Post-Mortem Income and Transfer Tax Planning

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I. Introduction; Overview

The following general topics are addressed:

- Income Tax Issues (including decedent's final return; estate's income tax return; distribution planning)
- Gift Tax Issues
- Estate Tax Issues (including valuation, administration expenses, filing estate tax return, portability, paying estate tax)
- Disclaimer Planning Issues

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II. Initial Matters For All Decedents

A. Form 56

- As a precursor to all of the various income tax issues, the fiduciary (the executor, if any, if not, the testamentary trustee, residuary legatees or distributees) should file Form 56 to advise the IRS of the fiduciary relationship. § 6903; Treas. Reg. §§ 601-503 & 301.6903. Written notice of the termination of the fiduciary relationship should also be filed (on Form 56) with the same office where the initial Form 56 was filed. Treas. Reg. § 301.6903-1(b). (p.1)

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B. Executor's Personal Liability for Income or Gift Taxes (§ 6905)

- The executor may file Form 5495 (filed after the relevant tax return has been filed) requesting release from personal liability for the decedent's income and gift taxes. The IRS then has 9 months to notify the executor of any amount due. After that date, the executor is discharged from personal liability for any deficiency thereafter found to be due. § 6905; Reg. §301.6905-1. (p. 8)

C. Executor's Personal Liability for Estate Taxes (§ 2204)

- The executor may have personal liability for the estate taxes of the estate. The executor may request a discharge from personal liability of estate tax after nine months from making the application (or if the application is made before the return is filed, nine months after the due date of the return). § 2204(a); Reg. §20.2204-1. The request for discharge from personal liability is made by attaching Form 5495 to the estate tax return, or by filing Form 5495 after the Form 706 has been filed. (p. 3)

III. Income Tax Planning

A. Decedent’s Final Return

1. **File Decedent's Final Income Tax Return.** The executor is required to file the decedent’s final income tax return for the period ending with the date of death. § 6012(b)(1).

2. **Net Operating Losses, Charitable Deduction and Capital Loss Carryovers.** Net operating loss (NOL) carryovers, charitable deduction carryovers and capital loss carryovers from a prior year are deductible for the last time on the decedent’s final income tax return. Any unused deductions are lost. If an NOL arises from a net business loss appearing on the decedent’s final return, the NOL may be carried back to previous years. §172(b)(1)(A)(i). (p.1-2)

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041

1. **Compressed Brackets.** Estates (and trusts) have very compressed income tax brackets. The highest brackets (39.6% rate for ordinary income, 20% rate for capital gains) is reached at only $12,300 for trusts and estates in 2015, $12,400 in 2016. (In contrast, the top income tax bracket for couples is at $464,850 in 2015 ($466,950 in 2016).) (p.15)

2. **Consider Fiscal Year.** A decedent's estate may elect a non-calendar fiscal year as long as the first year does not exceed 12 months and the year ends on the last day of the calendar month. §441(e); Reg. § 1.441-1T(b). The primary considerations in the selection of a non-calendar fiscal year include (1) deferring payment of income tax by the estate, (2) deferring beneficiaries' income tax on distributions, by allowing them to report the income in a taxable year after when the distribution was received in certain circumstances. (p.4)

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 (Continued)

3. Section 67(e)—Expenses Subject to 2% “Haircut” Rule

a. **Supreme Court.** The Supreme Court in *Knight v. Commissioner* held that investment advisory fees of an estate or trust are subject to the rule in §67 that miscellaneous itemized deductions can be deducted only to the extent they exceed 2% of AGI. The exception for trusts and estates in §67(e) does not apply. (p.6-7)

b. **Final Regulations.** Final regulations were published May 9, 2014, generally the same as the proposed regulations issued in 2011. The “unbundling” requirement was retained. In particular, for trustee fees the investment advisory portion of the fees will be subject to the 2% rule. That may be avoided if the trust invests through mutual funds. (p.8-10)

c. **AMT Tax.** The major tax cost of having expenses subject to the 2% rule are that the entire expense is a preference item for AMT purposes. (p.10)

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 (Continued)

4. Election Under §645 to Treat Revocable Trust as Part of Grantor's Estate

a. **Overview.** The Taxpayer Relief Act of 1997 permits the executor of an estate and the trustee of a "qualified revocable trust" to treat the trust as part of the estate for income tax purposes for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date". This change was made as the culmination of a long term planning project generally to treat estates and revocable trusts in a similar manner for income tax purposes. (p.12)

b. **Maximum Election Period.** The § 645 election generally will terminate twelve months after issuance of the estate tax closing letter. See Treas. Reg. § 1.645-1(f)(2)(ii). (p.12)

c. **Various Tax Effects of Making § 645 Election.** Two of the various income tax benefits that may result are:

- availability of a fiscal year under §644, Treas. Reg. § 1.645-1(e)(3)(i)
- no estimated tax obligation for 2 years after the decedent's death, Treas. Reg. § 1.645-1(e)(4). (p.13)
- Tax losses of the estate (perhaps attributable to administrative expense deductions) may offset revocable trust taxable income.

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B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 (Continued)

5. Income in Respect of a Decedent Deduction (For Estate or Beneficiary).

- Income in respect of a decedent (IRD) is, generally speaking, income that was earned before the decedent's death, but that was received after his death.
- To prevent a cash basis taxpayer from being able to avoid paying income tax on such items of income, IRD is taxed upon receipt by the estate or other beneficiary. §691(a)(1).
- Furthermore, to avoid double estate and income taxation on the same amount, an income tax deduction is allowed against IRD income, when it is received by the estate or by a beneficiary, for the estate tax attributable to the IRD income. §691(c).
- There is not a complete offset of the double tax because the §691(c) deduction is only allowed for the federal estate tax—but not the state estate or inheritance taxes—attributable to the income in respect of decedent items. (p.14-15)

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 (Continued)

6. 3.8% Tax on Net Investment Income

- 3.8% times lesser of (i) AGI over threshold, or (ii) Net investment income; §1411 (p.16)
- Threshold: $250,000 for married individuals; $11,950 for trusts and estates in 2013 ($12,300 in 2015, $12,400 in 2016))
- Trusts and Estates:
  - Low threshold
  - "Undistributed" net investment income
  - Most trust and estate income is NII (some exceptions are IRA distributions, tax-exempt income, and business income in which the trust materially participates) (p.19)
- Non-passive business exception - How does an estate or trust materially participate? (p.20)
  - IRS regulation project is underway
  - TAM 201317010 takes a hard-nosed position (p.21)

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B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 (Continued)

6. 3.8% Tax on Net Investment Income (Continued)

- *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (3/27/14) (p.35)
  - Activities of trustees as employees of the business count toward determining material participation by the trust
    - State law (Michigan) requires trustees to look out solely for the interests of trust beneficiaries, and trustees are not relieved of their duties of loyalty by conducting activities through an entity controlled by the trust. (p.22)
    - This holding seems inconsistent with the IRS position in TAM 201317010 (but that involved employees directly of the business rather than an LLC wholly owned and controlled by the trust)

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C. Funding and Distribution Planning

1. General Rules Regarding Income Tax Effects of Distributions

a. **General Rules and Capital Gains.** Any distribution from an estate, whether of income or principal, will generally carry out the income of the estate to the beneficiary to the extent of the estate's "distributable net income" (DNI). § 661 (deduction to estate); § 662 (income to beneficiary).
DNI is the taxable income of the estate with certain modifications. § 643(a). (p.23)

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C. Funding and Distribution Planning (Continued)

Capital Gains in DNI.

- One of the main exceptions from the general rule that DNI is the taxable income of the estate is that capital gains and losses are usually excluded from DNI since they are typically allocated to corpus and are not distributed to beneficiaries currently. § 643(a)(3). Regulations now provide substantially more flexibility to cause capital gains to be included in DNI. The regulations provide three general categories of situations in which capital gains may be included in DNI. (p.23)
- Treas. Reg. §1.643(a)-3(a): Capital gains will be included in DNI if they are (p. 23-24)

  "pursuant to the terms of the governing instrument and applicable law" or "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)"

  (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

  (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

  (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. Reg. §1.643(a)-3(b).

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C. Funding and Distribution Planning (Continued)

Capital Gains in DNI. (Continued)

- CGs allocated to income (p.24)
  - Mandated in trust agreement (if same distribution powers for income and principal)
  - Trustee discretion to allocate to capital gains to income
  - Cash distributions from entities are typically income under UPAIA
  - Capital gains distributed to trust from from flow-through entities
- CGs allocated to corpus but consistently included in distributions (p.25)
  - Must be exercised consistently and cannot vary from year to year. Treas. Reg. §1.643(a)-3(e)(Exs. 1, 2, 12, 13, 14).
- CGs allocated to corpus and actually distributed or utilized in determining what is distributed (p.25-26)
  - Examples are rather extreme
  - But the literal language...

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C. Funding and Distribution Planning (Continued)

1. General Rules Regarding Income Tax Effects of Distributions (Continued)

b. **Exception: Specific Bequest Exception.** Payments of specific bequests are excluded from the general rule that distributions carry out estate income to beneficiaries. This exception applies to a bequest of a specific sum of money or specific property and which is paid or credited all at once or in not more than 3 installments and that is ascertainable under the will at the date of death. § 663(a)(1); Reg. §1.663(a)-1(b). (p.27)

c. **Exception: Separate Share Rule.** The separate share rule is mandatory for estates. The general purpose is to provide a more equitable result for estate beneficiaries, by limiting the amount of distributable net income (or DNI) that is "carried out" as taxable income for a particular beneficiary to that beneficiary's pro rata share of such income that the beneficiary is entitled to receive from the estate. I.R.C. § 663(c). While this purpose is laudable, the application of the rule can be difficult, especially in estates with difficult-to-value assets. (p.27-28)

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C. Funding and Distribution Planning (Continued)

1. General Rules Regarding Income Tax Effects of Distributions (Continued)

c. Exception: Separate Share Rule. (Continued)

Effect. The general effect of the separate share rule is to limit the amount of DNI that is carried out to each beneficiary (which is taxable to the beneficiary, § 662(a), and deductible to the estate, § 661(a)) to the DNI that is allocable to each beneficiary's separate share. (p.28)

No "Flow-Through" Treatment. The rule only limits the amount of DNI carried out with distributions that are made. It does not create a "flow-through" system to allocate taxable income to beneficiaries who do not receive distributions. (p.28)

d. Interest on Funding Pecuniary Bequests. The IRS maintains that interest on funding pecuniary bequests is not included in the estate's DNI that is carried out to the beneficiary, and is not deductible by the estate as a distribution deduction under § 661 or other sections. However, it is interest income to the beneficiary. (p.28-29)

Overall Effect. Creates taxable income to the family. (p.28)

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C. Funding and Distribution Planning (Continued)

d. Interest on Funding Pecuniary Bequests. (Continued)

No § 212 or § 163 Deduction Either. A district court case has held that interest paid on specific bequests was not deductible. Schwan v. United States, 91 AFTR2d 2003-1658 (D. S.D. 2003). The court reasoned that the interest expense was not deductible under § 212 because it was not necessary for the estate to incur the interest charges. An investment interest deduction under § 163 was not allowed because the interest was not tied to debt incurred for an investment. (p.28)

Estate Tax Deduction May be Possible. Although cases have not allowed an income tax deduction for interest on pecuniary bequests, an estate tax deduction was allowed in Turner v. U.S., 93 AFTR2d 2004-686 (N.D. Tex. 2004). But it was a somewhat unusual situation. (p.29)

e. Distribution of Appreciated Property in Satisfaction of Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. A pecuniary bequest or amount is one that has a fixed or definite dollar amount. Reg. §1.661(a)-2(f)(1); Kenan v. Commissioner, 114 F.2d 217 (2nd Cir. 1940). (p.29)

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C. Funding and Distribution Planning (Continued)

1. General Rules Regarding Income Tax Effects of Distributions (Continued)

f. **Distribution of IRD to Satisfy Pecuniary Bequest Accelerates Recognition of IRD.** A distribution of a right to receive IRD in satisfaction of a fixed sum of money bequest will likely cause acceleration of tax on the IRD. See Treas. Reg. § 1.691(a)-4(b)(2).

The acceleration problem does not occur if IRD is distributed in satisfaction of a specific bequest, a percentage bequest (Ltr. Rul. 200234019), or of a portion of a residuary bequest (Ltr. Ruls. 201013033 & 200652028). (p.32)

g. **In-Kind Distributions Typically Not Taxable Transactions.** If a will leaves bequests to multiple beneficiaries, and if the beneficiaries agree to take specific assets of equal value rather than receiving pro rata distributions of a fractional interest in every asset, the IRS takes the position that this results in a taxable sale or exchange between the estate beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159.

Rev. Rul. 69-486 indicates, however, that if the executor has the authority to make a non-pro rata distribution, no taxable event occurs when a non-pro rata distribution is made. That is the reason that most trust instruments permit non-pro rata distributions. (p.32)

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C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting

- Section 2004 of Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, enacted July 31, 2015 (p.33)
- Background: Section 1014(a) refers to "fair market value" at the date of death. The value determined for estate tax purposes is generally deemed to be the "fair market value" under §1014(a), but that is not conclusive. Treas. Reg. §1.1014-3(a). A recipient of property from a decedent may argue that the fair market value at date of death is really higher than the estate tax value, if the person is not estopped from taking that position. Rev. Rul. 54-97. Apparently, the IRS thought it was getting whipsawed on low estate tax values but higher basis values. (p.32-33)
- Two Aspects on New Legislation: (1) Basis consistency; and (2) Information reporting

C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting (Continued)

- New Section 1014(f) (p.33)
  - "Fair market value" under §1014(a) shall not exceed the finally determined estate tax value
  - Applies only to property "whose inclusion in the decedent's estate increased the [estate tax] liability" (Reason: otherwise no whipsaw)
  - So the basis consistency requirement does not apply to estates, for example, that owe no estate tax due to the marital or charitable or administrative expense deductions, or because the estate is under the exemption amount. But that exception does not apply to the reporting requirements.

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C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting (Continued)

- Information Reporting-New Section 6035 Requiring Executor to Report Valuation Information (p.34)
  - **What estates?** If the estate is required to file an estate tax return under §6018(a)
  - **To whom?** To (1) the IRS and (2) "each person acquiring any interest in property included in the decedent's gross estate."
    - The IRS? Are they contemplating matching programs?
    - Trusts—Information is given to the trustee not to each beneficiary
  - When? 30 days after earlier of Form 706 due date or actual filing date. Supplemental statements are required 30 days after an adjustment. (But Instructions to Form 8971 extend this to 30 days after the return is actually filed if it is filed late.)
  - **Transition extension.** Extension granted on initial information reports until June 30, 2016 (after interim extensions to 2/29/16 & 3/31/16) (p.39)

C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting (Continued)

- Information Reporting-Form 8971 (p.34)
  - **General information.** Parts I and II list general information about the decedent and executor.
  - **Schedule A.** Schedule(s) A for each beneficiary are attached to Form 8971. Each beneficiary receives Schedule A listing Form 706 item number, description, whether the property increases the estate tax, valuation date, and value. (p.36)
  - **Filed separate from Form 706.**
  - **Undistributed property.** Schedule A lists all property that could be used to satisfy the bequest. (Proposed regs say this applies if executor has not "determined" what property will be distributed when the report is filed.) Instructions say to file supplemental report and statements when property is distributed, but proposed regs say executor may, but is not required, to file supplemental reports after determination is made.) (p.41-42, 45-46)

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C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting (Continued)

- Temporary and Proposed Regulations (p.37-50)
  - Filing requirement-not mere portability election returns (p.42)
  - Marital and charitable deduction property not subject to basis consistency but is subject to reporting (p.40)
  - Certain tangible personal property under $3,000 not subject to basis consistency OR information reporting (p.40, 43)
  - After discovered or omitted gets basis of zero unless supplemental 706 is filed before statue of limitations runs on assessments (p.41-42)
  - Exceptions from reporting: (1) Cash; (2) IRD; (3) certain tangible personal property; (4) sold assets. (p.43)
  - Subsequent transfer of gross estate property to a "related transferee" must be reported (appears to include gift to a grantor trust but not to other trusts) (p.47-49)
  - Reporting of non-probate trust assets in gross estate—unclear but appears executor gets information to give statements to trust beneficiaries (not the trustee) (p.44)

C. Funding and Distribution Planning (Continued)

2. Basis Consistency and Information Reporting

- **Practical Problem:** Most of the estate has probably not been distributed by 30 days after the estate tax return due date. What information must be reported to beneficiaries? (p.37, 41-42, 45-46)
- **Penalties**
  - Using inconsistent basis: §6662 accuracy related penalties on understatements apply (p.35)
  - Failure to give information returns and statements: §6721-6722

    General rule: $250.00 (indexed) per failure (after 2015)

    "Due to intentional disregard": $500 (indexed) or if greater "10 percent of the aggregate amount of the items required to be reported correctly." (p.35)
- ***Effective Date:*** Returns filed after date of enactment (Query-what about supplemental return filed after 7/31/15?) (p.35, 39)
- ***Fiduciary Concerns:*** Examples—(1) 706 values, (2) Audit adjustments (p.50)
- ***Revenue Estimate:*** $1.54 billion over 10 years (p.50)

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C. Funding and Distribution Planning (Continued)

3. Equitable Recoupment

- ***Description.*** An unfair result may occur in a situation in which an estate asset is sold after the decedent's death, the gain is reported using the date of death value as reported on the estate tax return as the basis of the asset, the time period for claiming an income tax refund expires, and afterward the estate tax value of the asset is finally determined and is increased. The basis should have been higher, which would have reduced the income tax. But the period for requesting an income tax refund has lapsed. In that situation, equitable recoupment may provide relief for the taxpayer by making an appropriate offset in the amount of additional estate taxes. (p.50)
- ***Requirements.*** There are five requirements to qualify for equitable recoupment. Estate of Branson v. Comm'r, 264 F.3d 904 (9th Cir. 2001), cert. denied 535 U.S. 927 (2002); Estate of Jorgensen, T.C. Memo. 2009-66. The IRS has fought the application of the doctrine in a variety of cases. (p.51)
- ***Planning—File Protective Claim for Refund.*** From a planning perspective, filing a protective claim for refund of the initial tax should be filed, if possible, rather than having to rely on an equitable recoupment argument. This is a fairly common situation, where the IRS claims that estate assets are undervalued for estate tax purposes. (p.51)

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III. Income Tax Planning

A. Decedent's Final Return

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041

C. Funding and Distribution Planning

D. Executor's Commissions

1. **Self Employment Income?** Generally not self employment income: Rev. Rul. 58-5, 1958-1 C.B. 322 (executor commissions of nonprofessional fiduciaries generally not treated as earnings from self-employment). (p.51)

2. **Waiver.** If executor will waive right to compensation, consider doing so in the first six months. Rev. Rul. 66-167, 1966-1 C.B.20. (p.51)

3. **Not Net Investment Income.** Executor's commissions are not net investment income subject to the 3.8% NII tax. (p.19)

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IV. Estate Tax Planning

A. Alternate Valuation Date

1. **Purpose.** The estate assets may decline in value during the first six months following the decedent’s death, to the point that much of the estate would be needed to pay estate tax based on the higher values that existed at the date of death.

2. **Requirements.** An executor may elect to have the estate assets valued as of a date six months after the decedent's death if (1) the gross estate declines as a result of making the election and (2) the combined estate and GST taxes decline as a result of making the election. (p.52)

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A. Alternate Valuation Date (Continued)

3. **Election Mechanics.** The election must be made on "the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted)." Reg. § 20.2031-1(b)(1). (p.53)

4. **Applies to All Assets.** If the election is made, it applies to all property in the gross estate and cannot be applied to only a portion of the property. Reg. §20.2032-1(b)(1).

5. **Effects of Sales and Distributions on Alternate Values.** A sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. (p.55)

6. **Proposed Regulations.** Proposed regulations (revised in November 2011) provide that the valuation date is accelerated if there is a change in ownership structure such that the interest after the change does not reasonably represent the assets on the date of death. Prop. Reg. § 20.2032-1(c)(1). (p.56)

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B. Special Use Valuation

1. **General Effect of Special Use Valuation.** Certain real estate used in a farm or in a trade or business may be valued at its use in that enterprise rather than at its fair market value measured by its "highest and best use," up to a maximum reduction of $750,000, indexed from 1999 ($1,100,000 in 2015). (p.57)
2. **Qualification Requirements.** A number of detailed requirements must be satisfied before special use valuation is available. An excellent summary of these requirements is included in the instructions for Schedule A on the Form 706. (p.57)
3. **Determining Special Use Value.** The property may be valued based on a capitalization of rents method (if it is farm or ranch land) or on a five-factor method. §2032A(e)(7-8). This can be complicated; start early. (p.58)
4. **Property Tax Values.** Some attorneys report that they have been successful (on multiple occasions) in getting IRS agents to approve using the "Agricultural Value" on property tax statements as the special use value. (p.58)

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C. General Valuation Considerations

1. **Substantial and Gross Undervaluation Penalty Tests, §6662 (g-h)**
   - 20% Substantial Undervaluation Penalty. If there is an underpayment of estate or gift tax by more than $5,000 and if the value claimed on the return is from 65% to 40% of the correct value, there is a 20% penalty.
   - 40% Gross Undervaluation Penalty. The penalty is 40% if the valuation claimed is 40% or less of the "correct" value.
   - Reasonable Cause Exception. There is a reasonable cause exception. Relying on an appraisal is not automatically reasonable cause; reliance must be reasonable and in good faith to qualify for the exception. (p.59)
2. **Valuation Adjustments**
   - Undivided interests in real estate (cases often allow discounts 20%-40%, and more) (p.64-67)
   - Minority and marketability discounts for entities (p.68-70)
   - FLP cases table (p.71-72)
   - IRS audits often involve disagreements over the appropriate size of these valuation adjustments

C. General Valuation Considerations (Continued)

3. Post-Transfer Events

- Subsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as "evidence of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time ... and no intervening events drastically changed the value of the property." *First Nat'l Bank of Kenosha*, 763 F.2d at 894; see *Schnorbach v. Kavanagh*, 102 F. Supp. 828, 834 [41 AFTR 808] (W.D. Mich. 1951). (p.75-78)
- If the sales price is greater than the value reported on the return, the IRS invariably will take the position that the higher sales price should be used.

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D. Administration Expenses

1. Income or Estate Tax Deduction.

- Generally, administration expenses can be deducted either on the estate tax return or on the estate's income tax return. There used to be a big advantage to being able to deduct expenses on the estate tax return (when the top rate was 55% or higher). That is often no longer the case when the top estate tax and income tax rates are the same. (Only "reasonable and necessary" administration expenses can be deducted on the estate tax return.) (p.4-5)

2. "Graegin Notes"

- If the estate borrows funds to pay estate taxes, giving a note that has a fixed interest rate for a fixed time period and that cannot be prepaid, cases have allowed an estate tax deduction for the full amount of interest that will be paid over the life of the loan. On a long term note, this can result in a substantial estate tax deduction—reducing the estate tax owed 9 months after date of death. The IRS often argues that a deduction will be allowed for fewer years than the full term of the note. (p.80-88)

3. Disputed or Uncertain Claims Against Estate

- Regulations applying to decedents dying on or after 10-20-2009 provide that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. (p.90) Rev. Proc. 2011-48 provides detailed procedures for filing and perfecting a protective claim for refund for such a disputed or contingent claim. (p.92-96)

E. Filing of Estate Tax Return and Payment of Estate Tax

1. General Filing and Payment Requirements

- **Who Must File.** Estates (of U.S. citizens or residents) for which the gross estate plus adjusted taxable gifts exceeds the applicable exclusion amount ($5 million indexed, in 2013-$5.25 million, in 2014-$5.34 million, in 2015-$5.43 million, in 2016-$5.45 million)). (p.112)

- **Initial Due Date.** Estate tax returns must be filed within nine months after the date of death. §6075. Extensions of time to file may be made on Form 4768. (p.113)

- **Extensions.**

  – Extensions are requested on Form 4768.

  – Separate" time to file" and "time to pay" extensions.

  – Automatic 6-month extension of time to file (but not for time to pay). Treas. Reg. § 20.6081-1(b).

  – Reasonable Cause Extension of Time to Pay. (§ 6161). Extensions may be granted for one year at a time, up to 10 years. (p.112-113)

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E. Filing of Estate Tax Return and Payment of Estate Tax (Continued)

2. Portability Election

- **Description.** The surviving spouse may use any unused estate tax exclusion amount from a deceased spouse if the estate elects portability by timely filing a timely and complete estate tax return. If an estate tax return is not otherwise required and is filed only to elect portability, generally there is no need to list values of each asset passing to a surviving spouse or charity (but an estimate of the total value of the gross estate within specified ranges must be specified). The IRS will consider 9100 relief for late filing if the estate was not required to file an estate tax return (p.103)
- **Advantages of Portability.** Simplicity, double basis step-up, saving state estate tax at first spouse's death, creating grantor trust with first deceased spouse's exemption, planning for qualified plan benefits or for "non-propertied spouse" (p.105)
- **Advantages of Credit Shelter Trust.** Exempting future appreciation from estate tax, maximizing use of GST exemption, blended family, remarriage, traditional non-tax advantages of trusts. (p.105)

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E. Filing of Estate Tax Return and Payment of Estate Tax (Continued)

3. **Extension of Time to Pay Tax Attributable to Closely-Held Business Under §6166**

   a. **General Description.** If the estate meets specific requirements, the estate is entitled to an extension of time to pay estate taxes attributable to a closely-held business over 14 years (5 years interest only; principal paid in equal installments at end of years 5-14) under § 6166. (p.113-114)

   b. **Advantages.** This deferral is typically extremely advantageous. If the estate is illiquid, it typically would have no ability to borrow funds from a third party on as favorable terms. (p.114)

      As a practical matter, an estate would never be able to borrow from a bank 40% of the value of the collateral for 14 years, and only have to deal with the bank once a year when payments are made. Section 6166 borrowing gives a better economic result than borrowing from a bank. (p.114)

   c. **Requirements.**

      1) Decedent is U.S. citizen or resident
      2) Interest in closely held business exceeds 35% of "adjusted gross estate"
      3) The business is a "trade or business" (no objective rules) and the interest is "closely held" (very objective requirements) (p.115-116)

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E. Filing of Estate Tax Return and Payment of Estate Tax (Continued)

3. Extension of Time to Pay Tax Attributable to Closely-Held Business Under §6166 (Continued)

d. Interest. 2% on a portion (estate tax attributable to first $1.0 million (indexed) of business interest over the estate tax exclusion amount). Balance: 45% of the normal IRS underpayment rate. So—low interest rate (4% x 45% = 1.80%). (p.115)

e. Acceleration. The deferred tax can be accelerated:

- if payments are not made when due (there is a 6 month grace period for this purpose);
- if there is a sale or disposition of 50% or more of the closely held business by family members, § 6166(g), or
- if the estate has undistributed net income. (p.117)

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V. Disclaimers

A. Effect

- If the transfer results from a "qualified disclaimer," it is not a taxable gift by the disclaimant.

B. General Requirements (p.131-132 248)

- Section 2518(b) defines a qualified disclaimer as an irrevocable and unqualified [yes, a "qualified" disclaimer must be "unqualified"] refusal by a person to accept an interest in property if—

  1. such refusal is in writing,
  2. such writing must be delivered to the transferor of the interest, his legal representative or the holder of the legal title to the property to which the interest relates or the person in possession of the property
  3. such delivery is made no later than the date which is 9 months after the later of—
     a. the date on which the transfer creating the interest in such person is made, or
     b. the day on which such person attains age 21,

V. Disclaimers

B. General Requirements (p.131-132 248) (Continued)

4. such person has not accepted the interest or any of its benefits,
5. as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer,
6. the interest passes either—
   a. to the spouse of the decedent, or
   b. to a person other than the person making the disclaimer.

C. Planning Flexibilities with Partial Disclaimers

1. **Can Disclaim Specific Assets From Trust**

   After a specific trust asset is disclaimed, it must "leave" the trust and pass to someone other than the disclaimant. Reg. §25.2518-3 (a) (2). (p.132)

2. **Formula Disclaimers are Permitted**

   The regulations and various private letter rulings indicate that a formula disclaimer may be a qualified disclaimer. Reg. §25.2518-3(d), Ex. 20 (fractional disclaimer; numerator of fraction is the smallest amount which will allow estate to pass free of federal estate tax and denominator is the value of residuary estate). (p.132)

D. Passing Without Any Direction By Disclaimant

1. **Disclaimant as Fiduciary.**

   The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Treas. Reg. §5.2518-2(e)(1)(i) & 25.2518-2(e)(5)Ex.(12). (p.135)

2. **Disclaimant Cannot Hold Power of Appointment.**

   A significant disadvantage to making a disclaimer is that the disclaimant cannot retain a limited power of appointment over disclaimed assets. Reg. § 25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). This is a significant disadvantage because holding a limited power of appointment provides a great deal of indirect "persuasive influence" with family members. (p.135)

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