



LEGAL HOTLINE FOR TEXANS

815 Brazos, Suite 1100, Austin, Texas 78701

(800) 622-2520 or (512) 477-3950

Pension Counseling (888) 343-4414

A FEW WORDS ABOUT TAXES

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The pamphlets of the Legal Hotline for Texans are general in nature and should not be relied on as advice for your particular circumstances. For advice that is specific to your particular circumstances, you should consult a lawyer.

The Legal Hotline for Texans (LHT) is a telephone hotline providing free legal advice and consultation and other free legal services to Texans Age 60 and Older or Eligible for Medicare; Crime Victims Age 60 and Older and their Family Members and Authorized Claimants; and Pension and Retirement Plan Employees, Participants and Beneficiaries.

Eligible Clients can consult with an attorney of the Legal Hotline for Texans free of charge by calling one of the phone numbers listed above. If clients would like to consult with an attorney in their communities, or if ongoing representation by an attorney is needed, the Legal Hotline for Texans may be able to make a referral. Depending on individual circumstances and local availability, such a referral may be to an organization providing free attorneys to low income persons, or may be to an attorney on the Legal Hotline for Texans' reduced-fee panel, or may be to a statewide or local lawyer referral service.

The Legal Hotline for Texans is a project of the Texas Legal Services Center with support from the Texas Department of Aging and Disability Services (DADS), the U.S. Centers for Medicare and Medicaid Services (CMS), the U.S. Administration on Aging (AoA), and the Texas Equal Access to Justice Foundation through the Texas Basic Civil Legal Services Program (BCLS) and the Texas Crime Victims Civil Legal Services Program (CVCLS).

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Tax Liabilities at Death

When a person dies (the decedent) and leaves property (the estate), that estate may be subject to several types of tax liabilities. The taxes owed may include income taxes, federal and state estate taxes, a gift tax and property taxes. The recent Economic Growth and Tax Relief Reconciliation Act of 2001 ultimately repeals the estate tax entirely in 2010. However, due to a sunset provision in the law, the estate tax will automatically revert in 2011 to the 2001 levels. Persons with large estates should consult an attorney specializing in estate tax planning to determine how these provisions affect their estate planning over the next few years and to determine whether provisions in their will should be re-written especially if there is a likelihood of death in the next few years.

INCOME TAXES

1. Personal Income Tax Return of Decedent

If the decedent's income during the year of his death was enough to require filing a personal income tax return for that year or a refund is due, a federal income tax return may need to be filed. The income tax return may be filed by the personal representative (executor or administrator of the estate) or the surviving spouse, (if the surviving spouse did not remarry within the year and if no executor or administrator has been appointed). If a personal representative has been appointed, then the administrator and the surviving spouse together can sign and file the joint return. In most cases, the decedent's final income tax return should be filed on or before April 15th of the year following the year of death. This should be done regardless of whether the return is joint or not. The decedent's income tax form is IRS 1040.

2. Fiduciary Income Tax

If the estate of the decedent had income of \$600 or more in a tax year, then a federal fiduciary income tax return must be filed. An estate is a taxable entity separate from the decedent, and it comes into being with the death of the decedent. It exists until the final distribution of the assets to the heirs and other beneficiaries are made. The estate's first tax year can be any period that ends on the last day of the month and does not exceed twelve months. The income tax is due by the 15th day of the 4th month following the close of the tax year. The fiduciary income tax is a **federal tax**.

The death of the decedent, for fiduciary income tax purposes, creates the estate. It is not necessary that an estate be opened in probate court to create an estate. For example, if a person dies and has a certificate of deposit in his or her own name, which does not mature for eighteen months, an estate has arisen and is earning income (the interest). If the interest earned during the estate's tax year is \$600 or more and that income is not paid or distributed directly to living individuals, even if the estate has no other income at all, a fiduciary income tax return is due; a fiduciary income tax is payable; and a tax year needs to be chosen.

For example, if a decedent died on March 14, leaving a certificate of deposit which matured in September of the year following his death and the certificate and other property generated \$600 or more of income, then a fiduciary income tax return will be due. The tax year

would start on March 15th in the year of death to February 28 of the following year. The tax would be due by the 15th of June of the following year.

A fiduciary income tax return may need to be filed and due even if the will has not yet been probated or there has been independent or dependent administration of the estate. Only the fiduciary files the return. The fiduciary is an executor, administrator, personal representative or person in possession of the decedent's estate.

In particular circumstances, there may be some advantages to filing a fiduciary income tax return. The beneficiaries of the estate may be in a high tax bracket, while the estate's income may consist of only interest and dividends and hence may be in a lower tax bracket. On the other hand, distributions may need to be made to the beneficiaries because the estate income tax rate is higher than the individual income tax rates. Beneficiaries who receive an income distribution also need to receive the IRS Schedule K-1 which is completed by the fiduciary of the estate.

The fiduciary income tax return is IRS Form 1041 which also contains instructions.

ESTATE TAXES

1. Federal Estate Taxes

When a decedent dies leaving a large estate, federal estate tax and state inheritance tax returns must be filed. The federal government applies an estate tax to the taxable estate at the time of death. The taxable estate is the value of the gross estate less the allowable deductions. On June 7, 2001 the Economic Growth and Tax Relief Reconciliation Act of 2001 was signed. This law made significant changes in the estate tax exemptions. Estates over the exemption must pay estate taxes. The new law sets the tax thresholds for estates as follows:

<u>Year of death</u>	<u>Estate Tax Exemption</u>
2004 and 2005	\$1.5 million
2006,2007,2008	\$2 million
2009	\$3.5 million.

By the year 2010 the estate tax is repealed. However, there is a sunset provision in the bills which means on January 1, 2011, the estate tax reverts back to the 2001 law. There will be no estate tax for persons dying between December 31, 2009 and December 31, 2010. From January 1, 2011 onward decedents' estates of \$1 million or greater will be required to pay estate taxes. Estate taxes are high. The estate and gift tax rate for estates over \$1 million in 2004 is 48%. The rate declines to 45% in 2009.

The taxable estate is the gross estate less allowable deductions. The size of the probate estate (that property which is transferred through the probate court) may be much smaller than the taxable gross estate. The gross estate includes the value of all the property in which the decedent had an interest at the time of death. The gross estate includes, but is not limited to:

1. Certain life insurance proceeds payable to the estate or, if the decedent owned the policy, to the heirs,
2. The value of certain annuities payable to the estate or heirs,

3. Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth (certain gifts)
4. One half the value of property owned by the husband and wife as joint tenants with right of survivorship, where the decedent and spouse are the only joint tenants.
5. Community property to the extent of the decedent's interest as defined by law.

The allowable deductions used in determining the taxable estate include:

1. Funeral expenses paid out of the estate, administration expenses
2. Debts owed at the time of death.
3. The marital deduction

An estate tax return IRS Form 706 must be filed by the executor if the gross estate, plus any adjustable taxable gifts and specific exemptions is more than the filing exemption at the time of death.

Information for the current year about estate taxes can be obtained from the IRS. Their website is www.irs.ustreas.gov. Publications entitled Introduction to Estate and Gift Taxes Publication 950 and instructions to Form 706 contain useful information. If the estate is complicated and large enough, a qualified estate tax professional should be consulted. The federal estate tax must be filed by the executor within nine months after the date of the decedent's death.

2. State Estate Tax

Texas also has an estate tax that is called the Inheritance Tax. Texas requires that the Inheritance Tax Return be filed regardless of whether tax is owed if the value of the gross estate equals or exceeds the amount required to file for the federal return. If an estate is small enough that no federal return is required to be filed, then the estate does not need to file a Texas Inheritance Tax Return. Texas Tax Code § 211.102 requires a Texas Inheritance Tax Return be filed with the Comptroller of Public Accounts along with any tax due, not later than nine months from the date of death, unless the Comptroller's office approves an extension of time to file and/or pay. An extension to file the inheritance tax return and/or pay the inheritance tax may be requested under Texas Tax Code § 211.103 if the estate is requesting the same extension from the Internal Revenue Service. The estate must send the Comptroller a copy of the federal extension Form 4768 along with a written request for an extension. If the I.R.S. grants an extension of time, the representative of the estate must notify the Texas Comptroller of Public Accounts within thirty (30) days. If an extension is denied by the I.R.S. or by the comptroller, the representative must go ahead and file a return using the best information available. To avoid penalties and interest, a Texas return should be filed no later than ten (10) days after the denial of an extension. Finally, within thirty (30) days after receiving the federal government's assessment of the value of the estate, the representative must notify the state comptroller of the federal assessment of the estate's value. The comptroller's office provides a form for making the report. The Comptroller of Public Accounts can be reached on the Internet at www.cpa.state.tx.us or 1-800-531-5441 (extension 5-0132).

The amount of credit for state inheritance taxes on federal estate taxes will be phased out by 2005 under the new Economic Growth and Reconciliation Act of 2001.

OTHER TAXES TO CONSIDER

1. Gift taxes

A gift tax is imposed upon the transfer of property to an individual. A gift is property given (including money, the use of property, or income from property) without expecting to receive something of at least equal value in return. Sale of property less than its full value or an interest free loan may qualify as a gift as well as the forgiveness of a debt. The general rule is that any gift is a taxable gift. Those gifts that are excluded in the rule:

1. Gifts of \$11,000 given to an individual in any taxable year
2. Certain tuition or medical expenses paid to an institution for the benefit of an individual
3. Gifts to your spouse
4. Gifts to a political organization for its use and gifts to charities.

The new Economic Growth and Tax Relief Reconciliation Act of 2001 also changed the gift tax rate, but did not eliminate the gift tax. Effective 2002 the gift tax exclusion over a lifetime is \$1,000,000. The gift tax will not be repealed. However, the rates will range from 41% up to 48% in 2004. A transfer to a trust will be counted as a taxable gift unless the trust is wholly owned by the donor or the donor's spouse under the provisions of the Tax Code.

For gifts over the allowable amount in any given year, IRS Form 709 must be filed.

Prior to transferring large sums of money or as a gift, it is advisable to consult with an attorney or tax advisor to consider the tax consequences of such a transfer.

Moreover, the new Economic Growth and Reconciliation Act changed the income tax step-up in basis rules. Until 2009 the basis of certain assets is the value of the asset at the date of death. In 2010 this rule will change and will be the lesser of the adjusted basis of the decedent, or the fair market value of the property at the date of the decedent's death. For example, if a person owns a home that has appreciated in value, until 2010 it is advantageous to transfer the home at death rather than during one's life-time to reduce capital gains taxes.

2. Property Taxes

In Texas, a person who owes delinquent property taxes on his or her homestead may defer (put off) the delinquent tax once he or she reaches the age of 65. Similarly, a disabled person, as defined under the Federal Old Age, Survivors and Disability Insurance laws, may defer delinquent taxes on a homestead. Persons age 65 and older and disabled persons may also abate (make void) a lawsuit to collect delinquent taxes on their homesteads. If a decedent owned a home with deferred property taxes, the property taxes may be due at death. Because deferrals incur an 8% interest on the tax owed and interest and penalties incurred before the deferral, the value of the home may end up being less than the value of the taxes, interest, and penalties. It may be the case that there is not enough money in the estate to pay the taxes owed. If so, the state may claim the home for the deferred taxes. If a person has enough income to pay the property taxes and wishes to leave his home to his heirs, it may not be advisable to defer taxes because of the added interest. On the other hand, it makes sense for a homeowner with very low

income who wants to stay in his homestead to defer taxes that he cannot pay and have them paid at death.

To get property taxes deferred, a homeowner must file an affidavit with the chief appraiser at the appraisal district where the property is located. The affidavit must explain the reasons for the deferral. Once a deferral affidavit is filed, the appraisal district cannot file a lawsuit to collect the delinquent taxes until the homeowner stops using the home as his residence. To abate a tax lawsuit, the homeowner must file an affidavit in the court where the lawsuit is pending. The affidavit must fully explain the facts supporting an abatement. After a hearing, if the court finds that the abatement is proper, then the court will make an order abating the lawsuit until the homeowner ceases to use the property as his residence.

A taxing authority can allow a homeowner aged 65 or older to perform service for the taxing authority in lieu of paying property taxes on a homestead. Under this option, a person must sign a contract with the taxing authority fully describing the work to be performed.

Surviving spouses between the ages of 55 and 65 of a decedent who had claimed the over 65 exemption, may keep that exemption by applying to the local appraisal district's office for a transfer of the exemption. If the surviving spouse no longer qualifies for the exemption, then the appraisal district's office should be notified **in writing** because failure to notify the office will result in a 50% delinquent penalty charge. For further information, contact your local appraisal district's office.