Post-Mortem Income Tax Planning in Estate Administration

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Planning During Estate Administration: Overall Considerations

(a) Post Tax Cuts and Jobs Act of 2017, in many estates, income tax planning is now central, rather than estate, gift and generation skipping transfer tax planning.

(b) Basic Exclusion Amount Doubled

(c) Generation Skipping Transfer Tax Exemption Doubled

(d) Portability – allows for flexibility

- (i) Outright to spouse
- (ii) QTIP Planning
- (iii) Disclaimer Planning

(e) Formula Funding Clauses

(f) State transfer tax

(g) Position the assets to maximize income tax basis adjustment

(f) Effective use of income and estate tax deductions

Income Tax Basis Planning

(a) Section 1014 provides that: "The basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person" be the fair market value on the date of the decedent's death or where an alternate valuation election is made under Section 2032 the alternate valuation date.

(b) When thinking about step-up planning, remember 1041(e). Where a donor makes a gift of property within 1 year of death to a decedent and where the property passes back to the donor or the donor's spouse from the decedent, then basis is not adjusted.

Income Tax Basis Planning: Inter Vivos Trusts

(a) Where no federal estate tax applicable, consider asking trustee to make a distribution of low basis assets out of a trust to a beneficiary where the trust contains a broad principal distribution power.

(b) Where no federal estate tax applicable, and where trust has low basis assets, if provisions of trust allow, have an independent person grant a general power of appointment to a trust beneficiary (when drafting, must consider state law issues; also consider releasing the appointer from liability in the trust document, consider protections so that power is not too broad, for example, require the consent of a non-adverse person; considering limiting the class in whom the general power of appointment could be exercised, for example, limiting the exercise to creditors only; consider state law creditor issues when granting this power.)

Income Tax Basis Planning: Inter Vivos Trusts

(c) Allow grantor to exercise a swap power in a grantor trust to receive low basis assets in exchange for cash or high basis assets. Alternatively, where there is no swap power, allow grantor to purchase low basis assets in exchange for cash from trust where trust is a grantor trust.

(d) Where there is little liquidity, pledge assets of the client as collateral for a short term loan. Use the loan proceeds to swap/purchase low basis assets from the grantor trust. During estate administration, the trust buy assets from the estate for cash and the executor use the cash to pay off the loan.

Income Tax Basis: Other Planning Options

(a) In the will, take advantage of portability. Transfer assets to the extent possible to a spouse either outright or in trust to receive a basis adjustment at the death of the second spouse.

(b) If the client owns a limited partnership interest that would require a valuation discount by virtue of the restrictions in the agreement, consider minimizing the restrictions by amending the agreement or converting to a general partnership interest. (Where no federal estate tax applicable)

(c) Basis adjustment for non-exempt GST Trust if GST Tax imposed. Section 2654(a)(2)

Final Income Tax Return of the Decedent

(a) The personal representative is required to file the final income tax return for the decedent which ends with his/her date of death. IRC § 6012(b)(1).

(b) Assuming the decedent is a calendar year taxpayer, return is due by April 15 of the year following the year of death.

(c) In certain cases, a joint return for a married couple may be filed by the executor. IRC § 6013(a)(3). The decedent's income through his date of death is reported on the joint return together with the full year of income for the surviving spouse. Surviving spouse cannot have remarried prior to end of taxable year.

(d) Deduction is available on Form 706 for unpaid income taxes, if they are on income properly includible in an income tax return of the decedent for a period before his death. Taxes on income received after the decedent's death are not deductible. Treas. Reg. § 20.2053-6(f).

(e) Where a joint return is filed, a deduction is available on Form 706 for decedent's share of the income taxes as s/he would be liable under local law, as between spouses under a reimbursement action. If there is not evidence to the contrary, then the deduction is presumed to be a ratio, of the amount of tax had decedent filed separately, bears to the total tax had both spouses filed separately. But, the deduction is capped at the lesser of (1) the decedent's liability reduced by amounts already contributed by the decedent toward the joint liability or (2) if there is an enforceable agreement between the executor and the spouse, the required contribution of the estate. Treas. Reg. § 20.2053-6(f).

(f) A joint return will presumably be filed where the tax liability will be lower than if both spouses filed separately; however, there is joint and several liability for the tax, which in each circumstance should be evaluated. IRC § 6013(d).

Taxable Year of the Estate

(a) The estate is a separate taxpayer.

(b) Executor must elect the taxable year of the estate. Unlike trusts, which can only use a calendar year (IRC § 644(a)), the taxable year for an estate can be either a fiscal year or a calendar year (IRC § 441(e). A revocable trust which becomes irrevocable at the death of the grantor can also make this election if it makes a Section 645 election.

(c) Timing. Match income with deductions. Also, fiscal year income tax planning opportunity when combined with distributions to beneficiaries – possible income tax deferral.

(d) Note that where a fiscal year is selected, the Form 1041 is due within 3 ½ months after the close of the fiscal year, unless properly extended.

Revocable Trusts

(a) Some estate plans are created with a funded qualified revocable trust which becomes irrevocable at the death of the grantor.

(b) A qualified revocable trust is a trust that, on the date of the decedent's death, was treated as owned by the decedent under an IRC § 676 power to revoke. Includes a power to revoke which is exercisable by the decedent with the consent of a non-adverse person or with the consent of the decedent's spouse. Treas. Reg. Section 1.645-1(b)(1)

(c) If both the executor of an estate and the trustee of a qualified revocable trust elect, the trust is treated and taxed as part of the estate (and not as a separate trust). During the election period, the estate and the trust will file only one Form 1041.

(d) The election period for treatment under Section 645 as a combined estate begins with the date of the decedent's death and ends on the earlier of (1) the day on which the electing trust and the related estate have distributed all of their assets or (2) the applicable date.

Revocable Trusts Continued

(e) The "applicable date" is 2 years after the date of the decedent's death if no Form 706 is required to be filed. If a Form 706 is required to be filed, then the applicable date is the later of 2 years after the date of the decedent's death or 6 months after the final determination of liability for estate tax.

(f) The trustee should obtain a TIN for the revocable trust after the death of the grantor to be used during the period of administration, unless the trust will be immediately terminated and the assets distributed to the trust beneficiaries. This is true even if a § 645 election is made. The estate and trust should have separate TINs.

4. Revocable Trusts Continued

(g) The regulations provide that a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Treas. Reg. Section 1.663(c)-4(a).

(h) Make the election by filing Form 8855. The election must be made on or before the date to file the first fiduciary income tax return and once made, the election is irrevocable. IRC § 645(c).

(i) Some potential benefits in making the election to treat the trust as part of the estate:

(1) Fiscal year end allowed to estates

(2) During the first 2 years, no estimated tax payments

(3) Trust may be able to pass out losses/deductions at the termination of the estate/trust.

(4) Medical expenses paid by the trust may be deducted on the decedent's final income tax return.

(5) Permitted deduction under IRC § 642(c) for amounts permanently set aside for charity in addition those paid to charity.

The Final Year of Estate/Trust

(a) In the final year of an estate or trust, a final 1041 income tax return is prepared and filed, but all items of income and capital gains are passed out to the beneficiaries.

(b) In the final year of an estate or trust after 2017 and before 2026 (the "restricted period"), no excess deductions can be passed out to beneficiaries. (IRC § 67(g)).

(c) In periods other than the restricted period, excess deductions can be passed out to the beneficiaries, other than any charitable deduction and the personal exemption. NOL's are carried out.

(d) In periods other than the restricted period, excess deductions in the hands of beneficiaries are treated like miscellaneous itemized deductions under IRC § 67(b).

(e) Strategy – can the beneficiaries use the deductions? Timing of payment of administrative costs – during period before 2026, minimize excess deductions to the extent possible. After 2026, think about the 2% floor.

Where to take deductions

(a) Decedent's final income tax return

(b) Estate tax return

(c) Estate income tax return

(d) Section 642(g): no double deductions

(e) Section 691(b)

- Note: While there are certain choices the personal representative must make, certain deductions are only appropriate on the Form 706, for example funeral expenses, federal gift and income taxes payable. Certain expenses are only appropriate on the Fiduciary Form 1041, for example, city, state and foreign taxes on income earned by the estate.

Form 706: Deductions: IRC § 2053(a)

- The value of the taxable estate is determined by deducting from the value of the gross estate the following:
  - Funeral expenses
  - Administration expenses
  - Claims against the estate
  - Unpaid mortgages on, or any indebtedness in respect of property where the value of the decedent's interest therein, undiminished by the mortgage or indebtedness is included in the value of the gross estate.
  - Also deductible are administration expenses related to property not subject to claims which is included in the gross estate. Examples include trust assets, jointly held property or life insurance proceeds include in the gross estate.

Deductions: Losses IRC § 2054

- The value of the taxable estate shall be determined by deducting from the value of the gross estate losses incurred during the settlement of estate arising from fires, storms, shipwrecks, or other casualties, or from theft, when such losses are not compensated for by insurance or otherwise.

Making the 642 (g) election – No Duplication of Deductions

(a) The amounts that are allowed under IRC § 2053(a)(2) – estate administrative expenses or under IRC § section 2054 (losses during administration) are not allowed as deductions on the fiduciary income tax return unless a statement is filed in duplicate that the deductible items have not been allowed as deductions on Form 706 and that the right to take the deduction on the Form 706 has been waived.

(b) The statement must be filed for the year that the items are claimed as deductions on the fiduciary income tax return and may be filed at any time prior to the expiration of the SOL period applicable to the taxable year where the deduction is taken. Treas. Reg. § 1.642(g)-1

(c) Rev. Rul. 70-361 – Statement and waiver is not all or nothing. Can mix and match fiduciary/estate return deductions so long as no duplication and proper statement/waiver is filed.

Overall Considerations Where to Take Deductions

- Generally when determining where to take deductions (between the estate or the fiduciary income tax return, or the final 1040), the personal representative must consider a number of issues.
- Is there enough income in the estate to receive a benefit for an income tax deduction?
- Which beneficiaries will benefit from each choice.
- Be careful when a credit shelter trust is funded with a formula clause. Formula clauses may have different results depending upon where the deduction is taken. Think about the marital deduction, the credit shelter trust, if there is remaining applicable credit exemption. Take your time and walk through the formula clause in the will/trust.
- Consider obtaining the consent of the beneficiaries where different options will treat beneficiaries differently.
- <u>Hubert</u> Regulations
- 2% floor and suspension of miscellaneous itemized deductions.

Medical Expenses

(a) Unreimbursed Medical Expenses which are incurred before the decedent passes away but remain unpaid after his death may be deducted either on the Form 706 or on the decedent's final income tax return.

(b) Form 706: Deductible under IRC § 2053(a) as a debt of the decedent.

(c) Final 1040: Final medical expense paid in the decedent's final income tax year together with unreimbursed medical expenses of the decedent if they are paid within 1 year of death (treated as if paid at the time incurred) (IRC § 213(d)) may be deducted. The executor must attach the 642(g) statement to the Final 1040 indicating that the medical expenses will not be claimed on the estate tax return together with a waiver of a right to deduct the expenses on the Form 706.

(d) An analysis will be needed to determine whether it is beneficial to take the deduction on the final income tax return or on the estate tax return. Currently, for income tax purposes, only medical expenses in any year exceeding 7.5%/10% of AGI are deductible so where there is a taxable estate it may make more sense to deduct on the estate tax return.

(e) Consider formula funding in a marital trust/credit shelter disposition. Taking the deduction on the income tax return may result in a smaller credit shelter trust. If there are different beneficiaries, this may be a concern.

(f) Rev. Rul. 77-357: If the medical expense deduction is taken on the final income tax return, the portion that does not exceed the 7.5%/10% threshold cannot be deducted on the Form 706 pursuant to IRC 2053(a).

Administrative Expenses

(a) The executor can elect to deduct administrative expenses on the estate tax return of the decedent (Form 706) or on the fiduciary income tax return (Form 1041) for the estate/trust.

(b) Examples of administrative expenses are appraisal fees, commissions paid to the executor/personal representative and trustees, attorneys fees, tax advice and fees for preparation of returns.

(c) Look at the tax rates to determine where to take the deductions. If a federal Form 706 is required to be filed, the deductions will likely be taken on the Form 706. Where there is only a DSUE Form 706 return being filed, it likely makes more sense to take the deductions on the fiduciary income tax return.

(d) Timing: Where deductions will be taken on the fiduciary income tax return, timing is important. Pay expenses during each fiscal/calendar year to coordinate with the taxable income. If the highest marginal income tax rate of the beneficiaries is lower than highest marginal income tax rate of the estate, each year of the estate administration, pay out remaining income beyond the administration expenses paid to the estate beneficiaries (as appropriate under the controlling documents). This will tax the remaining income at the beneficiaries' lower marginal rate.

Administrative Expenses Continued

Hubert Regulations

Be careful when electing to take administrative expenses on the fiduciary income tax return where there is an estate in excess of the applicable exclusion amount. If a deduction is not taken on the Form 706, then the estate may be subject to estate tax. Does the funding formula in the controlling documents ensure that remaining applicable exclusion amount will absorb the expenses and any credit shelter funding will be reduced accordingly. If the decedent has made large gifts during lifetime or there are transfers outside of the probate estate which will absorb unified credit be careful when taking deductions on the fiduciary income tax return. Also watch out for the Hubert Regulations for a possible elimination of the marital deduction (charitable deduction has a similar issue). Look at your formula clause and walk through it with care.

What happens with residuary marital and no available unified credit to pay administrative expenses? The Hubert regulations divide administrative expenses into two types of expenses: management expenses and transmission expenses. See Treas. Reg. § 20.2056(b)-4(d).

(i) Management expenses are incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration. Examples include investment advisory fees, stock brokerage commissions, custodial fees, and interest. If management expenses are deducted on the Federal estate tax return, the marital deduction will be reduced by the management expenses which are paid from the marital portion. (No double deduction). Further the marital deduction shall be reduced by the amount of the management expenses paid from the marital share but attributable to a property interest not included in the marital share.

(ii) Transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes and distributing the property. A transmission expense includes any expense that is not a management expense. For example: executor commission and attorney's fees, probate fees, appraisal fees and expenses defending a will contest or in a will construction proceeding. Transmission expenses will reduce the marital share, to the extent that they are paid from the marital share, whether or not deducted on the federal estate tax return.

Administrative Expenses Continued Form 1041 IRC §§ 212, 67 (e) and 67 (g)

- IRC § 67(g), which was added by the TRA 2017, provides that miscellaneous itemized deductions are not allowed for any tax year beginning December 31, 2017 and before January 1, 2026.
- IRC § 212 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, for the management, conservation or maintenance of property held for the production of income or in connection with the determination, collection or refund of any tax.
- Prior to TRA 2017, IRC § 67 provided that miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income. Generally, this is all deductions except for certain excluded items listed in IRC § 67(b). Notable exclusions (double negative, so permissible deductions without regard to 2% floor): § 642(c) charitable deduction, § 213, medical deduction, § 691(c) Deduction for estate taxes for items of IRD.
- IRC § 67(e): Special exception for trusts and estates.

Administrative Expenses Continued Form 1041 IRC § 212, 67 (e) and67 (g)

- § 67(e) provides an exception to the miscellaneous itemized deduction 2% floor limitation for estates and trusts as follows:
- Costs subject to the 2% floor are those commonly or customarily incurred by a hypothetical individual holding the same property.
- Costs which are excepted from the 2% floor are those that would not have been incurred if the property were not held in the estate or trust.
- Also excepted from the 2% floor for estates and trusts are deductions allowable under IRC § § 642(b), 651 and 661 .
- For example – tax preparation fees incurred for preparation of estate and GST returns and fiduciary income tax returns and the decedent's final individual income tax return are not subject to the 2% floor. Treas. Reg. § 1.67-4(b)(3)

Investment Advisory Fees, Appraisal Fees and Certain Fiduciary Expenses

- Treas. Reg. § 1.67-4(b)(4), (5) and (6)
- Investment Advisory Fees:
  - Fees for investment advice are incurred commonly by individual investors and are subject to the 2% floor.
  - However, certain investment advisory fees are incurred only because the investment advice is rendered to a trust or estate, or are attributable to an unusual investment objective of the trust or estate, or the need to balance the various interests of the beneficiaries or remaindermen. Those fees are not subject to the 2% floor.
- Appraisal Fees: Those fees incurred by the estate or nongrantor trust to determine the FMV of assets for purpose of making distributions or otherwise required to prepare the estate or trusts returns, or a GST return are not subject to the 2% floor because they are not common to individuals.
- Certain Fiduciary Expenses: Expenses such as probate court fees and costs; fiduciary bond premiums; legal publication; costs related to fiduciary accounts etc. are not subject to the 2% floor
- Unbundled Fees: Treas. Reg. § 1.67-4(c)

Fiduciary Charitable Contribution Deduction

(a) IRC Section 642(c) allows a fiduciary income tax deduction for a charitable contribution made by an estate or trust in certain circumstances:

  (i) The deduction is available for income paid by an estate or trust for charitable purposes.

  (ii) The deduction is available by estates and certain grandfathered trusts for amounts permanently set aside for charitable purposes.

(b) The terms of the will or trust must provide that gross income will be paid, without any restrictions.

(c) There is no deduction allowed for a payment made from principal, for example no deduction is available for a specific bequest under a will since it must be paid from principal.

(d) Unlike individuals under Section 170, there is no AGI limitation.

Estate Tax Charitable Deduction

- Section 2055 allows a deduction from the value of the gross estate for all bequests and other transfers made to certain charitable beneficiaries.
- There is no limitation on the amount of the deduction in the gross estate, except that the amount of the deduction cannot exceed the value of the property which is includible in the gross estate.
- If death taxes are payable out of the bequest passing to charity, the charitable deduction is reduced (this creates a circular tax calculation).
- If a bequest is split between charitable beneficiaries and non-charitable beneficiaries, a charitable deduction is only allowed if the bequest is in a certain format: where a Charitable Remainder Interest, either a unitrust or annuity interest; where a Charitable Lead Trust a unitrust or annuity interest.

Testamentary Charitable Lead Trust

- Testamentary charitable lead trust pays an annuity or unitrust interest to a charitable beneficiary for a period of time and the remainder passes to the decedent's heirs or other noncharitable beneficiaries.
- An estate tax charitable deduction is permitted for the present value of the annuity/unitrust payments. The annuity can be selected to equal the full value of the interest passing to charity.
- Any growth in value beyond the interest rate used to calculate the annuity will pass to the noncharitable beneficiaries.
- The trust will be taxed as a complex trust for income tax purposes but will be entitled to a 642(c) income tax deduction for the annuity payments paid to charity.
- Example: D bequeaths cash and marketable securities in the amount of $1,000,000 to a CLAT, with an annuity in the amount of $64,000 payable annually for 20 years at a time when the applicable 7520 rate is 2.6%. D's estate will receive a charitable deduction for approximately $988,000. Any growth over 2.6% will pass to the noncharitable beneficiaries. As the annuity is paid to charity, the estate will receive a deduction under 642(c). The trust is otherwise taxed for income tax purposes as a complex trust.

Bibliography – Slides 1 through 25

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GRAEGIN LOANS

Statutory Requirements

The basis for the deduction of interest expense for loans taken to pay estate tax is Section 2053 of I.R.C. and the Regulations under Section 2053 allowing for deduction for administration expenses allowed by the laws of the jurisdiction[1]. Reg. Section 20.2053-3(a) provides that an estate is allowed to deduct expenses that are "actually and necessarily incurred in the administration of the decedent's estate." Under the regs it is stated that "[e]xpenditures not essential to the proper settlement of the estate, but incurred for the benefit of heirs, legatees, or devisees, may not be taken as deductions.

The expenses must also be "bona fide" in nature. See Reg. Section 20.2053-1.

[1] The local law has to give executors authority to borrow for administration expenses – no reference to being allowable as a deduction for State death tax.

Statutory Requirements (Continued)

Deduction allowed even if not yet paid, if amount is "ascertainable with reasonable certainty" and "will be paid". Reg. Section 20.2053-1(d)(4).

Advantage – Deductions not limited to "present value"; but lender family member has interest income when paid or OID income, if interest accrued. The most famous case dealing with this issue is Estate of Graegin (Estate of Graegin v. C.I.R., T.C. Memo 1988-477 (1988)).

CECIL GRAEGIN

Cecil's story. Estate of Cecil Graegin v IRS. Cecil died in 1981. His wife Helen survived him. When Cecil was 68, he married Helen who was then 64. They did a pre-nup. Helen waived all of her marital rights in exchange for a promise that Cecil would provide in a trust for Helen to have the right to occupy the residence for the rest of her life and the trust would pay all expenses to maintain the residence and any excess income went to Helen. On Helen's death, or under other circumstances like cohabitation, the trust ended in favor of another trust that Cecil set up for his family .The trust was funded with bonds and cash of almost $170,000.

CECIL GRAEGIN (Continued)

- Cecil's trust for his family provided that after payment of expenses of administration his voting preferred stock in Graegin Industries would go to his son and 2 grandchildren. These shares were valued at $564,300. Total asset value subject to claims was $667,232. After paying other administration expenses and state inheritance taxes, only $20,000 remained available to pay federal estate taxes of $204,218. The executors decided to borrow funds from a subsidiary of Graegin Industries, rather than sell stock to raise the funds. So a loan was constructed between the estate and the subsidiary calling for payment of principal in 15 years and interest of 15% on the due date and prohibited prepayment of both principal and interest.

CECIL GRAEGIN (Continued)

- The estate deducted $459,491 on the Form 706 ($204,218 x 15% x 15 years) as an admin expense.
- The holding of the Tax Court was in favor of Cecil. The issue came down to an analysis of Reg Section 20.2053-3(a) which provides that the interest expense must be actually and necessarily incurred. (There was no issue concerning the allowance of interest expense in the laws of the jurisdiction-Indiana, per Section 2053(a)(2)). The Court observed that the estate lacked liquidity and did not have to have a forced sale of assets at a financial loss. But, there was one unusual fact that the Court pointed out which will not always be the case. That is, Cecil's executors had figured that Helen (remember her and the

CECIL GRAEGIN (Continued)

pre-nup) would live 15 years from the date her trust was created, after which her trust funds go back to Cecil's trust for issue. Also the executors anticipated dividends to be paid by Graegin Industries to Cecil's trust which would be available to pay the Note. There was a reason for the 15-year term and prohibition of prepayment.

GENERAL PROPOSITIONS

To meet the ascertainable interest requirement, loans prohibit prepayment and call for full payment on default. Basically, the Courts have looked at estate liquidity at the time of the loan as to not only to paying estate taxes, but also as to amount of funds necessary to maintain estate assets. Just because an estate has some liquid assets does not mean that a loan is not warranted- see Estate of Thompson [2] (funds need to pay employees, property tax, etc.)

Court allowed loan from life insurance trust.

[2] Estate of Thompson v. Com'r , T.C. Memo 1998-325, 76 T.C.M. (CCH36) 426, (1998)

GENERAL PROPOSITIONS (Continued)

- Having the same trustees (executors) and beneficiaries in borrower and lender is generally a bad fact regarding the "ascertainable interest" requirement of the Regs. In TAM 200513028, the IRS held that even if interest is paid in these circumstances, it has no economic impact This suggests the IRS is looking for real impact on net worth to satisfy the "bona fide" loan requirement.

FACTS AND HOLDING OF ESTATE OF KOONS v. COMM'R, IRS No 16-10646 (11^{th} Cir. 2017)

In 2017, the Eleventh Circuit decided this case on appeal from the U.S. Tax Court. The Eleventh Circuit upheld the decision of the Tax Court denying the "Graegin Loan" deduction. Mr. Koons owned a very valuable company that bottled and distributed Pepsi products. Mr. Koons' revocable trust owned 46.9% of the voting stock and 51.5% of the non-voting stock. His children owned most of the rest. To settle a dispute with Pepsi a sale was arranged and Mr. Koons' idea was to put all of the sale proceeds in an LLC with certain other assets and small businesses and use the funds to acquire and operate new businesses. Apparently, the children liked

FACTS AND HOLDINGS (Continued)

cash better than business and insisted that if they agreed to the sale they would be able to redeem their interests post sale. After the children's interests were redeemed, Mr. Koon's revocable trust owned over 70% of voting interest and over 71% of non-voting stock interest in the LLC. The estate had insufficient liquid assets to pay the estate tax and generation-skipping tax and borrowed $10.75 million from the LLC for a note providing for no payments for 18 years and then interest (9.5% per annum) and principal total in 14 installments over 6.5 years. With prepayments being prohibited, the projected interest was $71.4 million. The LLC had over $200 million of liquid assets at this time.

FACTS AND HOLDINGS (Continued)

- The Court focused on Reg. Section 20.2053(a) which clarifies that "expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions."
- The 11th Circuit distinguished between (1) the interest payments as necessary expenses to prevent financial loss and (2) the interest payments as expenses where the estate could have paid with liquid assets of one of its entities but elects to make a loan that will eventually be repaid from those same liquid assets, citing <u>Estate of Black v Comm'r</u>, 133 T.C. 340 (2009).

FACTS AND HOLDINGS (Continued)

- In Koons, the Court held that the estate had sufficient liquid assets to pay the tax and the estate lacked other liquid assets, so it would have to use the LLC assets to repay the loan and therefore was an indirect use of the funds. It rejected the argument that the trustee had a fiduciary duty to minority owners not to redeem stock pro rata to ownership. The Court observed that the majority owner could have received the LLC provision limiting distributions to 30% of excess cash flow also. (Owning majority interest in an LLC has its advantages.) The Court was not moved by the argument that it should not "second guess the executor's business judgment" put forth in reliance of <u>Estate of Murphy v. US.</u>, 104 AFTR2d 2009-7703.

FACTS AND HOLDINGS (Continued)

- NOTE THAT THE LOAN HERE WAS $10.75 MILLION DOLLARS WITH AN INTEREST DEDUCTION AFTER 18 YEARS OF $71.4 MILLION—THERE IS NO MRS. HELEN GRAEGIN HERE WARRANTING THE 18 YEARS.

Commercial Loan?

- IT DOES NOT HARM TO TRY FOR A COMMERCIAL LOAN. WITH AN INTEREST RATE SWAP SOME BANKS MAY BE WILLING TO GO WITH A FIXED RATE LOAN. I UNDERSTAND THIS HAS BEEN DONE BY CERTAIN BANKS IN THE PAST AND CAN'T HURT YOUR CASE THAT YOU TRIED COMMERCIAL FIRST.

Section 6166

Section 6166

- Basic Qualification
  - Closely held business value > 35% adjusted gross estate - § 6166(a)(1) and (2)
  - The election - § 6166(d)
  - Payment Dates - § 6166(a)(3)
  - Challenging IRS/Judicial Review - § 7479 (added by the Taxpayer Relief Act of 1997)
    - » Declaratory judgements
    - » Property qualifications
    - » Refund claims

Section 6166

Key Definitions

– Adjusted Gross Estate - § 6166(b)(b)

- The gross estate reduced by the sum of the amounts allowable as deductions under Sections 2053 and 2054

- Interest in a closely held business means an interest in a trade or business carried on as a

(i) Proprietorship

(ii) Partnership (a) with 45 or fewer partners or (b) 20% or more of the capital is in the gross estate; or

(iii) Corporation (a) with 45 or few shareholders or (b) 20% or more in value of the corporation's voting stock is in the gross estate

- Trade or business

-there is no definition

BRACH EICHLER LLC

Section 6166

Trade or business (real estate)

In the 1980s there were many private rulings that interpreted and applied Rev. Rul. 75-365, 75-366, 75-367. The rulings tried to make distinctions with respect to the level of activity involved in the management and operations of the real estate after referring to distinctions with little difference.

In Rev. Rul. 2006-34, the IRS backed off its fairly hardline approach to real estate as a trade or business. The ruling listed 6 non-exclusive factors to be considered:

1. Amount of time devoted
2. Whether an office has regular hours
3. Involvement in locating new tenants and lease negotiations
4. The provisions of landscaping and ground care
5. Involvement in repairs and maintenance
6. Handling tenant repair requests and complaints

Section 6166

Management Company Employees/Contractors

- In the 1970's ruling and in the many probate rulings in the 80's and 90's and early 2000's, the IRS would be fixated on the personal efforts of the decedent. The efforts of employees or contractors of a management company owned by the decedent was not sufficient.

- Rev. Ruling 2006-34 contains 5 hypothetical scenarios. In 4 of the scenarios the conclusion that the decedent was carrying on a trade or business was based on the services performed by employees and agents of a management company in which the decedent had 20% or greater ownership.

Section 6166

<u>Aggregation of Closely Held Interests</u>

- An estate that owns interests in two or more closely held businesses can qualify to aggregate the values of such interests to reach the 35% of the adjusted gross estate requirement.

- In order to aggregate an interest the estate must own 20% or more of the value of the closely held business.

- Example: Decedent has an adjusted gross estate of $7,000,000 which consists in part of 3 interests in closely held partnerships of 30%, 20% and 10% with values of $750,000, $750,000 and $1,000,000 respectively. The 10% interest worth $1,000,000 can not be aggregated. Thus, the total value of $1,500,000 does not reach the 35% hurdle.

Section 6166

General Planning Calculations

- Discount planning
- Passive assets
- Combine with § 6161 request
- Section 2035 coordination
- Generation skipping tax deferral - § 2661(2); § 6166(i)
  - direct skips
- Special Interest Rates - § 6601 (i)

Section 6166

Loss of Deferral/Acceleration

- Disposition of Interest/Withdrawal of Funds
  - the disposition or sale of 50% or more of the value
  - Section 303 redemptions excluded and treated as a reduction in the value of the interest
  - The tax is payable only after notice from IRS
  - Pay off a mortgage – not a disposition
  - Like kind exchange – not a disposition
- Undistributed Net Income
  - Must be paid to reduce the deferred tax
  - Definition – Section 6166(g)(2)(B) defines undistributed net income as the amount by which the estate's distributable net income for a particular taxable year, as defined in § 643, exceeds the sum of: (i) the distribution deduction determined under § 661(a)(1) and § 661(a)(2); (ii) the amount of the federal estate tax and interest paid by the estate during that taxable year (other than an amount required to be paid by the estate because of violating the undistributed income rule).
- Default in Payment/Default in providing a lien to secure payment in certain circumstances

Section 6166

Under § 6161(a)(1) the IRS may extend the time for payment for up to 12 months with 2 examples.

- The IRS can extend the period to pay estate tax for a reasonable period up to 10 years upon a showing of reasonable cause. § 6161(a)(2). Even the time for payment of § 6166 installments can be extended for up to 10 years.

- Reasonable cause can be; delay in marshalling assets due to reasons outside control; substantial assets are rights to money in the future; litigation; lack of liquidity to pay on time

- Deficiency amounts can be deferred for 4 years for reasonable cause

Post Mortem Partnership Planning

- Income in year of death allocations
  - Pre-death period
  - Pre-death period

  Section 754 elections
  - Timing – on partnership returns for year in which death occurs
  - Prior elections
  - Depreciation deduction starts again
  - Mandatory "step down" if more than $250,000
  - Unrealized receivables do not get step up on death (IRS rule) – Quick Trust v. Commissioner
  - How about § 1245 or § 1250 recapture

Section 2032: Alternate Valuation

- Default under § 2031 is that <u>all</u> property is valued at the fair market value as of the date of death
- § 2032 allows the executor to make an election to value all property as of either:
  1) six months after date of death if the estate is still holding the property; or
  2) value as of the date it was distributed, sold, etc., if the property is transferred prior to six months after the date of death
- Election applies to all property
- Election must result in both:
  1) the value of the gross estate being lower <u>**and**</u>
  2) the federal estate tax liability being lower

Making the Election

- Election is made on Part 3 of Form 706 which is filed timely (including extensions)

Form 706 (Rev. 11-2018)

Estate of:	Decedent's social security number

Part 3—Elections by the Executor

		Yes	No
Note: For information on electing portability of the decedent's DSUE amount, including how to opt out of the election, see Part 6—Portability of Deceased Spousal Unused Exclusion. **Note:** Some of the following elections may require the posting of bonds or liens.			
Please check "Yes" or "No" for each question. See instructions. 1 Do you elect alternate valuation?	1	✓	

- Election is irrevocable once made
- Late elections
  - No IRS Permission Needed: An election is allowed without needing permission from the IRS if the estate tax return is filed no later than one year after the estate tax return was due including extensions (meaning potentially up to 27 months after date of death (9 months until return due plus automatic six month extension plus 12 additional months) Treasury Regulation § 20.2032-1(b)(1)
  - IRS Permission Needed: If an estate tax return is filed within one year after the due date of the return (including extensions), then the executor may request an extension of time under § 9100 to make the election. Treasury Regulation § 20.2032-1(b)(1)
- Protective election: If the alternate valuation would not reduce both the value of the gross estate and federal estate tax liability, the executor may make an irrevocable protective election to have alternate valuation apply if it is determined the election would reduce the amount of the gross estate and federal estate tax liability. Treasury Regulation § 20.2032-1(b)(2)

Most Common Disqualifier to Make Alternate Valuation

- If an estate plan has a formula that will utilize the marital deduction so no estate taxes are owed, then an alternate valuation election is not available because there is no estate tax liability to reduce
- Potential solutions:
  - Disclaimer: Spouse could disclaim sufficient amount so a small estate tax is owed—will need to do so within nine months of the date of death in order to qualify as a qualified disclaimer
  - Partial QTIP Election: Executor could decide to not elect QTIP treatment for a portion of a marital trust—will need to do within 15 months of the decedent’s death (nine month filing deadline plus automatic six month extension)

Determining The Value for the Alternate Valuation

- The alternate valuation election still relies on the fair market value standard that is used for the date of death value—it is simply a timing election
- Timing:
  - » If the property is "distributed, sold, exchanged, or otherwise disposed" prior to six months after the decedent's date of death, then it is the fair market value on the date it was "distributed, sold, exchanged, or otherwise disposed"
  - » If the property is not "distributed, sold, exchanged, or otherwise disposed" then it is the fair market value as of six months after the date of death
- Affirmatively fixing the value to maximize the benefit of the election
  - » Making distributions to beneficiaries and funding sub-trusts (i.e. marital and credit shelter trusts) fixes the value
  - » If an asset reaches what the executor believes is a low point—there can be value in distributing so that the appreciation that may occur prior to six months will not be factored in
  - » Need to consider non-tax reasons to keep assets on hand
  - » Be aware that proposed regulations make clear that with businesses, only decreases in value due to "economic or market conditions" and not drops that can be created by business decisions to change the ownership or control structure. Proposed Treasury Regulation § 20.2032-1(f)(2)
- Updated valuations:
  - » For hard to value assets that required an appraisal, those valuations will need to be supplemented to reflect both date of death value and alternate valuation date
  - » Note that changes from "mere lapse of time" for assets such as life estates, patents, etc. do not get factored in to the update valuation § 2032(a)(3)

State Estate Tax Issues with Alternate Valuations

- Federal election can trigger additional state estate taxes—the effect a disclaimer or partial QTIP election to reduce the marital deduction may have trigger additional estate taxes especially in states where the state exemptions are lower than the federal estate tax exemption
- State alternate valuation elections: Some states allow for an election to be made for state estate tax purposes if no federal return is required to be filed

Other Tax Considerations Before Making the Election

- If an alternate valuation election is made, the values used for estate tax purposes become the value for income basis adjustment purposes. § 1014(a)(2)
  - Based on the estate tax apportionment, some beneficiaries may be negatively impacted by making the election
- Alternate valuation election could impact the estate's ability to qualify for benefits under § 303 and/or § 6166 because these provisions require that the value of the business interest exceeds 35% of the value of the gross estate (less expenses under § 2053 and § 2054)
  - Redemption of Stock Under § 303: This allows the redemption of closely held stock to be treated as a sale instead of a dividend up to the value of federal and death taxes as well as funeral and administration expenses
  - Deferral under § 6166: This allows the estate tax attributable to the interest in a closely held business for up to 15 years (with favorable interest charges)

Obtaining a Basis Adjustment

- Generally
  - Property "acquired from the decedent" receives a basis equal to the fair market value of the property at the date of the decedent's death (or the value on the alternate valuation date if such election is made. § 1014(a).
  - Property "acquired from the decedent" is broadly defined under § 1014(b) and includes all property in the gross estate (unless an exception applies)
- Exceptions
  - No basis adjustment for IRD (income in respect of a decedent) items (§ 1014(c)).
  - No basis adjustment for appreciated property acquired by the decedent by a gift within one year of death if it passes back to the donor or donor's spouse (§ 1014(e)).

Basis Reporting Requirements

- July 31, 2015, President Obama signed H.R. 3236, *Surface Transportation and Veterans Health Care Choice Improvement Act of 2015* into law which added § 1014(f) and § 6035
- § 1014(f) provides that the step up in basis "shall not exceed" the amount finally determined for estate tax purposes, but does not apply to property whose inclusion does not increase the tax liability (namely marital deduction property or charitable deduction property)
  - Note that while rule does not apply to property which qualifies for marital or charitable deduction, prior law regarding consistency would apply
- § 6035 imposes a requirement on executors required to file an estate tax return to provide a statement with the basis information within 30 days of the return being filed and a supplemental statement within 30 days if there is an adjustment to "each person acquiring any interest in property included in the decedent's gross estate…"
  - Does not apply for returns filed solely to elect portability or allocate GST

Form 8971 Assets to Be Reported

- Only need to report assets included in the federal gross estate (I.R.C. § 6035(a); Treas. Reg. § 1.6035-1(a)(1))
  - For a non-resident/non-citizen this would only be the US situs assets
  - Basis step still applies for worldwide estate under I.R.C. § 1014(b)—just no Form 8971 reporting requirement
- Items excluded:
  - Cash: (other than coins or currency with collector value) does not need to be reported (Prop. Treas. Reg. § 1.6035-1(b)(i))
  - IRD Items: Assets that do not receive a step up in basis by virtue of Section 1014(c) (Prop. Treas. Reg. § 1.6035-1(b)(ii))
  - Low Value Tangible Personal Property: Tangible personal property which does not require an appraisal under Treas. Reg. § 20.2031-6(b), which is for items with a value greater than $3,000, do not need to be listed. (Prop. Treas. Reg. § 1.6035-1(b)(iii))
  - Property that Was Disposed of and Not Distributed: Assets sold prior to the date the form is filed do not need to be reported. (Prop. Treas. Reg. § 1.6035-1(b)(iv))

Form 8971

- Form 8971 and Schedule A
  - » Form 8971 is sent to the IRS with copies of Schedule A—the Form 8971 itself is a certification Schedule A's were sent, who they were sent to, and the date provided
  - » Each beneficiary receiving property to which the basis consistency rules **may** apply must receive Schedule A listing:
    - » A description on the property (and the Schedule/Item number from the estate tax return)
    - » Whether the asset increased or decreased the size of the estate
      - » If it qualifies for the marital and charitable deduction the answer is "N"
      - » All other property the answer is "Y"
    - » The valuation date
    - » Value reported for estate tax purposes (i.e. on the Form 706)
  - » Must file a supplemental (i.e. amended) Form 8971 and Schedule A for any property adjusted on audit
- Resources
  - » Instructions (Rev. September 2016)
  - » Section 1014(f) and Proposed Reg. § 1.1014-10
  - » Section 6035 and Proposed Reg. § 1.6035-1

Personal Liability of the Fiduciary—Federal Priority Statute

- 31 USC 3713(a) states in relevant part "(1) A claim of the United States Government shall be paid first when . . . (B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor."
- 31 USC 3713(b) states in relevant part "A representative of a person or an estate… paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government."

Application of the Federal Priority Statute

- The executor or administrator is personally liable IF:
  - the executor distributed assets of the estate (with certain exceptions for administrative expenses);
  - the distribution(s) left the estate insolvent; and
  - the distribution(a) occurred after the executor had inquiry notice of the claim of the government.
- Inquiry notice has been found to be that the executor had facts that would put a "reasonably prudent person on inquiry" regarding an unpaid claim. *Allen v. Comm'r*, TC Memo 1999-385.
- Burden on fiduciary--*U.S. v. Estate of Reitano*, 114 AFTR 2d 2004-5919 (2014)
- Warning on Definition of Executor: While statute says executor, see *United States v. MacIntyre*. 110 A.F.T.R. 2d 5151 (S.D. TX 2012). The district court based its finding of liability on the elements of the federal priority statute as detailed in *Huddleston v. Comm'r*, TC Memo 1994-131 in which the Tax Court decision used the term "fiduciary" instead of the text of 31 U.S.C. § 3713 which states it is a "executor or administrator" of an estate. The Tax Court in *Huddleston* was dealing with a court appointed administrator of the estate, not a trustee, but the Tax Court used the term "fiduciary" often throughout its decision. The District Court in *MacIntyre*, simply found that a trustee is a "paradigmatic" example of a fiduciary and is therefore liable.

Protecting the Fiduciary

- Notice of Fiduciary Relationship - § 6903
- Discharge from Personal Liability - § 6905, § 2204
- Request for Prompt Assessment - § 6501(d)
- Estate tax closing letter

Notice of Fiduciary Relationship - § 6903

- Used to notify IRS of fiduciary appointment
- Form 56 – Notice Concerning Fiduciary Relationship
- Prevents IRS notices being sent to wrong address
  - Time period for filing Tax Court petition may expire if statutory notice of deficiency sent to deceased taxpayer's address
- File with Internal Revenue Service Center where decedent is required to file his/her tax return.
- Use Form 56 to notify IRS of commencement and termination of fiduciary relationship

Discharge from Personal Liability - § § 2204; 6905

- Fiduciary personally liable for decedent's unpaid income and gift taxes, and estate taxes if he pays others before paying government the taxes due at death
- Protection available from personal liability by requesting in writing (Form 5495) a discharge from personal liability.
- IRS has 9 months to assess tax due
  - No notice, fiduciary discharged
  - Notice of amount due, fiduciary discharged on payment

Discharge from Personal Liability - § 6905

- Discharge only effective to executor in his personal capacity and as to his personal assets
  - Doesn't release fiduciary in his fiduciary capacity
  - Doesn't protect beneficiaries from transferee liability
- File request with Internal Revenue Service Center where estate tax return is required to be filed, or if no 706 due, where decedent's final 1040 filed.
- Send by certified mail/return receipt to prove when 9 month period begins to run

Request for Prompt Assessment - § 6501(d)

- Applies to income and gift tax liability and estate's fiduciary income tax return
- Shortens the statute of limitations from 3 years to 18 months after filing the request
- Doesn't apply to returns filed after filing request – a new request is needed
- Use Form 4810
- File with Internal Revenue Service Center where the income or gift tax return was filed
- Send by certified mail/return receipt to prove date when 18 month period begins to run

Copies of Previously Filed 709s

- Question on Line 8a of Part 4 of Form 706: Have federal gift tax returns ever been filed?
- If yes, attach copies of the returns, if available, and provide periods covered and Internal Revenue Office where filed
- It is important to attach copies of all Form 709s in the possession of the Estate
- If there is uncertainty as to whether gift tax returns were ever filed, request a copy or transcript from the IRS of gift tax returns filed for specific years on IRS Form 4506 or IRS Form 4506-T
- During the estate administration process, if it is discovered that the decedent made unreported taxable gifts in prior years, file late Form 709s to report such gifts and use portions of decedent's federal applicable exclusion amount and/or pay gift tax, as appropriate
- Section 2204(d)—fiduciary not personally liable for estate tax attributable to unreported gifts made more than three years before death if fiduciary relied in good faith upon returns requested

Estate Tax Closing Letters and Transcripts

- IRS discontinued automatically issuing closing letters for returns filed after June 1, 2015
- Alleged Reason: flooded with estate tax returns electing portability
- IRS put forward transcript requests as an alternative:
  - Estate transcript will have a special code that says "closed examination of tax return"
  - Transaction code 421 indicates that an estate tax return has been accepted as filed or that an examination is complete
  - If the code doesn't appear, the tax return remains under review
  - Account transcripts for estate tax returns can be obtained by using Form 4605-T, Request for Transcript of Tax Return
  - Notice 2017-12 – transcript with Code 421 is the "functional equivalent" of a closing letter that you can take to probate court or state department of revenue
- Must wait four to six months after filing the Form 706 before requesting an account transcript or closing letter

Requesting an Estate Tax Closing Letter

- The executor or authorized representative must ask for an estate tax closing letter
- Call (866) 699-4083 or fax a written request to (855) 386-5127 or (855) 386-5128 to request a closing letter
- Request for closing letter goes to different area of IRS and responding IRS employee may ask questions or request additional information
- Issue: if you don't get closing letter, how long can a Section 645 election remain effective? Rule is 6 months after final determination

State Tax Liability Issues

- Fiduciaries must be mindful that each state has its own claims procedure in probate that give high priority to state claims
- Fiduciaries should follow local probate and tax procedures to secure relief
- Fiduciaries must determine what states other than the state of domicile that it may need to contend with and consult local counsel