the estate tax return. If they are to be deducted on the decedent's Form 1040, the deductions aren't automatically on the final 1040. Rather, you deduct each expense on the Form 1040 in the year the expense was incurred. This may require the filing of an amended federal income tax return on Form 1040X to deduct expenses incurred in an earlier taxable year. When such expenses are taken on Form 1040, you must attach a statement to the return stating that the expenses have not been and will not be claimed on an estate tax return.

Tip: A taxpayer who paid medical expenses for a deceased spouse or dependent can deduct the expenses in the year paid without attaching an election statement.

- Pension or annuity without a surviving annuitant--If the decedent was receiving a pension or annuity and some investment was lost because there was no surviving annuitant, you can deduct the lost investment as a miscellaneous itemized deduction not subject to the 2 percent adjusted gross income (AGI) limitation.

Technical Note: Funeral, probate, and other estate expenses may be deductible on one of the estate returns, but aren't deductible on the decedent's final Form 1040.

Standard deduction and personal exemption

The standard deduction and personal exemption generally can be claimed in full as if death hadn't occurred. A decedent can't use the standard deduction if the surviving spouse files separately and itemizes. In addition, a decedent can't claim the personal exemption if someone else can claim the decedent as a dependent.

Credits

You can claim, on the decedent's return, any credits that the decedent was eligible for before death. You may claim an earned income credit on behalf of a decedent, even if the decedent's return covers only part of a year and he or she wouldn't have qualified with a full year's income. A decedent's earned income credit is refundable if it exceeds the decedent's tax liability for the year.

Headings and signing the forms

Headings

Regardless of whether you file a joint return or a separate return for the decedent, you should write the following across the top of the tax return:

- "DECEASED"
- The decedent's name
- The date of death

If you file a joint return, write the names, address, and Social Security numbers of the decedent and surviving spouse in the space provided. If you file a separate return for the decedent, write the decedent's name in care of the person filing the form and that person's address.

Signing the forms

The following are the procedures for an estate representative, a surviving spouse, and a person in charge of a decedent's property:

- Estate representative--A court-appointed representative must sign the return and include his or her title. In the case of a joint return, the representative signs for the decedent and the surviving spouse signs, as usual, in the space for his or her signature. If the spouse is serving as the representative, he

or she should sign the return twice. Note that the surviving spouse shouldn't, in this circumstance, write the words "Filing as Surviving Spouse" on the signature line.

- Surviving spouse--A surviving spouse should first write "Filing as Surviving Spouse" in the space for the decedent's signature. He or she then signs in the space for his or her signature.

- Person in charge of a decedent's property--That person should sign his or her name followed by the words "Personal Representative."

Documents needed to claim a refund

If the tax return shows a refund, Form 1310 or other documentation may be required, depending on who files and signs the return. The following table outlines the required documentation in various circumstances:

Returns/Documents Required for Filing				
If the return is filed and signed by:		Then these documents are required to claim refund:		
Court-Appointed Representative	Surviving Spouse	Form 1310	Court Certificate	Death Certificate
Yes	Yes	No	Yes	No
Yes	No	No	Yes	No
No	Yes	No	No	No
No	No	Yes	No	Yes

Early filing

A decedent's Form 1040 must be filed on forms for the appropriate tax year and is due at the same time that the decedent's income tax return would have been due had death not occurred. The return can't be filed early so that the personal representative can be discharged and the probate estate closed.

Income in Respect of a Decedent

What is income in respect of a decedent (IRD)?

Income in respect of a decedent (IRD) is the gross income a deceased individual would have received had he or she not died and that has not been included on the deceased individual's final income tax return. If, like most people, the deceased individual was a cash basis taxpayer, IRD is income that the decedent earned but did not receive prior to death. IRD is reported on the recipient's income tax return in the year received. If IRD is paid to the decedent's estate, it is reported on the fiduciary return. If IRD is paid directly to a beneficiary, it is reported on the beneficiary's tax return.

Examples of IRD

IRD may include:

- The uncollected salaries, wages, bonuses, commissions, vacation pay, and sick pay of a cash basis employee
- Distributions from certain deferred compensation and stock option plans
- Taxable distributions from employer-sponsored retirement plans, including pension plans, profit-sharing plans, simplified employee pension plans (SEPs), and Keoghs
- Taxable distributions from individual retirement accounts (IRAs)
- Accounts receivable of a cash basis sole proprietor
- Interest and dividends accrued but unpaid at death of a cash basis taxpayer
- Gain from the sale of property if the sale is deemed to occur before death, but proceeds are not collected until after death
- Difference between the face amount and the decedent's basis in an installment sales obligation
- Distributive share of partnership items for the period before death for a partnership tax year that ends after death, unless the death causes the partner's tax year to close
- Death benefits received under a deferred annuity contract that are in excess of the owner-annuitant's investment in the annuity (if the owner-annuitant dies before the annuity start date)

Income tax deduction for estate taxes paid

IRD is included in the decedent's gross estate on Form 706 and may be subject to estate tax. As previously mentioned, income tax is also due on IRD when received by the estate or beneficiary. If estate tax is paid on IRD, however, an income tax deduction is allowed for the federal estate tax paid on the income.

> **Example(s):** Horatio's traditional IRA is valued at $200,000 at his death and consists entirely of deductible contributions. The $200,000 value of the IRA is included in his gross estate and subject to estate tax. With his other assets, Horatio's taxable estate exceeds the federal death tax exclusion amount. Horatio's daughter Guinevere is the designated beneficiary of his IRA and receives the IRA funds after his death. Distributions of the funds from Horatio's IRA are treated as income in respect of a decedent. Guinevere must report this income on her federal income tax return. Guinevere is allowed an income tax deduction for the estate taxes attributable to the IRA.

Tax Planning Tips: Life Insurance

Understanding the importance of life insurance is one thing. Understanding the tax rules is quite another. As insurance products have evolved and become more sophisticated, the line separating insurance vehicles from investment vehicles has grown blurry. To differentiate between the two, a mix of complex rules and exceptions now governs the taxation of insurance products. If you have neither the time nor the inclination to decipher the IRS regulations, here are some life insurance tax tips and background information to help you make sense of it all.

Life insurance contracts must meet IRS requirements

For federal income tax purposes, an insurance contract cannot be considered a life insurance contract--and qualify for favorable tax treatment--unless it meets state law requirements and satisfies the IRS's statutory definitions of what is or is not a life insurance policy. The IRS considers the type of policy, date of issue, amount of the death benefit, and premiums paid. The IRS definitions are essentially tests to ensure that an insurance policy isn't really an investment vehicle. The insurance company must comply with these rules and enforce the provisions.

Keep in mind that you can't deduct your premiums on your federal income tax return

Because life insurance is considered a personal expense, you can't deduct the premiums you pay for life insurance coverage.

Employer-paid life insurance may have a tax cost

The premium cost for the first $50,000 of life insurance coverage provided under an employer-provided group term life insurance plan does not have to be reported as income and is not taxed to you. However, amounts in excess of $50,000 paid for by your employer will trigger a taxable income for the "economic value" of the coverage provided to you.

You should determine whether your premiums were paid with pre- or after-tax dollars

The taxation of life insurance proceeds depends on several factors, including whether you paid your insurance premiums with pre- or after-tax dollars. If you buy a life insurance policy on your own or through your employer, your premiums are probably paid with after-tax dollars.

Different rules may apply if your company offers the option to purchase life insurance through a qualified retirement plan and you make pretax contributions. Although pretax contributions offer certain income tax advantages, one tradeoff is that you'll be required to pay a small tax on the economic value of the "pure life insurance" in the policy (i.e., the difference between the cash value and the death benefit) each year. Also, at death, the amount of the policy cash value that is paid as part of the death benefit is taxable income. These days, however, not many companies offer their employees the option to purchase life insurance through their qualified retirement plan.

Your life insurance beneficiary probably won't have to pay income tax on death benefit received

Whoever receives the death benefit from your insurance policy usually does not have to pay federal or state income tax on those proceeds. So, if you die owning a life insurance policy with a $500,000 death benefit, your

beneficiary under the policy will generally not have to pay income tax on the receipt of the $500,000. This is generally true regardless of whether you paid all of the premiums yourself, or whether your employer subsidized part or all of the premiums under a group term insurance plan.

Different income tax rules may apply if the death benefit is paid in installments instead of as a lump sum. The interest portion (if any) of each installment is generally treated as taxable to the beneficiary at ordinary income rates, while the principal portion is tax free.

In some cases, insurance proceeds may be included in your taxable estate

If you hold any incidents of ownership in an insurance policy at the time of your death, the proceeds from that insurance policy will be included in your taxable estate. Incidents of ownership include the right to change the beneficiary, the right to take out policy loans, and the right to surrender the policy for cash. Furthermore, if you gift away an insurance policy within three years of your death, then the proceeds from that policy will be pulled back into your taxable estate. To avoid having the policy included in your taxable estate, someone other than you (e.g., a beneficiary or a trust) should be the owner.

Note: If the owner, the insured, and the beneficiary are three different people, the payment of death benefit proceeds from a life insurance policy to the beneficiary may result in an unintended taxable gift from the owner to the beneficiary.

If your policy has a cash value component, that part will accumulate tax deferred

Unlike term life insurance policies, some life insurance policies (e.g., permanent life) have a cash value component. As the cash value grows, you may ultimately have more money in cash value than you paid in premiums. Generally, you are allowed to defer income taxes on those gains as long as you don't sell, withdraw from, or surrender the policy. If you do sell, surrender, or withdraw from the policy, the difference between what you get back and what you paid in is taxed as ordinary income.

You usually aren't taxed on dividends paid

Some policies, known as participating policies, pay dividends. An insurance dividend is the amount of your premium that is paid back to you if your insurance company achieves lower mortality and expense costs than it expected. Dividends are paid out of the insurer's surplus earnings for the year. Regardless of whether you take them in cash, keep them on deposit with the insurer, or buy additional life insurance within the policy, they are considered a return of premiums. As long as you don't get back more than you paid in, you are merely recouping your costs, and no tax is due. However, if you leave these dividends on deposit with your insurance company and they earn interest, the interest you receive should be included as taxable interest income.

Watch out for cash withdrawals in excess of basis--they're taxable

If you withdraw cash from a cash value life insurance policy, the amount of withdrawals up to your basis in the policy will be tax free. Generally, your basis is the amount of premiums you have paid into the policy less any dividends or withdrawals you have previously taken. Any withdrawals in excess of your basis (gain) will be taxed as ordinary income. However, if the policy is classified as a modified endowment contract (MEC) (a situation that occurs when you put in more premiums than the threshold allows), then the gain must be withdrawn first and taxed.

Keep in mind that if you withdraw part of your cash value, the death benefit available to your survivors will be reduced.

You probably won't have to pay taxes on loans taken against your policy

If you take out a loan against the cash value of your insurance policy, the amount of the loan is not taxable (except in the case of an MEC). This result is the case even if the loan is larger than the amount of the premiums you have paid in. Such a loan is not taxed as long as the policy is in force.

If you take out a loan against your policy, the death benefit and cash value of the policy will be reduced.

You can't deduct interest you've paid on policy loans

The interest you pay on any loans taken out against the cash value of your life insurance is not tax deductible. Certain loans on business-owned policies are an exception to this rule.

The surrender of your policy may result in taxable gain

If you surrender your cash value life insurance policy, any gain on the policy will be subject to federal (and possibly state) income tax. The gain on the surrender of a cash value policy is the difference between the gross cash value paid out (plus any loans outstanding) and your basis in the policy. Your basis is the total premiums that you paid in cash, minus any policy dividends and tax-free withdrawals that you made.

You may be able to exchange one policy for another without triggering tax liability

The tax code allows you to exchange one life insurance policy for another (or a life insurance policy for an annuity) without triggering current tax liability. This is known as a Section 1035 exchange. However, you must follow the IRS's rules when making the exchange.

When in doubt, consult a professional

The tax rules surrounding life insurance are obviously complex and are subject to change. For more information, contact a qualified insurance professional, attorney, or accountant.

Tax Planning Tips: Disability Insurance

The income you receive from disability income insurance may or may not be taxable. The taxability of disability income insurance benefits depends on what type of benefits you receive, whether the premiums were paid with pretax or after-tax dollars, and who paid the premiums (you or your employer).

Individual disability income insurance

The rules surrounding taxation of individual disability income insurance benefits are generally simple. Because you pay the premiums with after-tax dollars, the benefits you receive are tax free. However, unlike health insurance premiums, you can't deduct premiums paid for individual disability income insurance as a medical expense.

Sometimes, your employer pays for an individual disability insurance policy on you. This may be the case if you are considered to be a key employee of the business. If so, different rules may apply. If the employer gets the benefit, then the premium is not deductible to the company, and the benefit is not taxable when received by the company.

Employer-sponsored group disability insurance

If you are enrolled in a group disability insurance plan sponsored by your employer, the taxability of your benefits depends on who pays the premium. If you pay the total premium using after-tax income, then your benefits will be tax free. On the other hand, if your employer pays the total premium and does not include the cost of coverage in your gross income, then your benefits will be taxable.

If your employer pays part of the insurance premium and you pay the rest, then your tax liability will be split as well. The part of the benefit you receive that is related to the employer-paid share of the premium is taxable; any part of the benefit related to your share of the premium is tax free.

If you pay part of the premium for employer-sponsored disability coverage, the type of dollars you use to pay the premium determines whether your benefit will be taxable. If you pay your part of the premium with pretax dollars, through a cafeteria or medical reimbursement plan, you'll owe income tax on any disability benefit you receive that is related to that part of the premium. On the other hand, if you pay your part of the premium with after-tax dollars, you won't owe income tax on any disability benefit you receive that is related to that part of the premium.

Benefits under a cafeteria plan

An employer-sponsored cafeteria plan allows you to select among certain employee benefits, including health, life, and disability insurance. You normally pay for these benefits on a pretax basis. Sometimes, however, your employer pays the premium for the benefits you choose (up to a certain amount), and if you choose additional benefits, you pay for extra coverage using either pretax or after-tax dollars.

If you pay your share of the premium with after-tax dollars, that portion of your disability benefits will be considered tax-free income; you'll be taxed only on the portion of the benefit related to your employer's contribution. However, if you pay your share with pretax dollars, that portion of your disability benefits will be considered taxable income, and you'll have to pay income tax on all of your benefit.

If you are totally and permanently disabled, and you receive fully or partially taxable disability benefits from an employer-sponsored disability insurance plan, you may be eligible to claim a tax credit when you file your annual income tax return.

Group association disability insurance

Disability policies purchased through an association are called group policies because members of the association are offered special terms, conditions, and rates based on the characteristics of that group. Association policies function much like individual policies and have similar tax consequences. If you pay the premiums for an association policy, the benefits you receive are tax free, but you cannot deduct the cost of the premiums.

Government disability insurance

All, part, or none of the disability benefits you receive through government disability insurance programs may be taxable. How much of the benefit is taxable (and under what circumstances) depends on the type of government disability benefit you are receiving:

Social Security benefits: If the only income you had during the year was Social Security disability income, your benefit usually isn't taxable. However, if your total income exceeds a certain base amount and you earned other income during the year (or had substantial investment income), then you might have to pay tax on part of your benefit. More specifically, your Social Security benefit is taxable if your modified adjusted gross income plus one-half of your Social Security benefit exceeds the base amount for your filing status.

Medicare benefits: When you are disabled, you may be eligible to enroll in Medicare. If you pay premiums for the medical insurance portion of Medicare, you may deduct these premiums as a medical expense (provided, of course, that your medical expenses exceed 7.5 percent of your adjusted gross income). In addition, Medicare benefits you receive are not taxable.

Workers' compensation: Generally, if you receive a disability benefit from workers' compensation, that benefit won't be taxable. Any benefits paid to your survivors would also be tax exempt. However, in certain cases, you may be able to return to work and continue to receive payments. If this is the case, then your workers' compensation benefit would be taxable. Note, though, that if part of your workers' compensation benefit offsets (reduces) your Social Security benefit, then that part is considered to be a Social Security benefit. It may then be taxable according to the rules governing Social Security.

Veterans benefits: Disability benefits you receive from the Department of Veterans Affairs, formerly known as the Veterans Administration, are not taxable, except for certain payments for rehabilitative services.

Military benefits: Most military disability pensions are taxable. However, if you were disabled due to injury or illness resulting from active service in the armed forces of any country, your disability benefits may be tax free under certain conditions.

Federal employees retirement system (FERS) benefits: If you retire on disability, the payments under FERS that you receive from a pension or annuity are taxable as wages until you reach minimum retirement age. Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension.

Is it wiser to buy disability coverage with pretax or after-tax dollars?

If you pay for disability income insurance with pretax dollars, you are (in effect) reducing your taxable income. This means that you won't have income taxes withheld on the portion of your income you used to pay your disability income insurance premium. However, you also have to consider how your benefit would be taxed if you ever begin receiving disability benefits. If you use pretax dollars to pay your insurance premium, then your benefit would be fully taxable. However, if you use after-tax dollars, your benefit won't be taxable.

It comes down to this: If you never use your disability benefits, you'll save money by paying your premiums with pretax dollars. But if you do use your disability benefits, using after-tax dollars to pay your premiums places you in a better position. Consult your tax professional for advice.

Tax Tips: Health Insurance

Your health insurance coverage probably came in handy several times over the past year. It all seemed so simple at the time--you paid a deductible, and your insurance usually kicked in the rest. But what do you do at tax time? Just what are you taxed on, and what can you deduct on your federal income tax return?

Your income taxes may be affected by two aspects of your health insurance plan--the premiums and the benefits. Here's what you need to know.

You don't include employer-paid premiums in your income

For tax purposes, you can generally exclude from your income any health insurance premiums (including Medicare) paid by your employer. The premiums can be for insurance covering you, your spouse, and any dependents. It doesn't matter whether the premiums paid for an employer-sponsored group policy or an individual policy. You can even exclude premiums that your employer pays when you are laid off from your job.

What if your employer reimburses you for your premiums?

If you pay the premiums on your health insurance policy and receive a reimbursement from your employer for those premiums, the amount of the reimbursement is not taxable income. However, if your employer simply pays you a lump sum that may be used to pay health insurance premiums but is not required to be used for this purpose, that amount is taxable.

In most cases, you won't be able to deduct the premiums you pay

The deductibility of health insurance premiums follows the rules for deducting medical expenses. Usually, the premiums you pay on an individual health insurance policy won't be deductible. However, if you itemize deductions on Schedule A, and your unreimbursed medical expenses exceed 7.5 percent of your adjusted gross income (AGI) in any tax year, you may be able to take a deduction. You can deduct the amount by which your unreimbursed medical expenses exceed this 7.5 percent threshold.

For example, if your AGI is $100,000, then 7.5 percent of your AGI is $7,500. If your unreimbursed medical expenses amount to $8,000 and you itemize deductions, you'll be able to deduct $500 worth of your expenses.

Unreimbursed medical expenses include premiums paid for major medical, hospital, surgical, and physician's expense insurance, and amounts paid out of your pocket for treatment not covered by your health insurance.

If you're self-employed, special deduction rules may apply

In addition to the general rule of deducting premiums as medical expenses, self-employed individuals can deduct a percentage of their health insurance premiums as business expenses. These deductions aren't limited to amounts over 7.5 percent of AGI, as are medical expense deductions. They are limited, though, to amounts less than an individual's earned income. The definition of self-employed individuals includes sole proprietors, partners, and 2 percent S corporation shareholders.

If you qualify, you can deduct 100 percent of the cost of health insurance that you provide for yourself, your spouse, and your dependents. This deduction is taken on the front of your federal Form 1040; the portion of your health insurance premiums that is not deductible there can be added to your total medical expenses itemized in Schedule A.

Your health insurance benefits typically aren't taxable

Whether we're talking about an employer-sponsored group plan or a health insurance policy you bought on your own, you generally aren't taxed on the health insurance benefits you receive.

What about reimbursements for medical care? You can generally exclude from income reimbursements for hospital, surgical, or medical expenses that you receive from your employer's health insurance plan. These reimbursements can be for your own expenses or for those of your spouse or dependents. The exclusion applies regardless of whether your employer provides group or individual insurance, or serves as a self-insurer. The reimbursements can be for actual medical care or for insurance premiums on your own health insurance.

Note that there is no dollar limit on the amount of tax-free medical reimbursements you can receive in a year. However, if your total reimbursements for the year exceed your actual expenses, and your employer pays for all or part of your health insurance premiums, you may have to include some of the excess in your income.

Viatical Settlements

A viatical settlement is the sale of a life insurance policy by an individual who is terminally ill. The individual sells the policy to a third party (often a viatical settlement funding company) that pays the individual a lump-sum cash payment that is a percentage of the face value of the policy, usually 40 to 85 percent. Terminally ill individuals may wish to sell their life insurance policies in order to use the money in advance of their death rather than leave it directly to a beneficiary. For instance, you may want to sell your life insurance policy in order to have money to pay for living expenses, to pay for medical care, or to experience the joy of using or giving away the money before you die.

Who can sell a life insurance policy?

Selling your life insurance policy means selling your rights and obligations under the policy to the funding company. Most viatical settlement funding companies buy policies only from individuals who are terminally ill. In general, you must have a life expectancy of less than four years in order to be eligible to sell your policy, although some companies buy policies only from individuals whose life expectancy is less than 24 months. However, a few companies have begun to purchase life insurance policies from elderly individuals who are not terminally ill.

Who can buy a life insurance policy?

Life insurance policies are usually purchased by viatical settlement funding companies or providers. These companies are sometimes financed by investors or by loans from financial institutions. According to the Internal Revenue Code, a viatical settlement provider is a person who, as a business, regularly purchases or takes assignments of life insurance contracts. The viatical settlement funding company that purchases your policy will make money by receiving the full value of your policy when you die, even though it paid you only a percentage of the face value.

Once you sell your policy, the viatical settlement funding company will normally pay your policy premiums, which may cut into the company's profit margin. However, to compensate for this, viatical settlement funding companies will give you less money for your policy than your beneficiaries would otherwise receive.

How much will you receive for your policy?

Normally you will receive between 40 and 85 percent of the face value of your policy. How much you actually receive, however, depends on several factors, including the face value of the policy, how much the viatical settlement company will have to spend to continue paying your insurance premiums, and your projected life expectancy. Normally, the longer your life expectancy, the less you will receive.

How do you choose a viatical settlement company or provider?

Viatical settlement companies or providers are usually registered with or licensed by the state department of insurance, although many states do not require viatical settlement companies or providers to be licensed. Before doing business with a viatical settlement company or provider, determine whether the company is licensed or registered to do business in your state, and what your state's requirements are. This is important because whether the company or provider is licensed or registered plays a part in determining whether the proceeds paid to you from the sale of your policy will be tax free. Also, find out whether you will have to pay any additional fees (e.g., attorney's fees) after your policy is purchased, and make sure that once you sell your policy, funds owed to you will be kept in an escrow account for you until you receive them (it may take a few weeks to complete the transaction).

Should you sell your life insurance policy?

Selling your life insurance policy is a personal decision, and there is no single right decision for everyone. However, here are some factors to consider:

- What are the potential income tax consequences of selling the policy?
- Will selling your policy for less than face value adversely affect your survivors? Would they be better off receiving the full amount of the policy after your death?
- Are there any other sources of funds you could use to fund your wants and needs?
- Under the terms of your insurance contract, do you have options other than selling your policy? For instance, can you borrow against the policy cash value? Does the policy include an accelerated death benefit rider or a living benefit rider?

Income tax considerations

In general, if you are terminally ill (you have a life expectancy of 24 months or less), funds you receive from a viatical settlement are free from federal income tax. If you are chronically ill rather than terminally ill, funds you receive from a viatical settlement company are free from federal income tax, provided the funds are used to pay for qualified long-term care services. In either case, for the money you receive to be tax free, the viatical settlement company must be licensed or registered with the state in which you reside (Internal Revenue Code Section 101(g)). If licensing or registration is not required by your state, then the viatical settlement company must meet certain requirements in the Viatical Settlements Model Act issued by the National Association of Insurance Commissioners. Check with a tax professional for further information.

Gift and Estate Taxes

If you give away money or property during your life, those transfers may be subject to federal gift tax and perhaps state gift tax. The money and property you own when you die (i.e., your estate) may also be subject to federal estate taxes and some form of state death tax. You should understand these taxes and when they do and do not apply, especially since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act). This law contains several changes that are complicated and uncertain, making estate planning all the more difficult.

Federal gift tax and federal estate tax--background

Under pre-2001 Tax Act law, no gift tax or estate taxes were imposed on the first $675,000 of combined transfers (those made during life and those made at death). The tax rate tables were unified into one--that is, the same rates applied to gifts made and property owned by persons who died in 2001. Like income tax rates, gift and estate tax rates were graduated. Under this unified system, the recipient of a lifetime gift received a carryover basis in the property received, while the recipient of a bequest, or gift made at death, got a step-up in basis (usually fair market value on the date of death of the person who made the bequest or gift).

The law substantially changed this tax regime.

Federal gift tax

The 2001 Tax Act increased the applicable exclusion amount for gift tax purposes to $1 million. The top gift tax rate is 45 percent in 2009 and 35 percent in 2010 (the top marginal income tax rate in 2010 under the 2001 Tax Act). In 2011, the gift tax rates revert to pre-2001 Tax Act levels. The carryover basis rules remain in effect.

However, many gifts can still be made tax free, including:

- Gifts to your U.S. citizen spouse (you may give up to $133,000 in 2009 tax free to your noncitizen spouse)
- Gifts to qualified charities
- Gifts totaling up to $13,000 (in 2009) to any one person or entity during the tax year, or $26,000 if the gift is made by both you and your spouse (and you are both U.S. citizens)
- Amounts paid on behalf of any individual as tuition to an educational organization or to any person who provides medical care for an individual

State gift tax may also be owed if you are a resident of Connecticut, Louisiana, North Carolina, Tennessee, or Puerto Rico.

Federal estate tax

Under the 2001 Tax Act, the applicable exclusion amount for estate tax purposes is $3.5 million in 2009 (the applicable exclusion amount for gift tax purposes remains fixed at $1 million). The top estate tax rate is 45 percent in 2009. The estate tax (but not the gift tax) is repealed in 2010, but the estate tax applicable exclusion amount and rates revert to pre-2001 Tax Act levels in 2011.

When the estate tax is repealed in 2010, the basis rules will be changed to those similar to the gift tax basis rules. The step-up in basis rules return in 2011.

Federal generation-skipping transfer tax

The federal generation-skipping transfer tax (GSTT) taxes transfers of property you make, either during life or at death, to someone who is two or more generations below you, such as a grandchild. The GSTT is imposed in addition to, not instead of, federal gift tax or federal estate tax. You need to be aware of the GSTT if you make cumulative generation-skipping transfers in excess of the GSTT exemption, which is $3.5 million (in 2009). A flat tax equal to the highest estate tax bracket in effect in the year you make the transfer is imposed on every transfer you make after your exemption has been exhausted.

Some states also impose their own GSTT.

Note: The GSTT exemption is the same amount as the applicable exclusion amount for estate tax purposes.

State death taxes

The three types of state death taxes are estate tax, inheritance tax, and credit estate tax, which is also known as a sponge tax or pickup tax.

Life Insurance and Charitable Giving

Life insurance can be an excellent tool for charitable giving. Not only does life insurance allow you to make a substantial gift to charity at relatively little cost to you, but you may also benefit from tax rules that apply to gifts of life insurance.

Why use life insurance for charitable giving?

Life insurance allows you to make a much larger gift to charity than you might otherwise be able to afford. Although the cost to you (your premiums) is relatively small, the amount the charity will receive (the death benefit) can be quite substantial. As long as you continue to pay the premiums on the life insurance policy, the charity is guaranteed to receive the proceeds of the policy when you die. (Guarantees are subject to the claims-paying ability of the issuing insurance company.) Since life insurance proceeds paid to a charity are not subject to income and estate taxes, probate costs, and other expenses, the charity can count on receiving 100 percent of your gift.

Giving life insurance to charity also has certain income tax benefits. Depending on how you structure your gift, you may be able to take an income tax deduction equal to your basis in the policy or its fair market value (FMV), and you may be able to deduct the premiums you pay for the policy on your annual income tax return. When an insurance contract is transferred to a charity, the donor's income tax charitable deduction is based on the lesser of FMV or adjusted cost basis.

What are the disadvantages of using life insurance for charitable giving?

Donating a life insurance policy to charity (or naming the charity as beneficiary on the policy) means that you have less wealth to distribute among your heirs when you die. This may discourage you from making gifts to charity. However, this problem is relatively simple to solve. Buy another life insurance policy that will benefit your heirs instead of a charity.

Ways to give life insurance to charity

The simplest way to use life insurance to give to a charity is to name a charity to receive the benefits of your life insurance policy. You, as owner of the policy, simply designate the charity as beneficiary. Designating the charity as beneficiary may allow you to make a larger gift than you could otherwise afford. If the policy is a form of cash value life insurance, you still have access to the cash value of the policy during your lifetime. However, this type of charitable gift does not provide many of the income tax benefits of charitable giving, because you retain control of the policy during your life. When you die, the proceeds are included in your gross estate, although the full amount of the proceeds payable to the charity can be deducted from your gross estate.

Another alternative is to donate an existing life insurance policy to charity. To do this, you must assign all rights in the policy to the charity. You must also deliver the policy itself to the charity. By doing this, you give up all control of the life insurance policy forever. This strategy provides the full tax advantages of charitable giving because the transfer of ownership is irrevocable. You may be able to take an income tax deduction equal to the lesser of your adjusted cost basis or FMV. The policy is not included in your gross estate when you die, unless you die within three years of the transfer. In this case, your estate would get an offsetting charitable deduction.

A creative way to use life insurance to donate to a charity is simply for the charity to insure you. To use this strategy, you would allow the charity to purchase an insurance policy on your life. You would make annual tax-deductible gifts to the charity in an amount equal to the premium, and the charity would pay the premium to the insurance company.

One final method is to use a life insurance policy in conjunction with a charitable remainder trust. This strategy is relatively complex (it will require an attorney to set up), but it provides greater advantages than other, simpler methods. You set up a charitable remainder trust and transfer ownership of other, income-producing assets to the

trust. The income beneficiary of the trust (you or whomever you designate) will get the income from the assets in the trust. At the end of the trust term (which might be a certain number of years or upon the occurrence of a certain event, such as your death), the property in the trust would pass to the charity. You'll receive a current tax deduction when you establish the trust for the FMV of the gifted assets, reduced according to a formula determined by the IRS. Life insurance can then be purchased (usually inside an irrevocable life insurance trust to keep the proceeds out of your estate) to replace the assets that went to the charity instead of to your heirs.

Choosing an Income Tax Filing Status

Selecting a filing status is one of the first decisions you'll make when you fill out your federal income tax return, so it's important to know the rules. And because you may have more than one option, you need to know the advantages and disadvantages of each. Making the right decision about your filing status can save money and prevent problems with the IRS down the road.

The five filing statuses and how they affect your tax liability

Your filing status is especially important because it determines, in part, the tax rate applied to your taxable income, the amount of your standard deduction, and the types of deductions and credits available. By choosing the right filing status, you can minimize your taxes.

The five filing statuses are unmarried, married filing jointly, married filing separately, head of household, and qualifying widow(er) with dependent child. There are six income tax brackets. Your tax rate depends on your filing status and the amount of your taxable income. For example, if you're unmarried and your taxable income is more than $8,350 but not more than $33,950 (in 2009), it's taxed at 15 percent. If you're a head of household filer, though, your taxable income can climb to $45,500 and still be taxed at 15 percent. So, it's clear that some filing statuses are more beneficial than others.

Although you'll generally want to choose whichever filing status minimizes your taxes, other considerations (such as a pending divorce) may also come into play.

You're unmarried if you're unmarried or legally separated from your spouse on the last day of the year

This one's pretty straightforward. And, depending on your circumstances, it may be your only option. Your filing status is determined as of the last day of the tax year (December 31). To use the unmarried status, you must be unmarried or separated from your spouse by either divorce or a written separate maintenance decree on the last day of the year. Unfortunately, you jump into a higher tax bracket more quickly with the unmarried status than with some of the other filing statuses.

Married filing jointly often results in tax savings for married couples

You may file jointly if, on the last day of the tax year, you are:

- Married and living together as husband and wife
- Married and living apart, but not legally separated under a divorce decree or separate maintenance agreement, or
- Separated under an interlocutory (i.e., not final) decree of divorce

Also, you are considered married for the entire tax year for filing status purposes if your spouse died during the tax year.

When filing jointly, you and your spouse combine your income, exemptions, deductions, and credits. Filing jointly generally offers the most tax savings for married couples. For one thing, there are many credits that you can take if you file a joint return that you can't take if you file married filing separately. These include the child and dependent care credit, the adoption expense credit, the Hope credit (renamed the American Opportunity credit for 2009 and 2010), and the Lifetime Learning credit.

Still, this filing status is not always the most advantageous. If your spouse owes certain debts (including

defaulted student loans and unpaid child support), the IRS may divert any refund due on your joint tax return to the appropriate agency. To get your share of the refund, you'll have to file an injured spouse claim and probably have to jump through hoops. You can avoid the hassle by filing a separate return.

You don't have to be separated to choose married filing separately

You and your spouse can choose to file separately if you're married as of the last day of the tax year. Here, you'd report only your own income and claim only your own deductions and credits. Filing separately may be wise if you want to be responsible only for your own tax. With a joint return, by comparison, each spouse is jointly and individually liable for the full amount of the tax due. So, if your spouse skips town, you'd be left holding the tax bag unless you qualified as an innocent spouse.

Filing separately might also be the best tax move if one spouse has significant medical expenses or miscellaneous itemized deductions. Your ability to take these deductions is tied in to the level of your adjusted gross income (AGI). For example, medical expenses are deductible only if they exceed 7.5 percent of AGI. By filing separately, the AGI for each spouse is reduced. Keep in mind that if you and your spouse file separately and your spouse itemizes deductions, you'll have to do the same.

Remember, though, that you won't qualify for certain credits (such as the child and dependent care tax credit) and can't take certain deductions if you file separately. For example, you cannot deduct qualified education loan interest if you're married, unless you file a joint return.

Head of household status offers certain income tax advantages

Those who qualify for the head of household filing status get special tax treatment. Not only are the tax rates lower for head of household filers than for unmarried filers and married filing separately filers, but the standard deduction is larger as well. However, you'll have to satisfy the following requirements:

- Generally, you should be unmarried at the end of the year (unless you live apart from your spouse and meet certain tests)
- You must maintain a household for your child, dependent parent, or other qualifying dependent relative
- The household must be your home and generally must also be the main home of a qualifying relative for more than half of the year
- You must provide more than half the cost of maintaining the household
- You must be a U.S. citizen or resident alien for the entire tax year

Qualifying widow(er) with dependent child offers the advantages of a joint return

You may be able to select the qualifying widow(er) with dependent child filing status if your spouse died recently. This status allows you to use joint tax rates and offers the highest possible standard deduction, the one applicable to joint tax returns. To qualify, you must satisfy all of the following conditions:

- Your spouse died either last tax year or the tax year before that
- You qualified to file a joint return with your spouse for the year he or she died
- You have not remarried before the end of the tax year
- You have a qualifying dependent child
- You provide over half the cost of keeping up a home for yourself and your qualifying child

As you can see, choosing the correct filing status is not always easy. You might want to speak with a professional tax preparer or consult IRS Publication 17 for more information.

Organizing Your Finances When Your Spouse Has Died

Losing a spouse is a stressful transition. And the added pressure of having to settle the estate and organize finances can be overwhelming. Fortunately, there are steps you can take to make dealing with these matters less difficult.

Notify others

When your spouse dies, your first step should be to contact anyone who is close to you and your spouse, and anyone who may help you with funeral preparations. Next, you should contact your attorney and other financial professionals. You'll also want to contact life insurance companies, government agencies, and your spouse's employer for information on how you can file for benefits.

Get advice

Getting expert advice when you need it is essential. An attorney can help you go over your spouse's will and start estate settlement procedures. Your funeral director can also be an excellent source of information and may help you obtain copies of the death certificate and applications for Social Security and veterans benefits. Your life insurance agent can assist you with the claims process, or you can contact the company's policyholder service department directly. You may also wish to consult with a financial professional, accountant, or tax advisor to help you organize your finances.

Locate important documents and financial records

Before you can begin to settle your spouse's estate or apply for insurance proceeds or government benefits, you'll need to locate important documents and financial records (e.g., birth certificates, marriage certificates, life insurance policies). Keep in mind that you may need to obtain certified copies of certain documents. For example, you'll need a certified copy of your spouse's death certificate to apply for life insurance proceeds. And to apply for Social Security benefits, you'll need to provide birth, marriage, and death certificates.

Set up a filing system

If you've ever felt frustrated because you couldn't find an important document, you already know the importance of setting up a filing system. Start by reviewing all important documents and organizing them by topic area. Next, set up a file for each topic area. For example, you may want to set up separate files for estate records, insurance, government benefits, tax information, and so on. Finally, be sure to store your files in a safe but readily accessible place. That way, you'll be able to locate the information when you need it.

Set up a phone and mail system

During this stressful time, you probably have a lot on your mind. To help you keep track of certain tasks and details, set up a phone and mail system to record incoming and outgoing calls and mail. For phone calls, keep a sheet of paper or notebook by the phone and write down the date of the call, the caller's name, and a description of what you talked about. For mail, write down whom the mail came from, the date you received it, and, if you sent a response, the date it was sent.

Also, if you don't already have one, make a list of the names and phone numbers of organizations and people you might need to contact, and post it near your phone. For example, the list may include the phone numbers of your attorney, insurance agent, financial professionals, and friends--all of whom you can contact for advice.

Evaluate short-term income and expenses

When your spouse dies, you may have some immediate expenses to take care of, such as funeral costs and any outstanding debts that your spouse may have incurred (e.g., credit cards, car loan). Even if you are expecting money from an insurance or estate settlement, you may lack the funds to pay for those expenses right away. If that is the case, don't panic--you have several options. If your spouse had a life insurance policy that named you as the beneficiary, you may be able to get the life insurance proceeds within a few days after you file. And you can always ask the insurance company if they'll give you an advance. In the meantime, you can use credit cards for certain expenses. Or, if you need the cash, you can take out a cash advance against a credit card. Also, you can try to negotiate with creditors to allow you to postpone payment of certain debts for 30 days or more, if necessary.

Avoid hasty decisions

- Don't think about moving from your current home until you can make a decision based on reason rather than emotion.
- Don't spend money impulsively. When you're grieving, you may be especially vulnerable to pressure from salespeople.
- Don't cave in to pressure to sell or give away your spouse's possessions. Wait until you can make clear-headed decisions.
- Don't give or loan money to others without reviewing your finances first, taking into account your present and future needs and obligations.

How will estate taxes be paid if I leave no provision in my will?

Question:

How will estate taxes be paid if I leave no provision in my will?

Answer:

The IRS places an automatic lien against your estate for any estate taxes that may be due. If your will leaves no specific provision about how these taxes are to be paid, state law generally controls how the burden of paying the taxes will be distributed among your beneficiaries. As a result, your beneficiaries may end up paying taxes out of their own pockets or selling some of the property that you left to them to meet this obligation.

Most state apportionment statutes impose the tax payment liability only on those assets that contributed to the tax imposed. Thus, your spouse will not be responsible for any taxes if he or she received all your property free of tax under the unlimited marital deduction. Likewise, charities that received property free of tax under the charitable deduction will not have to carry any of the tax burden.

In addition, most state apportionment acts divide up the tax burden on a prorated basis. For example, if your taxable estate was evenly split between two beneficiaries, each beneficiary would be responsible for 50 percent (one-half) of the taxes due. Beneficiaries who received the taxable portion of your estate must pay their share of the taxes owed when they are due--generally nine months from the date of your death. They may have to sell their inheritances to get the cash. If their inheritances are already spent, however, they still must pay the taxes, and the IRS can go after any of their other assets to satisfy the lien.

Is it possible to name a charity as the beneficiary of my life insurance policy?

Question:

Is it possible to name a charity as the beneficiary of my life insurance policy?

Answer:

Yes, you can name a charity as your beneficiary. After you die, the charity will receive the death benefits from your life insurance policy just as any other beneficiary would.

You won't have to worry about gift taxes, and although the policy proceeds will be included in your taxable estate, you'll get an offsetting estate tax charitable deduction. On the downside, though, you won't be able to deduct your insurance premium payments (as a charitable income tax deduction) on your federal income tax return.

There are other ways you can help your favorite charity while still deriving an income tax benefit. For example, if you own an existing insurance policy on your life, you can donate the policy to a charity. You'd then make income-tax-deductible cash gifts to the charity, which the charity would use to continue the premium payments on the policy. You'd be eligible to claim an income tax deduction in the year of donation, for either the fair market value of the policy or your adjusted tax basis in it, whichever is less.

For information about other ways to help a charity while lowering your income taxes, speak with an attorney or tax advisor.

Will my beneficiaries have to pay taxes on the proceeds of my life insurance policy?

Question:

Will my beneficiaries have to pay taxes on the proceeds of my life insurance policy?

Answer:

If you mean the death benefits of the insurance policy, then these funds are generally free from income tax to your named beneficiary or beneficiaries.

You may elect to have the insurance company hold on to these proceeds after your death and distribute them to your beneficiary at a later date or in a series of installments. The funds that the insurer holds are earning interest, and when a payment is made to your beneficiary, it may include both principal and interest earned by that principal, or only interest. Although the principal portion of the payment is tax free, the interest portion is taxable to your beneficiary as ordinary income.

In some cases, if you transfer the ownership of your life insurance policy to another party before your death for monetary value or other consideration, the proceeds paid to the beneficiary at your death could be considered taxable income to that beneficiary. This is a complicated matter, and you should seek the assistance of a tax professional before completing the transaction.

The proceeds of your life insurance policy may be subject to federal estate taxes if you have what's known as incidents of ownership in the policy. If you control the policy in any way--that is, you can cancel it, surrender it, borrow against it, pledge or assign it, or can change the beneficiary--then you possess incidents of ownership in the policy, and the proceeds of the policy may be subject to federal estate taxes when you die. You might postpone these estate taxes if the proceeds of the policy are to go to your spouse, but the taxes might come due later when your spouse dies. Again, these issues are complicated; seek the advice of a qualified professional when planning your estate.

My spouse passed away this year. When I file my taxes, what filing status should I claim?

Question:

My spouse passed away this year. When I file my taxes, what filing status should I claim?

Answer:

As the surviving spouse, you have several filing choices that may be appropriate. You may be able to choose married filing jointly, married filing separately, qualifying widow(er), or head of household.

- Married filing jointly: You can usually file a joint return for the year your spouse died. Generally, you'll have to file in cooperation with the executor or administrator of your spouse's estate. If you remarry before year-end, you cannot file a joint return with your deceased spouse for that year.

- Married filing separately: To determine the most advantageous approach, you should figure taxes according to both the married filing jointly status and the married filing separately status.

- Qualifying widow(er): If you meet certain requirements (e.g., you support a dependent child for whom you can claim a tax exemption, and you have not remarried), you can file as a qualifying widow(er) in each of the two years following the year of your spouse's death. This status allows you to use the married filing jointly tax rates.

- Head of household: If you are ineligible to file jointly or as a qualifying widow(er), the head of household filing status may be possible. To qualify, you must provide support for a relative and meet several conditions.

Regardless of whether you file a joint return or a separate return for your spouse, you must write "DECEASED" across the top of the return, along with your spouse's name and date of death.

If you file a joint return and no personal representative has been appointed, write your (and your spouse's) name, address, and Social Security number in the regular name/address space at the top of the return. To sign the return, write "Filing as Surviving Spouse" in the space for your spouse's signature, then sign in the space for your own signature. If you are not filing a joint return, write your spouse's name at the top of the return and the personal representative's name and address in the remaining space. If a personal representative has been appointed, he or she must sign the return. Again, you must also sign if it is a joint return.

For additional details, consult a tax professional.

Anywhere Legal - The Virtual Law Firm
Bruce Glassman, JD, CPA/PFS
Attorney at Law
Jacksonville, FL
(904) 254-0504
webresponse@anywherelegal.com
http://www.anywherelegal.com

The hiring of a lawyer is an important decision which should not be based solely upon advertisements. This article presents general information and is not intended as legal advice, nor should you consider it as such. You should not act upon any information contained in this website without seeking professional advice.

Prepared by Forefield Inc. Copyright 2009 Forefield Inc.