SELECTED ISSUES IN POST-MORTEM ESTATE TAX PLANNING

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POST-MORTEM ESTATE PLANNING

I. INTRODUCTION

Most estate planning professionals think of "estate planning" as an activity undertaken for living clients, and "estate administration" as the activity undertaken for estates. In practice, however, there are a multitude to "planning" opportunities that arise during the administration of a decedent's estate. The goal of this outline is to focus attention on the tax planning opportunities that arise when administering the estate of a decedent. An exhaustive examination of the issues would result in a book-length outline (or a semester-long course in law school). This outline is intended to hit some of the highlights in the area of post-mortem estate planning. Broadly speaking, post-mortem planning can be broken down into estate tax issues and income tax issues. Because disclaimers are such an important part of post-death estate planning, that topic merits special attention.

II. ESTATE TAX ISSUES

Post-mortem planning in the estate tax arena looks at the elections and options that are available to the personal representative of an estate to minimize or defer estate taxes. A complementary concern is ensuring that availability of important estate tax deductions, and outlining steps to ensure that those deductions will be fully allowed.

A. Valuation Issues. One of the most important duties of a personal representative in completing an estate tax return is determining the fair market value of the assets of the decedent as of the relevant valuation date. Many times, the personal representative relies on valuation professionals to ensure that assets are properly valued. There are a number of factors that the personal representative must consider, however, when it comes to valuation of assets.

1. Valuation in General. Treasury Regulation 20.2031-1(b) sets forth the general rule of valuation for determining the fair market value of assets in the estate of a decedent. While many people are familiar with the "willing buyer/will seller" formulation of the regulation, a more complete recital in instructive:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. . . . The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

2. Specific Valuation Issues.

a. Real Estate. Except when special use valuation of real property is validly elected, real estate must be included on the return at its full fair market value. The regulations require that the "highest and best use of the property" be considered. Treas. Reg. § 20.2032A-3(a).

(1) To Appraise or Not to Appraise. Should the executor hire an expert to appraise the estate's real estate? This process can be costly,

and many executors try to avoid this expense if possible. In general, experience has shown that the IRS will accept something less than a formal appraisal, especially for residential real estate, when no tax is due. In those circumstances where no appraisal will be obtained, two sources of information should be compared. These include the assessed valuation for property tax purposes, and the opinion of a broker familiar with real property in the area, generally in the form of a letter to the executor.

(2) Property Tax Valuations. In some regions, executors routinely bring to the first meeting valuations assigned by county tax assessors. They are often irate to find out that the IRS is unlikely to accept these valuations, which may be two-thirds or less of the current value of the property. In other regions, and especially if prices are in a state of decline, local property tax valuations often exceed the current fair market value of property. Remember, that these valuations are a matter of public record. The examining attorney is advised to check this valuation even before contacting the estate representative. See IRS Estate Tax Examiner's Handbook § 630. In practice, many examiners do not review these valuations beforehand, but routinely ask for them in an audit. If the value returned is materially less than the value assessed by local taxing authorities, the IRS is apt to ask why the taxpayer failed to protest the evaluation, taking the position that the failure to protest is an "admission" of value by the decedent.

(3) Broker's Letters. Real estate brokers are typically happy to provide you with a letter giving an indication of the value of residential real property. In requesting these letters, you should make sure that the broker knows the purpose for which it is requested. A letter from you requesting a "low ball" or "estate tax" value for the property will not look good if discovered in litigation regarding the value of the property. Ask the appraiser instead to give you a realistic value. If there are any special characteristics of the property that the broker may not know about, it is certainly permissible for you or the executor to point these out to the broker. Ask the broker to include a single value in the letter, not a value range. Also, ask the broker to recite that he or she is familiar with property in the area of the subject property, and to indicate that the broker has personally inspected the subject parcel.

(4) Appraisals. If the determination is made to obtain an appraisal, the competence of the appraiser is important. Many people prefer to use an MAI appraiser, especially for commercial property. If valuation of the real property is of critical importance, special efforts on the part of the preparer may be called for.

(a) Experience and Reputation. Take some time to verify the reputation of the appraiser. Ask if he or she has testified in court, particularly with respect to estate tax valuation cases. Ask if he or she has performed services on behalf of the IRS. The IRS does not have appraisers on staff. Rather, they hire local appraisers to work for them on a case-by-case basis. If your appraiser is regularly engaged by the IRS, be sure that he or she can take an aggressive position on your behalf without fearing the loss of future IRS appointments. If you hire an appraiser and later use another, the IRS may utilize the services of the first appraiser. There is no "appraiser-client privilege." *Estate of Halas v. Comm'r*, 94 TC 570 (1990).

(b) Other Cases. If the appraiser has testified in court before, what was the outcome? Consider running the appraiser's name through Lexis and Westlaw. If a judge has criticized your expert in a written opinion, you may want to reconsider before retaining him or her. (Note: You can use this same method against the IRS's expert if you get into a dispute).

(c) Verbal Reports. Talk to your appraiser and get a verbal report before the written report is submitted. It is often difficult to get an appraiser to consider additional factors that impact values after a written report is prepared. If you get a written appraisal, and then decide to hire a different appraiser to prepare the "final" appraisal, be forewarned. The IRS examining attorney is likely to ask for copies of all appraisals. You should be ready to explain why you decided not to use the first appraisal--preferably some reason other than you thought it was too high.

(d) Personal Inspection. Make sure that you and the appraiser personally visit property. In several cases, judges have harshly criticized appraisers who have prepared written reports based upon statistical analysis without actually inspecting the property. The examining attorney may have some questions about the property that can be answered quickly by someone

who has been there. You will appear much more prepared and aware of the estate's assets if you can report that you have personally inspected the real property.

(e) Rental Income. Review the decedent's income tax returns for rental income. Make sure that the appraiser has this information so that rental income and valuation information will appear consistent.

(f) Adjustment Grids. The IRS frequently requests that "comparable" properties used to value nonresidential real property be analyzed by use of an "adjustment grid." This grid is simply a table, listing comparable property along one axis and comparison factors (such as size, location, condition, access, etc.) along the other. Comparable factors are then adjusted in the table, in dollar or percentage terms, to yield a net adjusted value for each comparable tract. These adjusted values should approximate the value shown for the subject tract. Advise the appraiser in advance that an adjustment grid may be required, so that one can be prepared in advance of the finalization of the report.

(5) Sales and Listings. Be sure that you know whether the property has been sold or listed for sale. The IRS is almost certain to ask whether any such activities have occurred. If the return shows a value of only half of the value that the property sold for ten months after the date of death, be prepared for an adjustment, or at least a fight. On the other hand, if the property sells for less than the appraised value, you should not feel compelled to report the value as appraised. *See, e.g.*, *Gettysburg National Bank v. U.S.*, 92-2 USTC ¶60,108 (D.C. PA 1992) (upholding a valuation of property for its $84,000 sales price fifteen months after date of death despite taxpayer's date-of-death appraisal at $115,000.)

(6) Discounts for Undivided Ownership. When the decedent owns less than one hundred percent of the fee interest in a parcel of real estate, an argument exists for valuing the property at less than the figure obtained by simply multiplying the decedent's ownership in the property times the fair market value of the fee. For example, in *Estate of Pillsbury v. Comm'r*, 64 TCM 284 (1992), the Tax Court permitted a fifteen percent discount for a decedent who owned an undivided seventy-seven percent in real property. The court there noted "Although the Cromwell Place property represents the majority interest, the owner of the property would nevertheless need an agreement or consent from the minority owner in order to exercise all of the rights associated with ownership of the property." Thus, it appears that discounts for lack of marketability should be available for individuals who own undivided interests in real property. Note, however, that the IRS has taken the position that fractional interest discounts for real property are limited to the cost of a partition action. TAM 9336002. *Cf. Estate of Yoale v. Comm'r*, 1989 T.C. Memo. No. 138 (upholding a 12.5 discount based upon a number of factors beyond costs of partition); *Estate of Barge v. Comm'r*, T.C. Memo 1997-188 (26% discount for a 25% undivided interest in timberland, based on cost and time for partition, anticipated annual income, applying a 10% capitalization rate and present value four years in the future); *Estate of Ellie Williams v. Comm'r*, T.C. Memo 1998-59 (20% for lack of marketability and additional 30% for lack of control and need to bring partition action to realize value–court noted absence of sales of fractional interests evidenced lack of marketability); *Estate of Brocato v. Comm'r*, T.C. Memo. 1999-424 (20% discount for decedent's 50% interest in multiple dwelling properties); *Estate of Forbes v. Comm'r*, 81 TCM 1399 (2001) (30% discount, based on various factors including: (1) minority interests; (2) restricted mark due to limited pool of potential buyers, difficulty of securing financing and likely costs of partitioning; (3) appraiser could not locate comparable sales; (4) specific characteristics of the property; and (5) possible intra-family conflicts); *Estate of Baird v. Comm'r*, T.C. Memo. 2001-258 (60% undivided interest discount for timberland). Zeydel & Benford, *Valuation Principles and Recent Developments: Practical Guidance for the Estate Planner*, 34 REAL PROP., PROB. AND TR .J. 207, 244-47 (1999).

(7) Mineral Property Interests. Don't forget that mineral properties, including working interests, royalty interests or retained minerals, are real property, and should be reported on Schedule A of the return. Many estates own mineral interests of varying degrees, ranging from vast oil and gas holdings to nominal interests the value of which is scarcely more than the cost of obtaining an appraisal. The method selected for valuing mineral interests depends to a large degree upon how material a component of the estate the minerals constitute. Analytical appraisals are the most common method of valuing significant

properties. The cost of these reports, however, makes them impractical for moderately valued property. The comparable sales method provides perhaps the best evidence of fair market value, assuming that other producers in the area are willing to disclose information about their prior sales transactions. *See* Treas. Reg. § 1.611-2(2). Another approach is based upon calculating the average net monthly revenue (eliminating production costs and taxes) from production during the prior twelve months, then assuming a production life of between twenty-four and sixty months. The estimation must be qualified if the well is new (because the first few months of production may be unrealistically high) or in an area where producing life is known to be short. Practitioners, whether explicitly or implicitly, interject a present value discount and a risk discount in selecting a suitable production life. Another approach utilizes a slightly more complicated formula. Production data and a production rate-versus-time plot for the lease is obtained from a public database service (e.g., Dwights Energy Service). Using this information and an estimate of the economic productive limit of the wells, a decline curve can be drawn to estimate future production. Finally, risk and present value discounts as well as oil pricing estimates can be applied. No matter which method of valuation you choose, be able to give a reasonable explanation, backed up by financial information, in case the IRS makes an inquiry. For a more detailed discussion of these valuation techniques, See Cantrill, "The Use of Clifford Trusts by the Owner of Oil and Gas Properties," 6 SMU Estate Planning Institute 10-7 to 10-9 (1984).

b. Stocks and Bonds.

(1) Publicly Traded Securities.

(a) Valuation Procedures. Generally speaking, the valuation of publicly traded securities is subject to little dispute. The valuation techniques described in the regulations are straight-forward and easy to apply. Treas. Reg. § 20.2031-2. If there were no sales on the valuation date but sales within a reasonable period before and after the valuation date exist, an inverse weighted average is used. If the security is traded daily but the valuation date falls on a weekend date, the value would be a simple mean of the mean of the Friday and Monday highs and lows. Treas. Reg. § 20.2031-2(b). The two most common errors for most publicly traded stocks are using the wrong values and failure to consider accrued income. Frequently, clients ask their brokers to provide values for securities. Many use the closing price on the date of death instead of averaging the high and the low price for that date. While the values reported don't tend to be materially different, use of the wrong values shows sloppiness, and may lead the examining attorney to inquire more deeply into other areas of the return. Be sure that the broker, or whoever assists you in determining values, uses the prescribed technique. If you are valuing the securities yourself, a look at the Wall Street Journal for the day after the date of death should get you the information you need. Most practitioners now access electronic security valuations services such as "Estate-Val" (www.estateval.com), produced by Estate Valuation & Pricing Systems, Inc., Santa Monica, California. This service offers detailed stock and bond valuation information for a nominal cost, and is the method used by the IRS to verify securities valuations.

(b) Blockage. In some circumstances, it may be appropriate to argue that the listed price does not reflect the value of the decedent's stock. The usual grounds for this distinction are restrictions and blockage.

i) The IRS recognizes that corporate executives, participants in initial public offerings and other insiders may have special restrictions on their ability to dispose of their stock. See Rev. Rul. 77-287, 1977-2 C.B. 319. These restrictions force insiders to take market risks that holders of unrestricted stock do not face. Get the input of a competent broker to give you guidance on this subject.

ii) Blockage relates to the notion that the market is driven by supply and demand. If the decedent holds a block of stock that is large in proportion to the average trading volume of the stock, it could well be argued that prices would decline if all of the decedent's stock were dumped on the market on the date of death. The courts have recognized that the decedent's stock can be valued as a block, and not on a share-by-share basis. *See, e.g.*, *Estate of Sydney M. Friedberg v. Comm'r*, 63 TCM 3080 (1992). Again, input from a knowledgeable broker is essential. The IRS Estate Tax Examiner's Handbook suggests that large blocks of stock may also be subject to an

upward adjustment for a "control premium." Be prepared for this argument in advance by discussing the issue with a knowledgeable broker.

(2) Savings Bonds. U.S. Series E Savings Bonds are valued at their redemption value. Rev. Rul. 55-278, 1955-1 C.B. 471. The accrued interest (the increment in value) on the bonds is all taxable for federal income tax purposes as gross income of the recipient of the redemption proceeds. Id. Despite the fact that these bonds carry with them an inherent income tax liability to the recipient, the IRS has rejected an argument that the value of the bonds may be discounted for estate tax purposes, reasoning that in applying the willing buyer-willing seller test, "the only willing buyer is the United States government." TAM 200303010.

(3) Dividends. If a dividend has been declared for stock owned by the decedent, the dividend should be reported as a separate line item, but only if the decedent died after the record date and before the payment date. For publicly traded stocks trading "ex-dividend" i.e., if the valuation date is on or after the ex-dividend date (the date that the seller of the stock is not entitled to the dividend) but before the record date (five days after the ex-dividend date when the records of the company or dividend disbursing agent show who owned the stock on the ex-dividend date), the dividend is not reported as a separate item, subject to the income-in-respect-of-a-decedent rules. Rather, the amount of the dividend is added to the quoted ex-dividend price in determining the fair market value of the stock. Treas. Reg. § 20.2031-2(i); Rev. Rul. 68-610, 1968-2 C.B. 405.

(4) Closely Held Stocks.

(a) Revenue Ruling 59-60. Revenue Ruling 59-60, 1959-1 C.B. 237, sets forth the factors to be considered when valuing an interest in a closely held business. This topic is a course in itself. As with real estate, it will probably be worthwhile to hire a professional business appraiser if the business is a material assets. This is particularly true in those circumstances where the estate intends to qualify for special relief provisions such as Sections 303 or 6166 of the Code, and eligibility based upon the ratio of the value of the business to the total estate may be at issue. If no formal appraisal is obtained, and you assist the executor in preparing an evaluation, you would be well served to attach a schedule describing the factors considered in arriving at your value. These evaluations are often compared to the language of Revenue Ruling 59-60, so you should consider incorporating into your discussion the factors there outlined.

(b) Financial Information. Be sure to include financial data for the closely held business. The instructions for Schedule F request balance sheets and income statements for partnerships and unincorporated businesses for the five years preceding the date of valuation. The IRS will often settle for two or three years worth of information if the operations of the business are fairly consistent. Avoid the temptation to include older years' information if they show substantially lower profits, in hopes of taking an "average" for valuation purposes. The IRS might compare those lean early years to the year of the date of death, and see a "trend" upward, which argues for a higher valuation.

(c) Necessity for Appraisal. Many times executors prefer to avoid the expense of obtaining an independent valuation of closely-held stock, even if the value of the business is significant. Instead, executors simply attach a statement to the estate tax return determining and explaining how the valuation is determined. Executors who seek to save fees in this regard for a material asset should consider the outcome in *Estate of Berg v. Comm'r*, 61 TCM 2949 (1991). In upholding the valuation and the understatement penalties imposed by the IRS where no formal evaluation was conducted for more than four years after the date of death, and minority discounts were taken without analysis based upon prior case law, the Tax Court noted:

> Petitioner's reporting of the Decedent's Vaberg stock was vague, cursory and inadequate. Particularly given that the Petitioner was granted an additional three months to accurately determine the values of the shares. In preparing its estate tax return, Petitioner did not commission an appraisal of the fair market value of the Vaberg stock, relying entirely on the underlying *Estate of Andrews v. Commissioner* . . . an opinion which provides no support for Petitioner's valuation. An unexplained reference to a single opinion of this Court decidedly distinguishable on its specific factual circumstances is not a reasonable basis for reporting the value of an interest in a closely held corporation. Petitioner's reporting

the value of the Decedent's interest in Vaberg demonstrates a lack of effort to reasonably determine the appropriate discounts.

(d) Buy-Sell Agreements. Many advisers are under the mistaken impression that the value fixed by a buy-sell agreement will set the value of the decedent's interest in a closely held business. While the selling price may be binding under local law, and may limit the cash available to the estate, the IRS is not bound by the value. Generally, unless the sales price represents a bona fide business arrangement, the IRS may disregard the buy-sell agreement as a tool to shift wealth at death. *See*, *Estate of Joseph H. Lauder v. Comm'r*, 69 TCM 997 (1990); 64 TCM 1643 (1992). *See also* Treas. Reg. § 20.2031-2(h); Rev. Rul. 59-60, 1959-1 C.B. 237. As to agreements entered into (or substantially modified) after October 8, 1990, when other parties to the buy-sell include family members of the decedent, the IRS may ignore the buy-sell valuation unless it is a "bona fide business arrangement" with terms "comparable to similar arrangements entered into by persons in an arms' length transaction." IRC § 2703.

(e) Loss of Key Man. Appraisers typically will apply an adjustment in valuing a decedent's interest in a closely held business if the decedent's services were a critical factor in the continued success of the business. *See, e.g., Estate of Ruben Rodriguez*, T.C. Memo. 1989-13; *Furman v. Comm'r*, T.C. 1998-157 (gift tax case permitting 40% combined marketability and minority interest discount and a 10% key manager discount).

(f) Built-in Gains. Before 1986, the so-called *General Utilities* doctrine provided that a liquidation of a corporation would not generally generate gain at the corporate level. Since 1986, the statutory repeal of that doctrine has permitted taxpayers to argue that the corporate level tax would be taken into account by a buyer of stock, and so should be considered in valuing the stock. Historically, the Tax Court has refused to permit an adjustment of corporate stock for the built-in gains tax where there was no plan of liquidation. *Eisenberg v. Comm'r*, T.C. Memo 1997-483. However, the Second Circuit reversed the Tax Court on this issue in *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir.1998) acq. 1999-4 IRB 4. The Second Circuit noted that the key inquiry for valuation purposes should be on what a hypothetical buyer would take into account in computing fair market value of the stock. The Court did not find that it would be speculative to conclude that a buyer would consider tax consequences. The Fifth Circuit allowed a similar adjustment for the corporate built-in gains tax in *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). *See also, Estate of Welch v. Comm'r*, 208 F.3d 213 (6th Cir. 2000), 85 A.F.T.R.2d 2000-534; *Estate of Simplot v. Comm'r*, 112 T.C. 130 (1999), rev'd on other grounds, 249 F.3d 1191 (9th Cir. 2001).

(g) Costs of Sale. Many times, an executor will ask that additional factors be considered in valuing an interest in a closely-held corporation. One point of contention relates to potential selling expenses and tax liabilities that might be incurred upon a sale of the underlying business assets. Courts have long held that it is inappropriate for such factors to be considered. *See, e.g.*, *Estate of Cruikshank v. Comm'r*, 9 T.C. 162 (1947); TAM 91500001.

c. Mortgages, Notes and Cash.

(1) Bank Accounts. Reporting of bank accounts is very straight forward. Here again, prior investigation can avoid unpleasant surprises on audit.

(a) Cancelled Checks. Review canceled checks written by the decedent. These provide a wealth of information about what the decedent spent funds on. These may provide clues as to debts and potentially refundable items (such as subscriptions to be canceled and the like).

(b) Reconciliation. Many practitioners do not do a formal bank reconciliation to get a closing balance on checking accounts. It is probable that any checks that failed to clear before the date of death were written in payment of valid debts of the decedent. Additions to the checking account for uncleared check are typically offset by a corresponding increase in the debts outstanding on the date of death. Accordingly, bank reconciliations do not change the amount of the taxable estate. In other words, you may exclude outstanding checks from Schedule C so long as they were written in payment of debts not also deducted on Schedule K. Treas. Reg. § 20.2031-5. If you do reconcile the account, don't forget to adjust Schedule K to include debts

"unpaid" on the date of death due to the fact that the check given in payment was still outstanding.

(c) Unusual withdrawals. Look for unusual transaction between the decedent and beneficiaries. Large sums transferred may reflect unreported gifts for which a post-death gift tax return may be required. If checks were written as gifts immediately before the date of death, find out when the checks cleared. This situation presents an exception to the "don't reconcile" rule described above, since a check written as a gift does not represent the payment of a debt. Expect the IRS to take the position that checks that failed to clear before the date of death are not "complete" gifts, since the decedent could have "revoked" them by stopping payment. *See, e.g.*, TAM 8722004.

(2) Cash On Hand. Some commentators have suggested that cash on hand should be reported, and that failure to do so may indicate carelessness in the preparation of the return. Most practitioners that I have questioned about the matter, however, rarely report cash on the person of the decedent. Interestingly, the IRS Estate Tax Examiners Handbook notes that most wealthy individuals carry fairly substantial amounts of cash on their person, especially in the case of a sudden death. It goes on to state, however, that "[i]nquiries as to the facts in each case require extra tact and diplomacy. It is not prudent to antagonize members of the decedent's family by reason of pocket money, the amount of which may be trivial in comparison with the gross estate. However, affidavits should be required where the decedent is known to have had the custom of carrying substantial amounts of cash on his/her person and the return discloses nothing of this nature." The Handbook fails to disclose how the examining attorney is supposed to familiarize himself with the decedent's "custom" regarding spending money.

(3) Mortgages and Notes. Schedule C, of course, lists mortgages and notes owed to the decedent. The balance due on these items is an estate tax asset. Be sure to accrue interest on these items through the date of death. Treas. Reg. § 20.2031-4.

(a) Installment Gain Obligations. If the note or mortgage represents an item being reported by the decedent using the installment gain method, no step-up in basis will be available, and the recipient of the remaining note payments will report the balance of the gain unless the note is disposed of by the estate in a manner that accelerates gain into the estate itself. IRC §§ 691(a); 1014(c).

(b) Reporting Notes at Less than the Outstanding Balance. If the maker of the note is insolvent or if for some other reason the outstanding balance of the note does not reflect the amount expected to be received by the estate, the executor might choose to value the note at less than its outstanding balance. For example, Technical Advice Memorandum 9240003 valued a promissory note held by the estate payable from the decedent's insolvent nephew at substantially less than the unpaid balance, reflecting the fact that the nephew's total indebtedness amounted to $455,000, while his assets totaled only $39,200. In fact, the decedent's Will distributed the promissory note to the nephew in the form of an inheritance and made a specific bequest of publicly-traded securities to the nephew in excess of $1,000,000. Nevertheless, the IRS agreed that the appropriate method for valuing the note was its value at the time of the noteholder's death, at which time the nephew was insolvent. Therefore, a reduced value was upheld. *See, Smith v. U.S.*, 77 A.F.T.R.2d 96-1164 (S.D. Miss. 1996) (note issued by Fortune 500 company may be discounted for lack of marketability; $5.5 million note valued at $3.5 million, based upon expert testimony that limited the pool of potential buyers); *Estate of Luton*, 68 T.C. Memo 1994-539; *Estate of Freidberg*, 63 T.C. Memo 1992-310; *Kronenberg v. Comm'r*, 64 T.C. 428 (1975). *See also* Harshman, *Planning Opportunities for Notes Receivable in an Estate*, EST. PL. (April 2003); Thompson, *Installment Obligations in Estate Administration: Issues and Opportunities*, PROB. & PROP. 51 (Nov/Dec 2000).). Notes that do not represent installment gain obligations will receive a new cost basis. Care must be taken in reporting notes at other than their face value, since the income tax consequences to the beneficiary who ultimately receives the note payments must be considered. *See* IRC § 453B. In general, any principal received in excess of basis will constitute ordinary income to the payee, since no "sale or exchange" occurs when collecting the note.

d. Life Insurance. Many clients are surprised to find that insurance is estate taxable. The insurance industry has done such a good job

marketing insurance as tax free to the recipient, that many clients believe that the exemption applies to estate taxes as well as income taxes.

(1) Includible v. Not Includible. Of course, most insurance on the life of the decedent will be includible in the taxable estate, either because it is payable to the estate, or more likely, because the decedent possessed some incident of ownership over the policy. IRC § 2042.

(a) Incidents of Ownership. In general, insurance is includible when the decedent owns or controls the policy. The "incidents of ownership" rules are very broad. Treasury Regulation Section 20.2042-1(c)(2) provides that they include "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."

(b) Indirect Incidents. Incidents of ownership may be direct or indirect. For example, buy-sell and company owned insurance is often includible in the estate either directly, if the decedent owns the company (and thereby controls the policy), or indirectly, by increasing the value of the company as a result of the decedent's death. See Treas. Reg. § 20.2042-1(c)(6). No double inclusion should occur. If the insurance received by the company is subject to an obligation to purchase the decedent's stock, the liabilities of the company will increase by a corresponding amount.

(c) Close Scrutiny. Life insurance trusts, or insurance owned by and payable to the decedent's children, involve situations where insurance may well be excluded from the estate. Expect the IRS to scrutinize the arrangement closely, since any indication of ownership or control by the decedent will result in a windfall to the government. Don't be surprised if the examining attorney asks for a copy of the policy, as well as the application, and all documents relevant to the creation and administration of the trust.

(d) Transferred Insurance vs. New Insurance. Section 2035(a)(2) provides if the insured makes a transfer of life insurance on the insured's life (or otherwise relinquishes incidents of ownership) within three years of the insured's death, the proceeds of the policy will nevertheless be subjected to tax in the estate of the insured. At one time, the IRS had some considerable success litigating "indirect" or "beamed" transfers by the insured. These cases involved situations in which the decedent transferred cash to a trust, which used the cash to buy insurance. If the decedent died within three years of the transfer of cash, the IRS argued that the decedent in effect transferred the insurance. *See, e.g., Bel v. U.S.*, 72-1 USTC ¶ 12818 (5th Cir. 1972). In a series of more recent cases, however, the IRS has not prevailed and the courts have criticized the IRS for continuing to litigate the issue. In *Estate of Perry v. Comm'r*, 91-1 USTC ¶ 60,073, the Court of Appeals for the Fifth Circuit held that the issue could not continue to be litigated in good faith by the IRS, and that taxpayers should begin seeking attorneys fees from the government if the issue was again pursued.

(2) Form 712's. Insurance valuation is very simple when the insurance company is cooperative. A Form 712 provides an exact valuation. It may not be as easy as it sounds, however. It seems that more often than not, the company ends up faxing the Form 712 the day before the return is due. Many death claim forms ask the claimant whether a Form 712 is desired. If possible, advise the claimant to request this form when the claim is filed, and be sure that a copy is provided to you as soon as possible.

e. Jointly Owned Property. Generally speaking, there are four types of co-owned property. However, only two forms of jointly owned property are properly reported on Schedule E. Tenancy in common, or simple co-ownership does not involve a survivorship feature and so assets held in this fashion are reportable on the appropriate schedule by indicating the percentage of undivided ownership in the description of the item. Likewise, community property with rights of survivorship, while involving a survivorship feature, is not reported on Schedule E by most practitioners in community property jurisdictions, since both halves of the community get a new cost basis. "True" joint tenancy with rights of survivorship and tenancies by the entirety are properly reportable on Schedule E. With regard to these forms of ownership, the reporting rules are quite clear. If the only joint tenants are husband and wife, one-half of the property is included in the estate of the first spouse to die. I.R.C. § 2040(b). For all other joint owners, *all* joint property is included in the estate of the *first* of the

joint tenants to die, except to the extent that the survivor can prove contribution. The amount excluded is the proportion of the value of the joint property attributable to the survivor's contribution. *See* IRC § 2040(a). Developing the facts necessary to apportion the property among the decedent and the surviving joint tenant(s) can be a very difficult task. Little advice can be given other than to start early, and hope that the decedent and the surviving joint tenant(s) kept good investment records. Can one apply a fractional interest discount for property owned jointly by a married couple includible under Section 2040? In *Estate of Wayne-Chi Young v. Comm'r*, 110 T.C. 297 (1998), the Tax Court held that under Section 2040, unlike Section 2033, the test for valuation is not how much a willing buyer would pay for the decedent's interest. Instead, Section 2040 provides an "artificial inclusion of the joint tenancy property: the entire value of the property less any contribution by the surviving joint tenant." Accordingly, the court reasoned that Section 2040 is not concerned with "quantifying the value of the fractional interest held by the decedent (as would be the case under § 2033)." *See also Estate of Fratini v. Comm'r*, T.C. Memo. 1998-308.

f. Miscellaneous Property. Schedule F is the repository for all sorts of assets not specifically assigned to other schedules. Several items bear particular mention.

(1) Household Goods. In practice, household goods are almost never listed separately, and room-by-room inventories described as "desirable" in Treasury Regulation Section 20.2031-6(a) are rarely taken. Rather, some reasonable lump sum value is assigned. Avoid the temptation to use the value assigned by home owners insurance policies, since it is a function of the value of the home and probably bears no real relationship to the fair market value of the contents of the decedent's furniture and person effects. On the other hand, note the comment in Section (11)10 of the IRS Estate Tax Examiner's Handbook. After lamenting the lack of consistency in reporting in this area, and the practice of reporting items as having a nominal value, the handbook states: "If we considered the items returned on Schedule F as truly reflecting the decedent's standard of living, we would conclude that the decedent owned but one suit, no wristwatch, and used orange crates for furniture."

(2) Cars, Boats and Airplanes. Cars can be reported at blue book value, but also check the local paper. Some models routinely sell for less than blue book value in a particular community. Boats and airplanes can be valued on a similar basis. Be sure to ask whether the executor has sold or intends to sell these assets, since an actual sales price will typically be regarded as the best indication of value.

(3) Jewelry, Gems and Furs. The IRS seems to believe that all wealthy individuals own an inordinate amount of valuable jewelry and furs. It is a good practice to review the homeowners' insurance policy and watch for specific bequests in the Will. The insured value may not reflect fair market value. If the decedent thought enough of the piece to get a rider on a policy, or to make a specific bequest of it in the Will, expect that the IRS will argue that more than a nominal value should be assigned. These items can usually be appraised on a fairly inexpensive basis, and a good appraisal should go a long way to avoiding an audit issue. The IRS has successfully maintained that retail value for the estate's jewelry should be used rather than wholesale value. *Lemann v. U.S.*, 94-1 USTC ¶60,159 (E.D. La. 1994).

(4) Antiques and Art. Treasury Regulation Section 20.2031-6(b) provides that articles having an artistic or intrinsic value of more than $3,000 call for an expert appraisal made under oath. In practice, the $3,000 limit is somewhat loosely enforced. If items have significant value, however, an appraisal is expected. Failure to obtain and attach an appraisal for a Schedule F item of substantial value may be enough by itself to draw an audit.

(5) Business Interests. Schedule C of the decedent's income tax return should give you on overview of the nature of the decedent's business interests operated as proprietorships. This type of business interest is valued in a manner similar to other closely held businesses with two notable exceptions. First, it is often easier to argue that no good will or going concern value should be assigned to a proprietorship, since the good will is more strongly associated with the individual operating the business, who, of course, is now deceased. Second, the liquidation value of the business usually establishes a floor for valuation, since no sort of minority or blockage discounts are generally available.

(6) Partnership Interests. Partnership K-1's on the decedent's income tax return again signal an estate tax asset. Partnerships are probably one of the most difficult of business interests to value, although customary valuation principles will apply. Beware of being tempted to either extreme. Thus, you may be tempted to assign little or no value to a tax-shelter partnership, but remember that the value assigned establishes a new basis. IRC § 1014. Especially if a Section 754 election is in effect at the partnership level, the income tax benefits of assigning basis, if justifiable, may be worthwhile. On the other hand, if the partnership interest was generating passive losses for the decedent that were suspended, those suspended losses may be recognized in the year of death on the decedent's final income tax return, but only to the extent that they exceed the amount by which the basis is stepped up in value. IRC § 469(g)(2). Thus, a high value may provide an increased basis against which to deduct future losses, but at the cost of foregoing an opportunity to take a current loss on the decedent's final 1040. Although the general partner of a limited partnership may be a good source of information, especially if recent trades of limited interests have occurred, general partner/promoters may have a tendency to overestimate the value of limited partnership interests, perhaps out of habit. Of course, since a limited partner has no ability to dissolve or control the partnership, the value of the interest is typically significantly less than a value obtained simply by multiplying the percentage interest held by the limited partner times the value of the underlying assets of the partnership. *See Estate of Harrison v. Comm'r,* 52 TCM 1306 (1987).

(7) Insurance on the Life of Another. If the decedent owns an interest in an insurance policy on the life of another (such as a deceased husband's one-half community property interest in a policy on the surviving wife's life), this interest must be valued and reported on Schedule F. Again, Form 712 should be requested from the insurance carrier. Specify that you want Part II of the form completed as of the date of death. The form computes the proper transfer tax value, known as the "interpolated terminal reserve" value of the contract. This value is approximately equal to cash value, but includes a few important adjustments (such as unearned premium) that the regulations require. Treas. Reg. § 20.2031-8(a)(2).

(8) Section 2044 Property. Remember that on the return of the second spouse to die, property included in the marital deduction trust established under the first spouses's Will will be included on the return. The same is true for spouses who are beneficiaries of lifetime trusts established by their spouse for which a QTIP election has been made. The property in the marital deduction trust, included in the deceased spouse's estate under Section 2044 of the Code, is reportable on Schedule F. Most practitioners typically attach an exhibit to the schedule which lists the assets in the trust in "Form 706 order" and shows the date-of-death value of the property. Don't forget that accrued income unpaid to the spouse before death is generally payable to the spouse's estate, and is taxable in the surviving spouse's estate. Property held by a QTIP trust should not be aggregated with the property of the decedent for purposes of valuation. In *Estate of Bonner v. Comm'r*, 84 F.3d 196 (5th Cir. 1996), the husband owned 62.5% interest in a ranch, a 50% interest in other real property, and a 50% interest in a pleasure boat. The remaining interest in each property was owned by a QTIP trust that had been established under his wife's Will. The estate claimed discounts of approximately 45% on the various properties. The Fifth Circuit rejected the IRS's argument that the interests included in the husband's estate under Section 2044(c) could be aggregated with those owned outright by the husband. The court held that Section 2044(c) should be governed by the same reasoning applied in *Estate of Bright v. Comm'r*, 658 F.2d 999 (5th Cir. 1981) (which held that no family attribution applied in valuing undivided community property interests). The Court noted that QTIP assets were not subject to the control of the surviving husband or his estate regarding their ultimate disposition. The Fifth Circuit concluded that the assets qualified for fractional interest discounts, and remanded the case to the district court to determine the appropriate discount. *See also Estate of Mellinger v. Comm'r*, 112 T.C. No. 4 (1999), *acq.*1999-2 C.B. 763; *Estate of Nowell v. Comm'r*, T.C. Memo 1999-15; *Estate of Lopes v. Comm'r*, T.C. Memo. 1999-225. For a discussion of planning issues involving the use of QTIP trusts to obtain valuation discounts, see Aghdami, "Valuation Discounts After *Mellinger*, *Nowell* and *Lopes*," 14 PROB. & PROP. 19 (March/April 2000).

(9) Refunds. One category of assets often overlooked by executors is refunds of unused prepaid items. While these refunds are estate

taxable, you may do the executor a service by reminding him or her to collect them. They include subscriptions, cable service, and similar items canceled after the decedent's death. More obvious are income tax refunds.

(10) Other Property. The IRS can be quite resourceful in identifying other assets that belong to the decedent. *See, e.g.*, TAM 9207004 (holding that the value of several bales of marijuana found at the site of the plane crash in which the decedent was killed was includible in the decedent's gross estate, since the decedent had possession and control of the property. No deduction was allowed for the subsequent confiscation of the drugs, since allowing a deduction would violate the public policy against drug trafficking.)

g. Transfers with Retained Interests. Transfers with retained interests are either very obvious (such as transfers to revocable trusts used as Will substitutes) or very subtle. In the former case, many practitioners report trust assets on the appropriate schedule, and not on Schedule G. In the latter case, the issue often involves some home-made estate planning (such as transfers with retained life estates) or some hyper-technical argument by an estate tax examining attorney trying to undo some sophisticated estate planning technique. From a reporting standpoint, be sure that questions 11 and 12 of Part 4 of the return have been properly answered. In addition, watch out for three unusual areas:

(1) Gift Tax Gross-Up. As noted earlier, transfers within three years of death are generally no longer includible in the gross estate. The three year rule is retained for life insurance, for "cutting retained strings" discussed in the next paragraph, and for gift taxes paid within three years of death. IRC §§ 2035(a), 2035(b). To understand the "abuse" at which this rule is directed, remember that although the gift and estate tax rates are the same on their face, they are very different in their application. As an example, assume a donor has twelve dollars and is faced with a flat fifty percent estate and gift tax rate. He can hold on to those dollars until death, at which time his heirs will receive six dollars and so will the IRS (50% of 12). If instead the donor gives the money away during his lifetime, he can give eight dollars to his heirs and four dollars to the IRS (50% of 8). Gifting is thus always cheaper from a transfer tax standpoint than holding onto the property until death. To prevent donors from taking advantage of this difference on their death bed, Congress enacted the gross-up rule. In the foregoing example, the four dollars paid as gift tax would be added back into the donor's estate if death occurred within three years of the gift. The IRS, having collected four dollars in gift taxes, would now get an additional two dollars in estate taxes (50% of 4), resulting in six dollars being paid in tax, just as if no gift were made.

(2) Outright Transfers with "Strings Attached". As mentioned earlier, if the decedent made a transfer, but retained the ability to receive the income or control the beneficial enjoyment of the property, the property will be included in the decedent's estate at its full fair market value at the date of death. IRC §§ 2036-2038. Only rarely will such transfers be made outside the context of a trust, although some practitioners, especially those not well versed in estate tax laws, still recommend conveyances of legal remainder interests in real property, having the donor retain a life estate. This practice has no effect for estate tax purposes, since a retained life estate is taxed as though the decedent owned a fee interest in the property at the date of death. IRC § 2036(a)(1). If such a retained interest is discovered before death, the decedent may be well advised to dispose of it before death. Congress apparently feared that taxpayers would set up situations in which enjoyment or control was retained, only to be renounced from the death bed. To avoid this potential problem, the three year rule continues to apply to renunciations of these interests.

(3) Transfers in Trust. Most transfers giving rise to Schedule G inclusion involve trusts established by the decedent during his or her lifetime for the benefit of others. Inclusion may result from an interest retained by the decedent (typically, a reversion, usually upon the untimely death of the intended beneficiary) or by administrative controls retained by the decedent. If the decedent is the grantor, and also the trustee or a co-trustee, the trust property will be included in the decedent's estate unless the decedent's powers as trustee cannot be exercised to alter the beneficial enjoyment without a violation of fiduciary duties. IRC § 2038(a)(1). More insidious is the situation where a third party is trustee, and the trustee is given broad powers. The IRS takes the position that if the grantor has retained the power to remove the trustee and appoint a successor, then the grantor has the powers of the trustee. Rev. Rul. 79-353, 1979-2

C.B. 325; *First National Bank of Denver v. U.S.*, 684 F.2d 1286 (10th Cir., 1981). This ruling has been harshly criticized by commentators, and has been rejected by the Tax Court in the context of removal powers held by a non-grantor beneficiary. *See Estate of Wall v. Comm'r*, 101 T.C. 21 (1993). In short, read the trust instrument. Since the Form 706 instructions require that a copy of all trusts created by the decedent be attached to the return, you know that they will be scrutinized by the examining attorney with an eye for inclusion.

(4) Donor's Capacity. Many taxpayers engage in gifting programs. When these programs are continued after the donor's incapacity, whether informally or pursuant to a power of attorney, the IRS can be expected to raise a question, since a legal guardian appointed to represent the donor could have the transfers voided if unauthorized. *See, e.g.*, *Estate of Collins v. U.S.*, 94-1 USTC ¶ 60,162 (E.D. Mi 1994); TAM 940304 (holding that under Texas law, an attorney-in-fact is not authorized to make gifts unless specifically authorized in the instrument). Be prepared to address these issues, especially where the death certificate indicates Alzheimer's Disease or some other brain disorder as a cause or complication of death.

h. Powers of Appointment. Schedule H typically comes into play when the decedent has been acting as the trustee of a trust created by another, of which he or she is also a beneficiary. Distinguishing between "special" powers of appointment, which are harmless, and "general" powers, which cause estate tax inclusion, is the key issue in most cases. In general, if the decedent could vest trust property in himself or herself (not subject to an "ascertainable standard"), his or her creditors, his or her estate, or the creditors of his or her estate, a general power of appointment will be presented. IRC § 2041(b)(1). If you determine that a power of appointment does not require estate tax inclusion, question 12b of Part 4 of Form 706 regarding the decedent's possession of "any power, beneficial interest, or trusteeship" must still be answered in the affirmative, and your explanation of its characterization as "special" instead of general should be set forth on Schedule H. Simply omitting this information can lead to penalties against the executor and the preparer if the examining attorney discovers the power of appointment and determines that it has been mischaracterized.

i. Annuities.

(1) Compare the Form 1040. Annuities that are in pay status are reported on Schedule I. Typically, these are pension payments that will have been disclosed on the decedent's Form 1040. The annuities are reportable based upon the present value of the remaining income stream. Many pensions are payable to spouses pursuant to a joint-survivor option, payable during the joint lives of the employee and the employee's spouse. Such pension payments are *automatically* subject to the QTIP election unless the executor elects out of QTIP treatment. IRC § 2056(b)(7)(C). Since there are circumstances when it is beneficial not to elect QTIP treatment (discussed at paragraphs M and Q below), watch out for the marital deduction treatment of these items.

(2) Review Contracts. Annuities are not includible in the gross estate to the extent that the consideration for the annuity was provided by someone other than the decedent or the decedent's employer. IRC § 2039(b). Also, an annuity that was being received by the decedent upon his or her death, that has no residual value (i.e., no one succeeds to the pension payments upon the decedent's death) has no value at the date of death, and thus has no estate tax value. Therefore, it is important to review and understand the annuity contract to ensure that you know who has provided the consideration, and what happens to the payments upon the insured's death.

(3) Pension Exclusions. Under former law, pensions were excluded from estate taxation. After 1982, that exclusion was limited to $100,000. After 1984, even that exclusion was repealed. Remember, however, that these changes included transitional rules for pensions in pay status when the rule changes were announced. Thus, pensions for which an annuity form of payment had been irrevocably elected, and that were in pay status on or before December 31, 1984 are still excluded to the extent of $100,000. See Tax Reform Act of 1984, § 525(b)(2). Pensions for which an annuity form of payment had been irrevocably elected, and that were in pay status on or before December 31, 1982 are totally exempt from estate taxation. See Tax Reform Act of 1984 § 525(b)(3). Such pensions should nonetheless be reported, but their values excluded with an explanation.

j. Administration Expenses. Having dealt with the asset side of the return at length, we are now finally ready to address issues involving deductible items.

(1) Income v. Estate Tax Deductions. Remember that in the area of administration expenses, many items are deductible on the estate tax return or the estate's income tax return, but not both. IRC § 642(g). With the maximum marginal income tax rate now below the minimum effective estate tax rate in many instances, the determination of where to deduct expenses is relatively clear. See the discussion of Schedule M below, however, relating to the payment of expenses from the marital share. Estate tax examining attorneys are quite even-handed in allowing the deduction of debts and expenses. Note, however, the caveat of section (15)10 (2) of the IRS Estate Tax Examiner's Handbook, which points out that "[a]n executor or representative who is argumentative over clearly non-deductible items may be trying to divert you from other possibly more significant issues."

(2) Funeral Expenses. These expenses are fully deductible on the Form 706, and may not be taken on the Form 1041. In many states, funeral expenses are an obligation of the estate, and *not* the surviving spouse. *See, e.g.,* Tex. Prob. Code § 320A (Vernon 2004). With the single exception noted below, it is very unusual for an examining attorney to question the reasonableness of these expenses, regardless of how simple or ornate the funeral. Funeral expenses include not only the burial plot, monument, and mortuary expenses, but also costs for future cemetery care. Treas. Reg. § 20.2053-2. Many practitioners also deduct costs of a minister, organist, flowers, wake, and the like. The only area of contention that you might expect to encounter in this area relates to payment of airfare for persons attending the funeral. Treasury Regulation Section 20.2053-2 limits such expenses to the cost of transporting one person accompanying the body to the place of burial. All other such costs are viewed as expenses of the family, and not the estate, regardless of whether the estate actually pays for such expenses. As a result, the IRS takes the position that they are not deductible under Section 2053 of the Code.

(3) Executor's Commissions. Executor's commissions may be provided for in the Will or fixed by local law. Most corporate executors charge fees based upon the size of the estate or on an hourly basis. If these fees exceed the statutory formula, the IRS may question their reasonableness. The Regulations provide fees must not only be reasonable, but be "allowable by the laws of the jurisdiction . . . under which the estate is being administered." IRC § 20.2053-1(a)(1). Don't forget that individuals as well as banks and trusts companies may claim this fee, unless the Will expressly provides for no compensation. Many executor/beneficiaries will take a fee, subject to income tax, to avoid an estate tax at what will likely be a higher marginal bracket. Note that if a Will provides for a "bequest in lieu of compensation" the payment is a bequest, and not compensation. As such, it is not deductible. Treas. Reg. § 20.2053-3(b)(2). Finally, remember that the IRS will ask that a Declaration of Executor's Commissions and Attorney's Fees (Form 4421) be signed by the executor and attorneys for the estate. This form includes the recipient's taxpayer identification number, and is referred to the income tax division to ensure proper income tax reporting by the recipient.

(4) Attorney and Accounting Fees. Fees incurred in the probate process and for tax preparation and advice are clearly deductible. Treas. Reg. § 20.2053-3(c). Estimates of these fees may be taken. If you are performing work for the estate and the surviving spouse or other family members, keep track of your time and bill them separately. Some commentators suggest a 50/50 allocation between the estate and the surviving spouse, but courts have been more liberal in finding that the bulk of the expenses arise from the fact of the decedent's death. *See, e.g.*, *Ray v. U.S.*, 385 F. Supp. 372, 382 (S.D. Tex. 1974) (allowing 95% of the expenses to be allocated to the estate). Note that if the return is audited, the attorneys for the estate, but not the accountants, will be asked to sign a Form 4421. You are free to draw whatever inference you wish from this disparate treatment.

(5) Interest Expenses. Section 2053 does not expressly refer to the deduction of interest. To obtain a deduction, the executor must show that interest constitutes a reasonable and necessary administration expense. Since under the current scheme effective estate tax rates are always higher than the income tax rates, and since interest is not deductible for income tax purposes if it constitutes "personal interest," obtaining an estate tax deduction for interest is extremely valuable. For an excellent discussion on deductibility of interest

generally, see Lindquist, *Making Lemonade from Lemons--Deducting Interest on the From 706*, 14 PROB. & PROP. 21-26 (May/June 2000).

(a) Interest Accrued Before Death. Naturally, interest that accrued before the date of the decedent's death is deductible as a claim against the estate. IRC §2053(a)(3). Interest accrued at the date of death on a federal income tax deficiency is an item of "deduction in respect of a decedent" that may be deducted both as an income tax deduction on the estate's fiduciary return and as a deduction for claims on the estate tax return. Rev. Rul. 71-422, 1971-2 C.B. 255.

(b) Interest Accruing After Death. With respect to interest that accrues after death, however, the issue is more complex. For example, post-death interest on an unpaid income tax liability has be held to be deductible as an administration expense. *Maehlling v. U.S.*, 1967-2 USTC ¶12,486 (S.D. Ind. 1967); Rev. Rul. 69-402, 1969-2 C.B. 176. Generally, however, interest that accrues after the date of death is not deductible as a claim, even if the debt is payable in installments which mature after death. Rev. Rul. 77-461, 1977-2 C.B. 324. However, some courts have permitted the executor to deduct interest accruing after death on pre-death debts if the executor can establish that the debt remained outstanding in order to avoid selling estate assets at sacrifice prices, so long as interest is an allowable expense of administration under local law. *Ballance v. U.S.*, 347 F.2d 419 (7th Cir. 1965); *Estate of Wheless v. Comm'r*, 72 T.C. 470 (1979), nonacq. 1982-2 C.B. 3. Although the IRS has not acquiesced in these holdings, Revenue Ruling 77-461 itself provides that if the executor had obtained an extension of the decedent's obligations in order to avoid a sacrifice sale of assets, "any additional interest could be deductible as an administration expense." 1977-2 C.B. at 325.

(c) Interest Accruing on Debts Incurred After Death. If the debt giving rise to the interest expense was incurred by the executor after the decedent's death, and is necessary for the administration of the estate, the interest may be deducted for estate tax purposes. *See, e.g., Estate of Huntington v. Comm'r*, 36 B.T.A. 698 (1937) (interest and other expense incurred to obtain $9,500,000 loan for payment of taxes, claims against the estate and administration expenses was deductible because issuance of notes "avoided the necessity of sacrificing the assets of the estate by immediate or forced sale"); *See also, Estate of Todd v. Comm'r*, 57 T.C. 288 (1971) (interest deductible if allowable expense under state law and actually and necessarily incurred); *Hipp v. U.S.*, 72-1 USTC 12,824 (D. S.C. 1971) (interest deductible if "essential to the proper settlement of the estate and . . . not incurred for the individual benefit of the heirs, legatees, or devisees"). However, interest will not be deductible if the estate administration is unduly prolonged or where the estate could have sold assets other than at distress prices instead of borrowing funds. *See Hiberna Bank v. U.S.*, 75-2 USTC 13,102 (N.D. Calif. 1975), aff'd, 581 F.2d 741 (9th Cir. 1978).

(d) Interest On Deferred Estate Taxes. Interest payable with respect to an estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law, even if the interest accrues due to the executor's willful delay in filing the estate tax return and in paying the estate tax. Rev. Rul. 81-154, 1981-1 C.B. 470 (interest on estate tax deficiency deductible "without regard to the manner in which it was incurred" to the extent that the expense is allowable under local law). Similarly, interest paid on deferred state death taxes is a deductible administration expense, regardless of the reason for the interest charge. Rev. Rul. 81-256, 1981-2 C.B. 1983. However, The Taxpayer Relief Act of 1997 provides a special rule for interest paid on estate taxes deferred under Section 6166. That interest is not deductible for estate or income tax purposes. IRC §§2053(c)(1)(D), 163(k). Instead, the Code provides a lower rate of interest for Section 6166 deferrals. These rules do not apply to interest paid on deferrals under sections 6161 (discretionary extensions) or 6163 (extensions for estate taxes on reversionary or remainder interests). Even for section 6166 deferrals, payments being made for decedents dying before January 1, 1998 continue to be deductible (unless a special election is made to apply the new rules.)

(e) Timing of Deduction For Interest Paid to IRS On Deferred Estate Taxes. Interest payable to the IRS on deferred estate taxes may not be estimated and deducted in advance. Instead, the deduction must be taken as the interest is paid. Rev. Rul. 80-250, 1980-2 C.B. 278. The rationale for denying an up-front deduction is that, if a deduction were allowed, the executor might later accelerate payment of the deferred tax,

avoiding the actual payment of interest. In addition, the interest rate on deferred taxes will fluctuate, making it impossible to estimate the projected interest expense accurately. *Id*.

(f) Deduction For Interest Paid to Third Parties On Deferred Estate Taxes. If the borrowing to pay the estate tax is from a third party, and not from the IRS, a different result might obtain. Unlike interest payable to the IRS, interest on private loans used to pay estate taxes is not automatically deductible. The IRS permits a deduction only when the executor can show that the borrowing was necessary in order to avoid a forced sale of assets. Rev. Rul. 84-75, 1984-1 C.B. 193. *See also, Estate of Sturgis v. Comm'r,* T.C. Memo 1987-415. *Cf. Estate of Lasarzig v. Comm'r*, T.C. Memo. 1999-307 (borrowing was not essential to the administration of the estate but was for the individual benefit of the beneficiaries). If the loan establishes a predictable rate of interest, and expressly prohibits prepayment, may the executor claim a an up-front deduction for all interest that will accrue under the note? In *Estate of Graegin v. Comm'r*, T.C. Memo, 1988-477, the Tax Court permitted an executor to take an estate tax deduction for projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The executor borrowed $204,218 from a corporation, 97% of whose stock was owned by the decedent or the decedent's son. The unsecured note provided a fixed 15% interest rate for a 15 year term, and provided a substantial prepayment penalty. The estate's projected cash flow would have permitted it to make some annual payments on the note, but note provided for all principal and interest to be paid in a single balloon payment at the end of the 15 year term. The Tax Court permitted the estate to deduct the projected interest as of the date of death, reasoning that the amount of the interest was ascertainable because of the fixed term of the note and the substantial prepayment penalty. The court noted that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable. The court also observed that, regarding the close relationship between the estate and the lender, that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. 88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid. The IRS approved a similar loan in PLR 199903038. In contrast the IRS has privately ruled that where the lender was a limited partnership 99% of the limited partnership interests were owned by the estate, and where a child of the decedent was both the executor of the estate and the general partner of the partnership, no interest expense was allowed, since the same parties appeared on all sides of the transactions, and the distribution of the partnership's interest income would be made in virtually identical amounts as the interest of the beneficiaries of the estate. TAM 200513028.

In those case where *Graegin* style lending is available, the estate tax savings can be dramatic. Borrowing an example from Stacy Eastland, assume a $10 million taxable estate in a 55% bracket, so that $5.5 million is due in estate taxes. Assume further that the estate borrows $1 million from a closely-held company under a 16 year note, providing for a 14.8% interest rate, with a balloon payment at the end of the 16 year period. The accumulated interest payment due at the end of the 16 years would be $8.1 million. If the interest is deductible under *Graegin*, deduction of $8.1 million in interest would result in a taxable estate of $10 - $8.1 or $1.9 million, which would result in a federal estate tax (at a 55% rate) of $1.0 million. The $8 million of interest would be paid to the company (which in turn, is owned primarily by family members), and would constitute taxable income to them when paid. Nevertheless, the overall result is a very considerable estate tax savings. See, Eastland, *Why My Algebra Teacher Rolls Over In Her Grave: The Mathematics of Estate Planning*, 1990 HECKERLING INST. ON EST. PL. 1805.

(6) Other Administrative Expenses. Other expenses incurred in the administration of the estate are also deductible, and may be estimated if not yet paid. These typically include probate court filing fees, publication expenses, appraisers' fees, brokerage commissions, and other expenses incurred during the administration of the estate.

(a) Selling Expenses. One area frequently review on audit involves selling expenses necessary to pay debts, expenses, or taxes, preserve the estate, or effect distributions are deductible. Treas. Reg. § 20.2053-3(d)(2). Permissible expenses include costs incurred for selling stocks, bond, and real estate. Many practitioners also include in this category expenses

for fixing up a home before sale, or simply maintaining the home during the administration of the estate. *See* Treas. Reg. § 20.2053-3(d)(1). These expenses are often questioned by the IRS. *See, e.g., Estate of Swayne v. Comm'r*, 43 T.C. 190 (1964). The focus of the inquiry here is whether the expense was incurred because the estate needed to sell the property to pay debts or to effect a distribution. Treas. Reg. § 20.2053-3(d)(2). If not, the IRS is likely to say that the expense was incurred for a beneficiary of the estate, and not for the estate itself. As a test, compare the cash shown on Schedule C of the Form 706 to the debts and expenses shown on Schedules J and K, plus estate and income taxes, plus expenses deducted on Form 1041's. If the cash on hand at the date of death was insufficient to pay the estate's bills, the estate is in a good position to argue that the sale was necessary in the administration of the estate. The IRS has been known to object to expenses incurred in selling real property when the estate has more liquid assets, such as publicly traded stocks and bonds, that could have been sold for a lower cost. Don't let the examining attorney bully you on this point. The IRS should not be permitted to substitute its judgement for that of the executor as to which assets should be sold.

(b) Preservation of Assets During Administration. A related issue is how long expenses for maintaining the decedent's residence or other property may be deducted as an administrative expense. In *Estate of Marguerite S. Millikin*, 69 TCM 3032 (1995), the estate attempted to sell the decedent's residence from March 1990 to April 1994. The Tax Court refused to permit the estate to deduct over $600,000 of maintenance expenses and $150,000 of selling expenses, reasoning that there was no necessity that the estate sell the residence and maintain it until it could be sold. On appeal, the Sixth Circuit refused to rule that the expenses were non-deductible, and instead remanded the case to the Tax Court to determine whether maintaining the residence for five years was reasonable under the circumstances. 125 F.3d 339 (6th Cir. 1997). The Tax Court, on remand, concluded that maintenance expenses could be deducted up to the estate tax due date, nine months after the decedent's death, but that maintenance and selling expenses incurred after that date could not be deducted. It has since been suggest that one should look to Section 645 of the Code (which permits a revocable trust to be treated as an estate from income tax purposes) to fix the reasonable period for administering an estate. Section 645 provides that revocable trusts can elect to be treated as part of the estate until six months after the final determination of the estate tax liability if a federal estate tax return is required for the estate. The author argues that if a reasonable period of administration for estate tax purposes is not governed by the new income tax rule under section 645, the expenses may be deductible for income but not estate tax purposes, which would create a double standard. Kasner, *What Is a Reasonable Period for Estate Administration?*, 77 TAX NOTES No. 1, 91 (October 6, 1997).

k. Debts of the Decedent.

(1) Mortgages and Other Secured Debts. These items are usually noncontroversial, so long as the property for which the debt was incurred has been included in the gross estate. You should make explicit cross references to the schedule and item number of the real estate, car, boat, or whatever is securing the debt, so that the IRS knows that asset has not been omitted. Don't forget to deduct any interest accrued on the obligation through the date of death.

(2) Unsecured Debts. Except as noted in the next paragraph, these items are also relatively unlikely to be questioned. If the decedent owned rental property, deposits and unearned rent reflected in the decedent's cash on hand should be offset by a liability of the estate on this schedule. In addition, you should review the check register used by the decedent and the executor as a good source to identify these items. The first utility bills, credit card payments, and other similar items paid after death usually reflect a debt owed at the time of death. Also look for medical expenses paid. These items are deductible on estate tax return or, if paid within one year of death, the decedent's final income tax return (not the estate's Form 1041). With the current income tax threshold, it is the rare case in which they will constitute an income tax deduction. Note that the IRS takes the position that you can't take the 7½ % threshold on the Form 706 and the excess on the final Form 1040. Rev. Rul. 77-357, 1977-2 C.B. 328.

(3) Debts Owed to Related Parties. If a liability is owed to a beneficiary of the estate, you should develop the facts surrounding the transaction giving rise to the indebtedness and disclose them on the return. Although I have

never run across it myself, the IRS apparently feels that there is a widespread practice of people executing notes payable to beneficiaries, and gifting the notes before death. No gift is reported, but the estate claims a deduction for the note. The beneficiary gets a disguised inheritance when the note is paid. The technique works, of course, only if gift tax fraud is committed, and the IRS has been given explicit instructions to inquire into such transactions. If your decedent attempted such a shallow ploy, don't bother attempting to report the note as a valid debt. Note, however, that even where the note given in the first instance is reported as a gift (or if a note is given in exchange for gifted property), the IRS might seek to deny the debt if there is no expectation of repayment. *See Estate of Flandreau v. Comm'r*, 93-1 USTC ¶ 60,137 (2d Cir. 1993). *Cf Muserlain v. Comm'r*, 91-1 USTC ¶ 60,066 (2nd Cir. 1991) (denying an interest deduction to a "donor" who regularly borrowed back cash gifted to children, giving demand loans on which no principal payments were made).

(4) Disputed Obligations. It is not unusual for a decedent to die with unresolved contingent claims pending against the estate. If, for example, the decedent died in an automobile accident for which the estate is being sued, it is likely that contingent claims exist. The existence of such a claim might pose a bit of a dilemma for the executor. If the contested claim is taken as a deduction on the estate tax return, that action might be seen as an admission of liability in the civil lawsuit. If, on the other hand, no deduction is claimed, but the suit is ultimately resolved against the decedent, it might then be too late to file a claim for refund of estate taxes. Form 706 solves this problem by having a special column on Schedule K for contested claims. These items can be reported on the return without an admission of liability on the part of the estate. But how is such a claim to be valued. Some courts have held that post death events could be used to determine the value of the claim. Others have strictly followed the rationale of the 1929 Supreme Court decision in *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929), holding that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death. *See Estate of Van Horne v. Comm'r*, 720 F.2d 1114 (9th Cir. 1983); *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982). In 1999, the Fifth Circuit Court of Appeals ruled that post-death events (such as a settlement agreement) should not be considered in determining the value of the debt at the date of death. *Estate of Smith v. Comm'r*, 198 F.3d 515 (5th Cir. 1999), nonacq. 2000-19 IRB. The Tenth and Eleventh Circuits have reached a similar result. *Estate of McMorris v. Comm'r*, 243 F.3d 1254 (10th Cir. 2001); *Estate of O'Neal v. U.S.*, 258 F.3d 1265 (11th Cir. 2001).

The IRS continues to maintain that only the actual settlement value may be deducted under section 2053(a)(3). FSA 200217022. As a result, if the return is examined, a contingent claim may not be allowed as a deduction. Instead, the examining attorney will likely seek to simply note the existence of the claim, deny the deduction, and expect the taxpayer to file a claim for refund when the contingency is resolved. If you chose to accept this approach, you must *be careful not to let the statute of limitations expire*! The best practice is to file the claim for refund immediately after the conclusion of the examination, and not wait until the contingency is resolved.

l. Losses Incurred During Administration.

(1) Uninsured Losses. These items are deducted on Schedule L. They arise relatively infrequently, since most executors do a good job of protecting the assets of the estate, and of insuring them against theft and casualty. If some asset is subject to an uninsured loss, give the executor the good news that it is deductible, along with the bad news that he or she may need to stand good for the loss out of personal funds if the loss could have been prevented by prudent actions on the executor's part.

(2) Property Not Subject to Claims. Can an estate deduct expenses incurred for administering property that aren't paid by the estate? For example, what about the administration expenses incurred in winding up the affairs of a marital deduction trust included in the estate under section 2044? These expenses are deductible, even if not paid by the probate estate, as Schedule L items. Treas. Reg. § 20.2053-8. Note that these deductions are generally limited to expenses incurred as a result of the death of the deceased beneficiary. Treas. Reg. § 20.2053-8(b). In addition, they must be paid before the expiration of the period of limitation for assessment (typically, three years after the return is filed. IRC § 6501). This category should, however, include all of the expenses of winding

down the marital deduction trust, as well as other non-probate expenses, such as those incurred in administering a revocable trust being used as an estate surrogate. *See* TAM 9121002 (applying §2053(b) and Reg. §20.2053-8 to expenses of QTIP trust). *See also*, *Grant v. Comm'r*, 294 F.3d 352 (2d Cir. 2002), *aff'g*, T.C. Memo. 1999-396.

m. The Estate Tax Marital Deduction. The estate tax marital deduction is available for property passing in a qualifying manner to a spouse of the decedent, so long as the spouse is a citizen of the United States. IRC § 2056(a). A bequest to a surviving spouse, either outright or in trust, qualifies for the deduction so long as the bequest does not constitute a nondeductible terminable interest. IRC § 2056(b)(1). The nondeductible terminable interest rule is generally subject to five exceptions. First, a gift conditioned upon the spouse surviving the decedent for a fixed period of time does not constitute a nondeductible terminable interest so long as the period of survival cannot exceed six months. IRC § 2056(b)(3). Second, the grant of a life estate to a surviving spouse is sufficient, so long as the spouse's access to the income from the property is exclusive and unlimited during the spouse's lifetime, and the spouse is granted a general power of appointment over the property at death. IRC § 2056(b)(5). Third, a trust may be created for the exclusive benefit of the spouse, with the remainder passing to the estate of the spouse upon his or her death. Treas. Reg. §§ 20.2056(c)-2(b)(1)(i); 20.2056(c)-2(b)(1)(ii); 20.2056(c)-2(b)(1)(iii). Fourth, property may pass to the spouse in a form which constitutes "qualified terminable interest property" commonly referred to as a "QTIP" trust. IRC § 2056(b)(7). Finally, the spouse may be given an interest in a trust that constitutes a qualified charitable remainder trust. IRC § 2056(b)(8).

(1) QTIP Requirements. The basic requirements for qualifying for QTIP treatment are (i) the property must pass from the decedent, (ii) the surviving spouse must be entitled to all of the income from the property for life, payable annually or in more frequent intervals, and (iii) no person may have the power, exercisable during the spouse's life, to appoint the property to any person other than the spouse. IRC § 2056(b)(7)(B)(ii). If the property meets these requirements, QTIP treatment will be allowed only if the executor makes an election on the federal estate tax return, agreeing that the property will be subjected to tax upon the subsequent death of the surviving spouse. IRC § 2056(b)(7)(B)(v).

(2) Conditional QTIPs. Some Wills provide that any portion of a QTIP trust for which the executor fails to make QTIP election will pour-over to a bypass trust (which typically would not qualify for a QTIP election because it either would not provide for a mandatory income interest for the spouse or would provide for potential discretionary beneficiaries other than the spouse during spouse's lifetime). At one time, the IRS argued that an income interest (or life estate) that is contingent upon the executor's election did not constitute a qualifying income interest for life, regardless of whether the election was actually made. After having its position repeated rejected by the courts, the IRS revised its regulations to permit a deduction even if the income interest is contingent on making the QTIP election, and the unelected portion of the property will pass to or for the benefit of beneficiaries other than the surviving spouse. Treas. Reg. § 20.2056(b)-7(d)(3)(i).

(3) To Elect or Not to Elect. The executor may not always want to make a QTIP election. In determining whether to make the election, the executor should consider a number of factors:

(a) Estate Equalization. Particularly for large estates, estate tax savings may be obtained by equalizing the estates of the spouses to take advantage of lower marginal brackets in the estate of the first spouse to die. The savings available is now limited, due to the simultaneous increase in the estate tax exemption and the reduction in the top marginal rate. Even if some tax may be saved, this savings must be weighed against the time value of the use of the estate taxes paid at the first spouse's death. If the second spouse dies soon after the first spouse, a previously taxed properly credit under Section 2013 of the Code discussed below may be further decrease the estate tax payable at the surviving spouse's subsequent death. For a discussion of the mathematical analysis of whether to attempt to equalize the estates of the decedent and the surviving spouse, see Pennell, 239 - 4th T.M., Estate Tax Marital Deduction A-14-15 (1990).

(b) Availability of the Previously Taxed Property Credit. If a QTIP election is not made, and as a result, estate tax is paid at the first spouse's death, and if those assets pass to a trust

for which the spouse has an income interest, the estate of the second spouse to die may receive a credit under Section 2013 of the Code for the full actuarial value of the life estate, even if the amount of the income actually distributed to the spouse from the trust is much less than the actuarial value of the entire interest. *See* TAM 8512004. In planning this type of arrangement, the surviving spouse must have enough assets to generate estate tax to fully utilize the credit. If the credit may be available, the executor of the first estate may wish to consider filing an extension of time for filing of the estate tax return for up to six months to extend the period during which to decide whether to make the QTIP election.

(4) Disclaimers to Qualify for QTIP Treatment. If a bequest is made to a trust providing for a mandatory income interest in the surviving spouse and for discretionary principal distributions to children, the children should consider disclaiming their rights to receive principal distributions if QTIP treatment is desirable. Likewise, if the surviving spouse has the power to distribute QTIP property to others before his or her death, the spouse should consider disclaiming this power to ensure qualifying for QTIP treatment. These notions are discussed in more detail below at page 32.

(5) Making the QTIP Elections. The QTIP 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 or, if a timely return is not filed, the first estate tax return filed by the executor after the due date." Treas. Reg. § 20.2056(b)-7(b)(4). The election, once made, is irrevocable. IRC § 2056(b)(7)(B)(v). Under the current version of Form 706 the election is made simply by listing property on Schedule M. All property interests shown on Schedule M are considered to be part of the QTIP election unless the executor affirmatively elects out of QTIP treatment. If a QTIP election is not timely made, the executor may be able to seek an extension of time under Treasury Regulation Section 301.9100-1(c). The extension requires a showing that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government.

(6) Partial Elections. The executor may make a partial QTIP election "provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519." Treas. Reg. § 20.2056(b)-7(b)(2)(i). Moreover, the Regulations permit formula elections. Treas. Reg. §§ 20.2056(b)-7(b)(2)(i); 20.2056(b)-7(h) Ex. 7, 8. *See also* TAM 9116003. Formula elections may be used to assure that the taxable estate is reduced to zero, even if additional assets are discovered or assets are revalued during an audit.

(7) Creating Separate QTIP Trusts. If a partial QTIP election is made, planning flexibility can be increased by separating the single trust into two separate trusts, one of which is totally elected and the other of which is totally non-elected. This approach allows the trustee to distribute funds from the elected trust, thereby reducing the amount that will be subject to estate tax at the surviving spouse's subsequent death. The Regulations expressly permit severing a partial QTIP trust into separate trusts as long as state law or the governing instrument requires the trustee to sever the trust according to the fair market value of the assets at the time of the division. Treas. Reg. § 20.2056(b)-7(b)(2)(ii).

(8) Unnecessary QTIP Elections. An unnecessary election of QTIP treatment for a credit shelter trust can be disregarded pursuant to Rev. Proc. 2001-38, 2001-1 C.B. 1335. The QTIP election is disregarded if it is not needed to reduce estate tax at the first spouse's death. Therefore, the trust (for which the QTIP election is disregarded) would not be included in the surviving spouse's estate at his or her subsequent death under section 2044. Ltr. Rul. 200236021. .

(9) Planning for Non-Citizen Spouses. Transfers to non-citizen spouses do not qualify for the estate tax marital deduction unless the transfer is to a "qualified domestic trust" or "QDOT." A QDOT is essentially a QTIP trust, with a number of additional features designed to ensure collection of estate tax whenever principal is distributed from the trust. To qualify as a QDOT, the trust must meet the following requirements: (1) The trust instrument must require that one trustee of the trust be an individual citizen of the United States or a domestic corporation; (2) no distribution (other than a distribution of income) may be made from the trust unless the trustee who is an individual U.S. citizen or domestic corporation has the right to withhold the estate tax

imposed under Section 2056A(b); (3) the trust must meet additional requirements contained in Regulations regarding bonding or solvency of the trustee, and other matters designed to ensure collection of the estate tax; and (4) the executor must irrevocably elect for assets in the QDOT to qualify for the estate tax marital deduction. IRC § 2056A(a). The IRS may waive the U.S. trustee requirement if, for example, the use of a U.S. trustee is prohibited by another country. IRC § 2056A(a)(1)(A) gives the IRS regulatory authority to waive the U.S. trustee requirement.

(a) Making the QDOT Election. The QDOT election must be made by the executor of the decedent's estate on the last estate tax return filed before the due date or, if a timely return is not filed, on the first return filed after the due date. Treas. Reg. § 20.2056A-3(a). Partial QDOT elections are not permitted. However, if a trust is actually severed, a QDOT election may be made separately for each separate trust. Treas. Reg. § 20.2056A-3(b). The executor may make a protective QDOT election if there is a bona fide legal issue concerning either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. Treas. Reg. § 20.2056A-3(c).

(b) Tax Consequences of QDOT Distributions. Distributions of principal from the QDOT during the surviving spouse's lifetime are generally subject a special estate tax. The special tax for lifetime distributions also applies if the trust ceases to qualify as a QDOT. Treas. Reg. § 20.2056A-5(b)(3). The tax does not apply to (i) distributions of income (but not including capital gains or other items that would be allocated to corpus under applicable local law), Treas. Reg. § 20.2056A-5(c)(2); (ii) distributions of principal on account of hardship, including a distribution in response to an immediate and substantial financial need relating to the spouse's health, maintenance, education or support (or of any person the spouse is legally obligated to support) if amounts cannot be obtained from other sources reasonably available to the surviving spouse. Treas. Reg. § 20.2056A-5(c)(1); (iii) payments for the ordinary and necessary expenses of the QDOT, Treas. Reg. § 20.2056A 5(c)(3)(i); (iv) payments to governmental authorities for income taxes imposed on the QDOT or for distributions to the surviving spouse to reimburse the spouse for any income tax on "phantom" income generated by the QDOT and taxable to the surviving spouse, Treas. Reg. § 20.2056A-5(c)(3)(ii), (iv). In addition, if the surviving spouse who was a resident at all times after the death of the decedent becomes a U.S. citizen after the establishment of QDOT, then no tax is imposed on QDOT distributions after the surviving spouse becomes a U.S. citizen. Treas. Reg. § 20.2056A-10(a).

(c) The QDOT Estate Tax. The amount of the tax is generally the amount of estate tax that would have been imposed if the amount involved had been included in the decedent's taxable estate and had not been deductible. IRC § 2056A(b)(2). The tax is due on the 15th day of the fourth month following the calendar year in which the taxable event occurs. IRC § 2056A(b)(5). Upon the spouse's death, estate tax is imposed as if the distributed assets were included in the decedent's estate and not the surviving spouse's estate. For property of the QDOT that is also includible in the surviving spouse's estate (such as under Section 2044 of the Code), a Section 2013 credit is allowed to the surviving spouse without regard to when the first decedent died)for the U.S. estate tax paid. IRC § 2056(d)(3); Treas. Reg. § 20.2056A-7.

n. The Estate Tax Charitable Deduction. Bequests to qualifying charitable organizations described in Section 2055(a) of the Code qualify for the estate tax charitable deduction. There is no limitation on the amount of the deduction for assets passing to charity. As in the income tax area, however, a bequest that creates both charitable and non-charitable interests in the same property (so-called "split-interest" gifts) must meet special rules in order to qualify for the estate tax charitable deduction. In general, split-interest gifts must take the form of a charitable remainder trust, a charitable lead trust, a pooled income fund, or a remainder interest in a personal residence or farm.

(1) Valuation Issues. As with the marital deduction, if the Will authorizes the executor to select assets to satisfy a charitable bequest using asset values as finally determined for estate tax purposes, the estate tax charitable deduction will be disallowed unless state law (or the Will) requires the executor to select assets in an impartial manner. The rationale of Revenue Procedure 64-19, 1964-1 C.B. 682 (relating to an executor's power to fund a pecuniary marital

deduction bequest with assets using estate tax values) applies equally to charitable bequests. The value of the interest passing to the charity would be impossible to value if the executor could fund the bequest with assets that have depreciated during the period of administration. *See* PLR 8339005.

(2) Contingent Gifts. In general, no charitable deduction is allowed if the gift to charity is contingent upon some future event. For example, if a bequest is made to an individual subject to a survival requirement, and if the individual survives the decedent, but fails to survive for the stated survival period, the estate tax charitable deduction may not be allowed. Treasury Regulations provide that a bequest to charity that contains a contingency which is "not so remote as to be negligible" results in a disallowance of the charitable deduction. Treas. Reg. § 20.2055-2(b)(1). Treasury Regulation Section 20.2055-2(c)(1)(ii) provides that if a power in an individual to consume or invade assets terminates before the time that the estate tax return is filed, the termination of the power will be treated as a disclaimer, and the contingent interest passing to charity as a result of the lapse of the power will qualify for the estate tax charitable deduction. However, various cases have indicated that this regulation only applies to the termination of a power and does not apply to a property interest itself. *See e.g.*, *Merchants Nat'l Bank v. U.S.*, 583 F.2d 19 (1st Cir. 1978). If only a part of the bequests under a Will take the form of a disqualified a split-interest, but the remainder passes to charity, a charitable deduction may be allowed for the amount passing to the charity. *See, e.g.,* Rev. Rul. 83-20, 1983-1 C.B. 231.

(3) Apportionment of Taxes. The amount of the federal estate tax charitable deduction must be reduced by the amount of any death taxes payable out of the bequest, thus requiring a circular computation to determine the ultimate amount of tax due. Reg. §20.2055-3.

(4) Reformation of Defective Bequests. Because of the technical nature of split-interest trusts, Congress permits reformation of defective split-interest gifts. Section 2055(e)(3)(C) describes three types of interests to which the reformation rules apply. Two types of interests are "reformable," while the third category is not. Specifically, if the trust provides for the required annuity or unitrust payments of specified dollar amounts or a fixed percentage of the fair market value of the property, but is invalid because it has incorrect or missing miscellaneous administrative requirements, the trust can be reformed. Examples of such defects would be the omission of special provisions dealing with short taxable years, additional contributions, and the final year in which the non-charitable interest terminates. No time deadline is imposed for a reformable interest in this category. IRC § 2055(e)(3)(C)(ii). If the instrument does not require payments that take the form of an annuity trust or unitrust, but the trust meets the statutory requirements for charitable bequests as they existed before 1969 (which required only that the charity's interest be "ascertainable"), the interest may be reformed. For instruments falling in this category, the judicial reformation proceeding must begin within 90 days of (i) the estate tax return filing date (with extensions), or (ii) if no estate tax return is required, the due date (with extensions) for the trust's first income tax return. IRC § 2055(e)(3)(C)(iii). If the trust does not contain annuity or unitrust amounts, and permits principal invasions not limited by an ascertainable standard, no reformation is allowed. IRC § 2055(e)(3)(C)(i).

(5) Reformation Requirements. Section 2055(e)(3)(B) of the Code outlines the requirements necessary to effect a "qualified reformation." First, the actuarial value of the reformed charitable interest cannot vary by more than five percent from the value of the unreformed charitable interest. Therefore, in negotiating the amount of the annuity or unitrust percentage interest, the amount or percentage must be set so that the value of the charity's interest will not go up or down by more than five percent of the value of the charitable interest before the change. IRC § 2055(e)(3)(B)(i). Second, the interest term cannot be changed, except that if a term interest exceeds 20 years, it can be reduced to 20 years in order to comply with the 20 year maximum term requirement. §2055(e)(3)(B)(ii). Third, the reformation must be retroactive to the date of death (or for an inter vivos trust, to the date of the creation of the trust). IRC § 2055(e)(3)(B)(iii). The statute also outlines two situations in which reformation proceedings are not necessary in order to obtain an estate tax deduction. First, if all non-charitable beneficiaries of a "reformable" split-interest trust die before the due date of the estate tax return (including extensions) the reformable interest will be deemed to have been

reformed. IRC § 2055(a)(3)(F). Second, in the case of charitable remainder unitrusts and annuity trusts (but not charitable lead trusts) that are created after December 31, 1979, the trust instrument may provide that payments to non-charitable income beneficiaries will end upon the occurrence of a contingency. *See* IRC § 664(f). In that case, the trust will still constitute a charitable remainder trust, but the deduction will be determined by ignoring the contingency.

(6) Deduction for Reformed Gifts. The amount of the deduction allowed following a reformation is equal to the lesser of (i) the actuarial value of the charitable interest after the reformation, or (ii) the actuarial value of the charitable interest before the reformation. IRC § 2055(e)(3)(E).

B. Alternation Valuation Date.

1. General Rule. The executor of an estate may elect to value the estate's assets on the "alternate valuation date" if the election will result in the reduction of estate taxed. Generally, the alternate valuation date is exactly six calendar months after the decedent's date of death. However, if any asset is sold or distributed during the six month period between the date of death and the alternate valuation date, that asset is valued as of the date of sale or distribution. §2032(a). If publicly traded securities are sold, the actual sales, not the mean between the high and low on the date of sale, is used. Rev. Rul 70-512, 1970-2 C.B. 192. For estates of decedents dying after July 18, 1984, the election may be made only if it will decrease the value of the gross estate and the combined amount of federal estate tax (reduced by allowable credits) and federal generation-skipping transfer tax. IRC § 2032(c).

2. Included vs. Excluded Property. Not all estate assets are available for alternate valuation. Treasury regulations give detailed guidance about which assets are "included" and "excluded" in the alternate valuation date value. For example, income earned or accrued after the date of death is generally excluded. Treas. Reg. § 20.2032-1(d). Property interests owned at the date of death are included even if they change form during the six month period. Events that occur after the date of death but before the alternate valuation date generally are considered except for changes in value due to the mere lapse of time (such as, for example, the value of an annuity). If the estate includes an asset the value of which depends upon applying the Section 7520 rate, the IRS has privately ruled that the Section 7520 rate on the date of death, rather than on the alternate valuation date, should be used. PLR 9637006.

3. Method of Election. The election is made by checking a box on the estate tax return. In the August 2004 version of Form 706, the election is in Part 3, item 1 on the top of page 2. Once made, the election is irrevocable. IRC § 2032(d)(1). Unlike many elections, the alternate valuation election has an absolute deadline. The election cannot be made if the federal estate tax return is filed more than one year after the expiration of the time for filing the return (including extensions). IRC § 2032(d)(2). However, if the estate tax return is filed without making the alternate valuation date election, but a supplemental return is filed within the one year maximum period for making the election by statute, Section 9100 relief may be available to extend the date for making the election up to the one year date. *See* PLR 200203031 and 200021021. Therefore, on a return filed with no tax due, if an audit results in a loss of deductions or credits sufficient to produce an estate tax, the executor may seek relief to make a late alternate valuation date election. No Section 9100 relief is available if the time period is past the one year time limit imposed by Section 2032(d)(2).

4. Protective Elections. An alternate valuation election may be made by a protective election. *Estate of Mapes v. Comm'r*, 99 T.C. 511 (1992). See also TAM 9846002. In PLR 199942015 the IRS approved an election that would become effective only if the date-of-death value of the decedent's gross estate, as finally determined, was higher, and the sum of the estate and GST tax imposed on the estate (reduced by taxes allowable against such taxes) is higher than the amount of the same taxes determined under Section 2032 of the Code using the appropriate alternate valuation date or dates.

5. Reasons to Make the Election. Obviously the most common reason to make an alternate valuation election is that it results in a lower estate tax. If the aggregate value of assets in the estate has decline by the time of the alternate valuation date, and if the estate is in the position of having to pay an estate tax, making the alternate valuation election would generally produce a favorable result. But even if no tax is otherwise due, making

the election may serve to minimize the value of property otherwise passing to the surviving spouse or QTIP trust. This reduction may serve to decrease taxes payable at the death of the second spouse. Generally, an estate that has an unlimited estate tax marital deduction available will not pay estate tax, and so no election is available. It may be possible, however, for the spouse disclaim a sufficient amount so that a small federal estate tax would be produced, but for the election. Alternatively, the executor could make a partial QTIP election to generate a small federal estate tax. For decedents dying before 2005, or in states that have replace the "pick-up" inheritance tax, the executor must evaluate whether state inheritance or estate tax will result from this strategy. *See* Fox, Pomeroy & Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal Sate Death Tax Credit: Boom, Bust or Unknown?" 29 ACTEC J. 26, 30 (Summer 2003). An alternative approach would be to generate a savings in GST tax. If the decedent devised any part of the estate to grandchildren, the executor might allocate the GST exemption to other bequests (overriding the automatic GST exemption allocation that would otherwise be made to testamentary direct skips). In some circumstances, the GST tax would be reduced if using the alternate valuation date values reduced the size of the estate.

6. <u>Impact of Sales and Distributions</u>. If the executor sells of distributes an asset within the six-month alternate valuation period, that action will fix the alternate valuation of that particular asset as of the date of the sale or distribution. If the alternate valuation is to be selected, distributions should be made during the six-month period only if the executor anticipates that the value of an asset has reached a low, and that the value may increase before the end of the six-month period.

C. <u>Special Use Valuation</u>. Qualifying real property used in a farm or in a trade or business may be valued based upon its use in that enterprise rather than at its fair market value measured by its "highest and best use." IRC § 2032A. The maximum reduction in value is $750,000, increased for cost of living increases beginning in 1999, with any increase being rounded down to the next lowest multiple of $10,000. IRC § 2032A(a)(3). For 2008, the $750,000 amount has increased to $960,000. Rev. Proc. 2007-66, § 3.31, 2007-45 IRB 970. Special use valuation applies not only for estate taxation, but for purposes of the GST tax as well. IRC § 2624(b).

1. <u>Qualification Requirements</u>. To be eligible for special use valuations, a number of specific requirements must be satisfied.

a. <u>The Citizen or Resident Requirement</u>. The decedent must have been a citizen or resident of the United States at the time of death. IRC § 2032A(a)(1)(A).

b. <u>Qualified Real Property</u>. The real property must be "qualified real property," which means real property (i) located in the United States, (ii) "acquired from or passed from" the decedent to a "qualified heir," and (iii) used for a "qualified use" at the time of death (iv) by the decedent or a "member of the decedent's family." IRC § 2032A(b)(1). "Qualified use" of real property is defined as use for farming purposes, or use in a trade or business other than farming.

c. <u>The Fifty Percent of Estate Test</u>. Fifty percent or more of the "adjusted value" of the gross estate must consist of real *or personal* property that was (i) used for a "qualified use" by the decedent or "member of the decedent's family" on the date of death, and (ii) "acquired from or passed from" the decedent to a "qualified heir." IRC § 2032A(b)(1)(a). The "adjusted value" of the gross estate is the value of the gross estate less allowable deductions under Section 2053(a)(4). IRC § 2032A(b)(3)(B). Cash used in the business may be used to meet the fifty percent test, but it is unclear how much cash may be used. *See Mapes v. Comm'r*, 99 T.C. No. 27 (1992) (checking account contained farm receipts and investment interests and account was used for both farming and personal expenses; none of the account could be used to meet fifty percent tests); *Cf* Treas. Reg. § 20.6166A-2(c)(2).

d. <u>The Twenty-Five Percent Test</u>. In addition to the fifty percent test, twenty-five percent or more of the "adjusted value" of the gross estate must consist of *real property* that was (i) "acquired from or passed from" the decedent to a "qualified heir," and (ii) during five or more years of the eight year period before retirement, disability or death, the "material participation" test and "qualified use" test set forth below are satisfied. IRC § 2032A(b)(1)(B). If the decedent owned real property as community property, for purposes of both the twenty-five percent and the

fifty percent test, the community property is treated as though the decedent owned all of the community in his or her individual capacity. IRC § 2032A(e)(10).

e. Qualified Use in Five of Eight Years. The real property for which an election is made must have been owned and used for a "qualified use" by the decedent or a "member of the decedent's family" for a period aggregating five years or more during the eight year period ending on the date of death. IRC § 2032A(b)(1)(C)(i).

f. Material Participation in Five of Eight Years. The decedent or "member of the decedent's family" must have materially participated with respect to the real property for a period aggregating five years or more during the eight year period ending on the earlier of the date of retirement, disability or death (provided the retirement or disability continues until the date of death). IRC §§ 2032A(b)(1)(C)(ii); 2032A(b)(4). Material participation may be shown by direct involvement in the management of the farm or business, with actual employment on a substantially full time basis, or any lesser extent necessary personally to manage fully the farm or business. Treas. Reg. § 20.2032A-3(e)(1). If the involvement is less than full time management, the material participation must be pursuant to an arrangement providing for actual participation in the production or management of production. Treas. Reg. § 20.2032A-3(e)(1).

(1) The Self-Employment Tax Test. If the taxpayer is not paying tax on self-employment income attributable to the business, material participation is presumed not to have occurred (although the executor may demonstrate evidence to overcome the presumption). Treas. Reg. § 20.2032A-(3)(e)(1). Factors that are considered in determining the presence of material participation are listed in Regulation Section 2032A-(3)(e)(2).

(2) Lease Real Estate. If the real property is leased by the decedent or qualified heir, the decedent or qualified heir must still have regular and substantial involvement in financial and management decisions. *Mangels v. Comm'r*, 828 F.2d 1324 (8th Cir. 1987).

(3) Tacking Spouse's Participation. A surviving spouse's active management may be tacked to a deceased spouse's material participation to satisfy the five of eight year before death, disability, or retirement requirement. The surviving spouse's active management can be tacked, even though there was an intervening period with no material participation by the deceased spouse before death during a continuous period of retirement or disability. IRC § 2032A(b)(5)(C).

g. All Interests Must Pass to Qualified Heirs. The "qualified heirs" must receive all of the present and future interests in the qualified real property. A remainder interest by itself will not qualify for special use valuation. For example, if a surviving spouse receives a life estate and the spouse's brother receives the remainder interests following the life estate, the property would not qualify for special use valuation (because the spouse's brother is not a "qualified heir"). Treas. Reg. § 20.2032A-8(a)(2). If a trust receives the real property, *all beneficiaries* of the trust must be qualified heirs. *See* PLR 8337015 (real property did not qualify for special use valuation where trustee had discretionary authority to make payments to non-qualified heirs).

(1) "Qualified Heir". A "qualified heir" includes a member of the decedent's family who acquired the property from the decedent. If a qualified heir disposes of an interest in qualified real property to any member of his family, the member shall thereafter be treated as the qualified heir with respect to that interest. IRC § 2032A(e)(1). The term "member of the family" means with respect to any individual, (i) parents and ancestor of the individual, (ii) the spouse of the individual, (iii) a lineal descendant of the individual, of such individual's spouse, or of a parent of such individual, or (iv) the spouse of an lineal descendant described in subparagraph (iii). A legally adopted child of an individual is treated as the child of such individual by blood. IRC § 2032A(e)(2).

(2) Trust Interests. For interests in trust, the IRS takes the position that all beneficiaries must be qualified heirs. Property passing to a trust qualifies only to the extent that an identifiable interest may pass only to qualified heirs, and cannot pass to persons who would be non-qualified heirs. PLR 8332012; 8444034. *See also* Treas. Reg. § 20.2032A-8(a)(2). The courts, however, have invalidated the regulations to the extent that they would disallow an election where there is only a remote possibility of a

non-qualified heir receiving an interest in the trust property. *Estate of Thompson v.* Comm'r, 864 F.2d 1128 (4th Cir. 1989); *Estate of Davis v. Comm'r*, 86 T.C. 1156 (1986).

h. The Election Requirement. The executor must file a notice of election for special use valuation treatment. IRC § 2032A(a)(1)(B); Treas. Reg. § 20.2032A-8. Once the election is made, it is irrevocable. The IRS requires strict compliance with all of the mechanical requirements for the election. The election and the recapture agreement described in next paragraph must be filed at the same time as the federal estate tax return.

(1) Protective Elections. The executor may make a protective election, in case the estate is deemed to qualify for special use valuation as a result of value adjustments made on audit. The protective election must be made on a timely filed estate tax return. Treas. Reg. § 20.2032A-8(b). The executor may give the notice of protective election by checking the appropriate box on Part 1 of Schedule A-1 of Form 706 and providing the requested information. If the estate qualifies for special use valuation after value adjustments made in the estate tax audit, the executor must file an additional notice of election within sixty days on an amended Form 706. All of the information required by Regulation Section 20.2032A-8(a)(3) and the recapture agreement must be supplied to the IRS at that time.

(2) Late Elections. Section 9100 relief may be available if the election is not timely filed. For example, PLR 199911030 granted an extension of time to make the election where the estate did not make the election on the estate tax return, but established that it acted reasonably and in good faith and that granting the extension would not prejudice the interests of the government.

(3) Substantial Compliance. In 1997, Section 2032A(d)(3) was amended to require the IRS to develop procedures so that in any case in which the executor makes an election and submits the required agreement within the time prescribed, but (1) the notice of election does not contain all the required information or (2) the signatures of one or more persons required to enter into the required recapture agreement are not included on the agreement as filed or (3) the agreement does not contain all required information, the executor will have a reasonable period of time (not exceeding 90 days) after notification of such failures to provide the missing information or signatures.

2. The Recapture Tax and Agreement. A recapture tax is imposed by Section 2032A(c) in the case of (i) a failure to meet the "qualified use" test or the "material participation" test for ten years after the date of death, or (ii) certain dispositions within 10 years after the date of death. All persons with an interest in the "qualified real property" for which an election is made must sign an agreement to consent to personal liability for the additional estate tax (recapture tax) imposed by Section 2032A(c) if the property ceases to qualify for the election. The recapture agreement must be filed with the election. IRC §§ 2032A(a)(1)(B), 2032A(d)(2); Treas. Reg. § 20.2032A-8(c); *See also Estate of Lucas v. U.S.*, 96-2 USTC ¶60,247 (11th Cir. 1996).

a. Who Must Sign. All co-owners of the property, including persons who did not receive any interest from the decedent, must sign the recapture agreement. Treas. Reg. § 20.2032A-8(c)(2). A surviving spouse who has a community property interest in the property must also sign the agreement. TAM 8523004. If one of the beneficiaries lacks legal capacity, a guardian generally must be appointed to sign on that beneficiary's behalf. Treas. Reg. §20.2032A-8(c)(3). If property passes to a trust, the trustee *and all beneficiaries of the trust* (including remaindermen or contingent beneficiaries) must sign the agreement. Treas. Reg. § 20.2032A-8(c)(2). Under the regulation, even very remote contingent beneficiaries must sign the agreement. However, cases and even a few private letter rulings have demonstrated some reasonableness and flexibility on this issue. *See Estate of Smoot v. Comm'r*, 892 F.2d 597 (7th Cir. 1989); *Estate of Davis v. Comm'r*, 86 T.C. 1156 (1986); TAM 9038002.

b. Continued Qualified Use. Section 2032A(c)(6) provides that for ten years after the decedent's death, all qualified heirs must actively materially participate with respect to the real property being operated in a qualified use for at least five years of any eight year period after the decedent's death. IRC § 2032A(c). The material participation requirement may be satisfied by the qualified heir or by any member of his or her

family. IRC § 2032A(c)(6)(B)(ii). The term "member of the family" includes the lineal descendant of a parent of the qualified heir. IRC § 2032A(e)(2)(C). For example, if a decedent's son is the only family member who is actively participating in the management of a ranching operation, his management activities would satisfy the material participation test with respect to any interest in the ranch left to him, his brothers or sisters, or to his children (either outright or in trust for them). In addition, management activities of the son would meet the material participation requirement with respect to interests left to a trust with the son as trustee for a qualified heir of the decedent who has not reached age 21 or who is disabled. IRC § 2032A(c)(7)(B)(ii). However, the activities of the executor will not satisfy the post-death material participation by qualified heirs requirement if the executor is not a qualified heir. However, there is up to a two year grace period after the date of death for a qualified heir to begin use of the property, which is not counted in the 8-year test (but the period from the date of death until the qualified heir begins the use is tacked on to the end of the 10-year recapture period). IRC § 2032A(c)(7)(A).

c. "Active Management". For certain heirs, there is a lower standard of participation. For those heirs, mere "active management" is required rather than material participation. Active management does not require day-to-day participation. This lower standard applies to "eligible qualified heirs," which include a surviving spouse, a person under age 21, a disabled person, and a student. IRC § 2032A(c)(7)(B-C).

d. Net Cash Rentals. Before the Revenue Act of 1997, several cases had held that a cash rental by a qualified heir other than a surviving spouse was not a qualified use. The Taxpayer Relief Act of 1997 amended this recapture provision, effective for decedents dying after December 31, 1976, to provide that a surviving spouse or a lineal descendant of the decedent is not treated as failing to use qualified real property in a qualified use solely because the spouse or descendant rents the property to a member of the family of the spouse or descendant on a net cash basis. IRC § 2032A(c)(7)(E).

e. Disqualifying Dispositions. The recapture tax also applies if a qualified heir disposes any portion of the real property to anyone other than a family member within ten years of the date of death. IRC §§ 2032A(c)(1)(A), (c)(1)(B), and (c)(6)(B).

f. Impact Upon Basis. If there is recapture, the income tax basis of the property will continue to be the special use value of the property. IRC § 1014(a)(3). However, if a qualified heir so elects, the basis in the property can be increased up to the full date-of-death value of the property. If the election is made, in addition to paying the recapture tax, the heir must pay interest from the original due date of the return at the prevailing underpayment rate on the amount of the recapture tax. IRC § 1016(c).

3. Valuation Methods. If special use valuation is used, the property may be valued based on a "capitalization of rents" method (if it is farm or ranch land) or a "five-factor method" under IRC §§ 2032A(e)(7); 2032A(e)(8). The capitalization of rents method is most commonly used. Under this method the property is valued by dividing the average annual gross cash rental (after payment of state and local real estate taxes) for comparable land for the five most recent full calendar years ending before death, by the average annual effective interest rate for all new Farm Credit Bank Loans in the district where the property is located for the year of death. These rate are published annual for each of seven Farm Bureau districts. The capitalization of rents method requires the executor to obtain comparable lease information in order to compute special use value. Cash rentals from the decedent's land cannot be used; only cash rentals from comparable land that are the result of arms' length bargaining may be used. Courts generally have been strict in requiring the identification of comparable land and of five years of actual cash rents from those comparable properties. *See Rogers v. Comm'r*, T.C. Memo. 2000-133. The *Rogers* case also illustrates the differences that can arise under the two alternative valuation methods. The capitalization method provided a value of $83.62 per acre of timberland on the estate's tracts; the "five factor" method provided a value of $350 per acre for pastureland. Generally, minority interest discounts can not be applied to the special use value. *See Maddox v. Comm'r*, 93 T.C. 228 (1989); TAM 9119008. However, for purposes of determining the limit based on the $750,000 (indexed) maximum reduction in value attributable to special use valuation, the estate can determine the highest and best use value taking into

consideration a minority interest discount. *Estate of Hoover v. Comm'r*, 69 F.3d 1044 (10th Cir. 1995), *rev'g*, 102 T.C. 777 (1994), *acq. in part*, 1999-1 IRB 5.

4. Considerations in Making the Election. The executor should consider a number of tax and non-tax factors before making a special use valuation election. For example, if the election is made, the income tax basis of the property will be reduced to the special use value. IRC § 1014(a)(3). In additions, the family will need to be aware of the imposition of the recapture tax if the they cease to use the premises and materially participate in the qualified use of the property. If the beneficiaries consent to the special use valuation election, they will be estopped from later disavowing the election. *See LeFever*, et al. v. Comm'r, 100 F.3d 778 (10th Cir. 1996). The IRS will retain a lien against the property for the recapture tax for ten years following the decedent's death, so lenders may be less willing to extend credit during that period. Application of the recapture tax may be of special concern to family members that do not received the benefits of the estate tax savings. If the decedent's Will does not specifically allocate the savings attributable to the special use valuation election to the heirs receiving special valuation use property, the beneficiaries may wish to enter into an agreement under which the beneficiary receiving the special valuation property receives the benefits of the election.

III. DISCLAIMER ISSUES

A. General Requirements. Section 2518(b) defines a qualified disclaimer as an irrevocable and unqualified refusal by a person to accept an interest in property if: (i) the refusal is in writing; (ii) the writing is 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; (iii) the delivery is made no later than nine months after date on which the transfer creating the interest is made, or if later, nine months after the day the transferee attains age 21; (iv) the transferee has not accepted the interest or any of its benefits; (v) as a result of the disclaimer, the interest passes without any direction on the part of the person making the disclaimer; and (vi) the interest passes either to the spouse of the decedent, or to a person other than the person making the disclaimer. If the disclaimer is not treated as a "qualified disclaimer," it typically is treated as a gift.

1. The Nine Month Rule. The nine-month period is strictly applied. An extension to file a gift or estate tax return does not extend the time for making a qualified disclaimer. PLR. 9223051. There is no mechanism to extend the nine month period. However, if the due date for the disclaimer falls on a weekend or legal holiday, the disclaimer period is extended to the next succeeding day which is not a weekend or legal holiday. Treas. Reg. § 25.2518-2(c)(2). The disclaimer must be filed within nine months after the later of the date on which the transfer creating the interest is made or the date on which the disclaimant attains age twenty-one. Treas. Reg. §25.2518-2(c)(1).

a. Date of the Transfer. For inter vivos transfers, the date of the transfer is generally the date that a completed gift is made. See PLR. 9001062 (no transfer for disclaimer purposes until gift becomes complete). If the initial transfer is to an irrevocable trust, the nine month period starts on the date of the transfer. If the transfer is to a revocable trust, the nine month period starts on the date that the trust becomes irrevocable. These rules apply even if the *interest* being disclaimed will not vest for many years. See PLR 9027026 (beneficiary could not disclaim interest in irrevocable trust created twenty years earlier even though beneficiary had never received distributions); Treas. Reg. § 25.2518-2(c)(3) (remainder beneficiaries of QTIP trust must disclaim within nine months after death of spouse *creating* the trust and not within nine months of death of surviving spouse). If a transferor makes a gift with "strings attached," so that although a taxable gift is made for gift tax purposes, the interest is nonetheless included in the transferor's gross estate for estate tax purposes, the nine month period for disclaimers still runs from the time of the earlier taxable transfer. Treas. Reg. § 25.2518-2(c)(3); PLR 8617011. However, if the gifted asset is later included in the transferor's gross estate because of a retained or contingent general power of appointment, the disclaimer period runs from the date of the transferor's death and not the date on which the irrevocable trust was created. Treas. Reg. § 25.2518-2(c)(5), Ex. 2. For interests created before 1977, instead of a strict nine month time frame, a disclaimer is not treated as a taxable transfer if the disclaimer that is "unequivocal and effective under the local law" is made "within a reasonable time after knowledge

of the existence of the transfer." Treas. Reg. §25.2511-1(c)(2). Note that as under current law, for transfers before 1977, the period for making a disclaimer "within a reasonable time" begins to run from the time that a contingent interest is created, not when it vests. *Jewett v. Comm'r*, 455 U.S. 305 (1982). *See* PLR 200202036.

b. Joint Tenants with Rights of Survivorship. Before an amendment of Treasury Regulations in 1997, a number of cases involved litigation regarding whether the nine month period for disclaiming joint tenancy property ran from the time of the creation of the ownership, or from the death of one of the joint tenants. An amendment of the regulations, effective December 31, 1997, added substantial certainty to this area. Under these regulations, the mere establishment of an interest in a joint bank account is "incomplete" for disclaimer purposes. Therefore, for purposes of both the timeliness requirement and the acceptance of benefits test, a disclaimer may be made within nine months of the first joint tenant's death. Treas. Reg. § 25.2518 2(c)(5) Ex. 10. So long as state law permits the depositor to the joint account to withdraw his or her contributions without the consent of the other co-tenant, the transfer creating the survivor's interest in the account does not occur until the decedent's death. Treas. Reg. §25.2518-2(c)(4)(iii). Naturally, a surviving joint tenant cannot disclaim any portion of the account attributable to that person's contribution. Treas. Reg. § 25.2518-2(c)(4)(iii). A disclaimer is permitted, however as to all or any portion of the account attributable to the decedent's contribution, and not just as to one-half of the account. As to assets other than bank accounts, proposed regulations published in 1996 took the position that the time for disclaiming property depended upon whether the ownership was "unilaterally severable" by one of the co-tenants. As to those co-tenancies, the period for disclaimer began to run at death. The proposed regulation noted that since tenancy by the entirety property could not be unilaterally severed, a disclaimer of tenancy by the entireties interest must have been completed within 9 months of creation (if that were even possible). Fortunately, the final regulations provide for disclaimer of jointly held property that is not unilaterally severable on the same basis as joint property that is unilaterally severable. Treas. Reg. § 25.2518-2(c)(4)(i). When someone contributes property to create a joint tenancy, there is a transfer of a one-half *lifetime* interest in the property that begins immediately. As to this interest, the nine-month disclaimer period begins to run from the creation of the tenancy, regardless of whether such interest can be unilaterally severed under local law. Treas. Reg. § 25.2518-2(c)(4)(i). However, as to the *survivorship* interest, the nine-month disclaimer period runs from the death of the first joint tenant to die. Treas. Reg. § 25.2518-2(c)(4)(i).

c. The Age Twenty-One Rule. If the transferee is under 21 years of age at the time of the transfer, he or she has until nine months after his or her 21st birthday to disclaim property. This rule applies regardless of the age of majority in the state in which the beneficiary resides. As noted below, the deferral until age 21 apples even if the beneficiary accepts the property after reaching the legal age of majority in the state. *See* Treas. Reg. § 25.2518-2(d)(4) Ex. 11 (disclaimer allowed as long as beneficiary does not accept any dividends *after* attaining age twenty-one). Similarly, a disclaimer is not precluded if a parent or guardian acting on behalf of a minor beneficiary has taken any action that would otherwise be considered an acceptance of the property. Treas. Reg. § 25.2518-2(d)(3).

2. No Prior Acceptance Requirement. An important requirement for a qualified disclaimer is that the disclaiming person "has not accepted the interest or any of its benefits." This requirement is problematic because of the natural tendency of beneficiaries to want to receive their inheritance before consulting with counsel about the possible benefits of a disclaimer.

a. Methods of Acceptance. Generally speaking, a beneficiary may "accept the interest or any of its benefits" by accepting income, exercising control, or accepting consideration in exchange for property. Thus, for example, if a Will bequeaths 100 share of X Co. stock to B, and B accepts quarterly X Co. dividends, then B is deemed to have accepted the stock. Treas. Reg. §§ 25.2518-2(d)(1) ("accepting dividends, interest, or rents from the property"), 25.2518-2(d)(4), Ex. 6, 11. If, before disclaiming the stock, B directs the broker to sell the X Co. stock, those actions constitute acceptance. Treas. Reg. §§ 25.2518-2(d)(1) ("directing others to act with respect to the property"), 25.2518-2(d)(4), Ex. 4 (beneficiary requests that executor sell farm and thereafter attempts to disclaim sales proceeds; "[b]y requesting the executor to sell the farm B

accepted the farm even though the executor may not have been legally obligated to comply with B's request"). In addition, if B agrees to disclaim only if the decedent's spouse makes a gift to B, accepting consideration for the disclaimer is treated as accepting benefits from the disclaimed property. Treas. Reg. §§ 25.2518-2(d)(1) ("acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed"), 25.2518-2(d)(4), Ex. 2.

b. Actions Not Constituting Acceptance. Mere retitling of assets in the name of the beneficiary, without more, does not constitute acceptance. More specifically, merely taking delivery of an instrument of title, without more, does not constitute acceptance. Moreover, a disclaimant is not considered to have accepted property merely because under applicable local law title to the property vests immediately in the disclaimant upon the death of a decedent. Treas. Reg. §§ 25.2518-2(d)(1); 25,2518-2(d)(4), Ex. 6 (donor's re-registering gifted shares into donee's name before disclaimer did not constitute acceptance where beneficiary did not pledge the shares, accept any dividends or otherwise commit any acts indicative of acceptance). Actions of a beneficiary who is also a fiduciary in preserving or protecting assets do not constitute acceptance if they are "in the exercise of fiduciary powers to preserve and maintain the disclaimed property." Treas. Reg. § 25.2518-2(d)(2). As mentioned above, a beneficiary who is less than 21 years old has until nine months after his or her 21st birthday to disclaim property. The disclaimer is permitted even if the beneficiary accepts the property after reaching the legal age of majority in the state, so long as no benefits are accepted after the beneficiary reaches age 21. *See* Treas. Reg. § 25.2518-2(d)(4) Ex. 11.

c. Implied Promise of Future Benefits. In a classic example of Internal Revenue Code double-speak, Section 2518(b) provides that to be "qualified," the disclaimer must be "unqualified." A disclaimer that is conditioned on the promise of future payments is ineffective. This rule obviously does not mean that the disclaimant cannot have any hope of future benefits. Drawing the line between expectations and promises, however, can at times be difficult, as illustrated in *Estate of Monroe v. Comm'r*, 124 F.3d 699 (5th Cir. 1997). In *Monroe*, the wife's Will made a number of specific bequests, with the residue of her estate passing to her husband. As a result of the bequests, estate taxes were owed. The husband asked 29 of the beneficiaries to disclaim, and surprisingly, all 29 beneficiaries signed disclaimers (totally about $900,000). Shortly thereafter (within a few days or weeks), each beneficiary received a personal check from the husband marked "gift" in the approximate amount of the disclaimed bequest. The IRS took the position that the disclaimers were invalid, arguing that the husband's "gifts" were actually consideration paid for the disclaimers, and that acceptance of this consideration was the equivalent of accepting the bequests. There was no evidence that the husband told the beneficiaries that they would receive assets in exchange for the disclaimers, except for one household employee who testified that the husband had promised to "take care" of him if he disclaimed his bequest. All of the other legatees merely assumed certain consequences of their decisions. Some testified that they either were afraid of refusing to abide by the husband's wishes or expected to get the money back from him later. The Tax Court held that all but one of the disclaimers were invalid. 104 T.C. 352 (1995). The Fifth Circuit disagreed with the Tax Court's view that refusal to accept property is not "unqualified" if it rests on an "implied promise" that the disclaimant will be better off executing the disclaimer than not doing so. The Court held that the statutory use of the term "unqualified" meant that there was no "tangible receipt of property" in exchange for giving the disclaimer. 124 F.3d at 709. The Court found that the Commissioner's approach of viewing an "expectation" or "implied promise" as invalidating the disclaimer would be an "incomprehensible subjective standard." 124 F.3d at 709.

d. Joint Assets and Community Property. A potentially difficult area in the context of acceptance arises when the beneficiary proposing to disclaim the asset co-owned the asset with the decedent before death. The issue then becomes whether the beneficiary's actions are related to his or her co-ownership, or constitute acceptance of the decedent's interest in the property. In general, the IRS has been quite lenient in this regard. For example, in several rulings, the IRS has allocated the entire amount of a withdrawal to the disclaimant's personal interest in a jointly owned asset. PLR. 9218015 (no acceptance of decedent's interest in brokerage account where payments from credit card used with account were less than spouse's one-half interest at the date of death);

PLR 9214022 (withdrawals by surviving spouse were deemed attributable to her interest where balance in joint tenancy cash account never fell below the value of decedent's one-half interest). In other cases, however, the IRS has held the parties to a more rigorous standard. For example, in PLR 9214022, the IRS ruled that stock in a jointly owned brokerage account was treated differently from cash. Withdrawals of stock were allocated one-half to the surviving spouse's interest and one-half to the decedent's interest. The surviving spouse could not disclaim that portion of the decedent's interest in the account that was attributable to the accepted stock. *See also*, PLR 9012053. Assets held as community property before death raise similar issues. Treasury Regulations make clear that the occupancy of a community property residence by a surviving spouse is not an acceptance of benefits. Reg. §25.2518 2(d)(4), Ex. 8. One letter ruling has held that retitling community property assets into the surviving spouse's name did not constitute acceptance of the decedent's share of the community assets as long as the surviving spouse had not drawn any funds or income from the accounts. PLR 9507017. *See also* PLRs 9232014 & 9218015 (no acceptance where community property assets were segregated and the surviving spouse assumed control of his or her one-half community property interest in the assets).

3. No Direction of Control by Disclaimant. Section 2518(b)(4) requires that the disclaimed property pass "without any direction on the part of the person making the disclaimer."

a. Planning with Splintered Interests. Treasury Regulations prevent splintering transferred interests to avoid this restriction. For example, suppose a Will leaves 1/3 of the residuary estate to D with any disclaimed portion of it going to E, 1/3 of the residuary estate to D with any disclaimed portion of that 1/3 passing to F, and 1/3 of the residuary estate to D with any disclaimed portion of that 1/3 passing to G. The regulations provide that if D disclaims 1/3 of the residue, thereby causing it to pass to E, the disclaimer will not be recognized, because D has effectively directed that the disclaimed property to E. Treas. Reg. § 25.2518-2(e)(5) Ex. 9. However, if D receives a bequest of Whiteacre which, if disclaimed, will pass to E and a bequest of Blackacre which, if disclaimed, will pass to F, a qualified disclaimer of either property (or an undivided interest in each property) would be valid. Treas. Reg. § 25.2518-2(e)(5)Ex. 10. The distinction between these examples is that in the former, the disclaimer involves the transfer of a single property or interest (i.e., the residuary estate) whereas in the latter, separate properties are involved.

b. Disclaiming Benefits but Serving as Fiduciary. If the disclaimant is the trustee of a trust to which the disclaimed property passes, he or she can exercise fiduciary powers to preserve or maintain the disclaimed property without being treated as accepting the property or any of it benefits. However, the disclaimant fiduciary cannot retain a *wholly discretionary* power to direct the enjoyment of the disclaimed interest. Treas. Reg. § 25.2518-2(d)(2). The trustee that makes the disclaimer can retain the fiduciary power to distribute to designated beneficiaries if the power to make distributions is subject to an ascertainable standard (such as "health, education, maintenance and support"). Treas. Reg. §§ 25.2518-2(e)(1)(i); 25.2518-2(e)(5)Ex.(12). A similar issue arises when the disclaimed property passes to a private foundation for which the disclaimant serves as a director or trustee. The IRS maintains that the disclaimant's participation in selecting charitable grant recipients would prevent the disclaimer from being a qualified disclaimer because of the "passes without any direction" requirement. *See* Rev. Rul. 72-552, 1972-2 C.B. 525. One method of allowing a disclaimer in this situation is for the foundation's bylaws to be amended to prohibit the disclaimant from participating in the selection of grant recipients with respect to the disclaimed property. *See* PLR 199929027 (disclaimants irrevocably waived any right to participate in any decisions relating to disclaimed paintings); Alternatively, the will could provide that disclaimed assets would pass to a separate fund of the foundation over which the disclaimant held no powers. *Cf.* PLR 200108032. An alternate solution is to have the disclaimed property pass to a donor-advised fund of a community foundation. *See* PLR 9532027.

c. Disclaiming Benefits but Retaining Power of Appointment. A significant disadvantage to making a disclaimer is that the disclaimant cannot retain a limited power of appointment over disclaimed assets, unless the power of appointment is limited by an ascertainable standard. Treas. Reg. §§ 25.2518-2(e)(2); 25.2518-2(e)(5) Ex. 5. Drafting a limited power

of appointment limited by such a standard is unusual, unless drafted in anticipation of the trust holding disclaimed property.

B. Partial Disclaimers. A disclaimer is not an all or nothing proposition. The final regulations interpreting Section 2518 permit disclaimers of a portion of a bequest, so long as the property disclaimed is separately created by the transferor.

1. Separate Interests. For example, each interest in income and each interest in principal are treated as separate interests. Treas. Reg. § 25.2518 3(a)(1)(i). However, the disclaimer itself cannot create the separate interests. *See e.g.*, *Estate of Walshire v. U.S.*, 288 F.3d 342 (8th Cir. 2002) (a disclaimer of a remainder interest with the disclaimant retaining a life estate is not a valid disclaimer when the Will devised a fee interest). Similarly, the regulations invalidate a disclaimer of an income interest for a certain number of years, retaining the income interest after the term expires is not a qualified disclaimer. Treas. Reg. § 25.2518-3(a)(1)(i). If the bequest takes the form of discrete units (such as shares of stock), the disclaimer may be made for some but not all of the units. In addition, a power of appointment over trust principal is treated as an interest separate from the interest of the beneficiary of trust income or principal. Treas. Reg. §§ 25.2518 3(a)(1)(iii), 25.2518 3(d) Ex. 21. If a bequest is made in trust, the disclaimer of a specific asset is effective only if, as a result of the disclaimer, the disclaimed asset leaves the trust and passes to someone other than the disclaimant (or passes to the decedent's spouse). Treas. Reg. § 25.2518 3 (a) (2). While early rulings were in conflict, the final regulations make it clear that if the disclaimant is bequeathed the residue of the estate, her or she may validly disclaim a pecuniary (fixed dollar) amount while retaining the residue. Treas. Reg. § 25.2518-3(c). The regulations require that post-death income attributable to the disclaimed portion be prorated.

2. Formula Disclaimers. The final regulations and private letter rulings confirm that disclaimers may take the form of a formula. Treas. Reg. § 25.2518-3(d), Ex. 20; *See also* PLR 9646010, 9435014, 9338010. A number of rulings have permitted disclaimers under reverse pecuniary formulas (disclaiming all except a certain amount). *See* PLR 200130034, 200001045, 9437029, 9435014, 9319022. For a discussion of the use of formula disclaimers, see Akers, "An Overview of Post-Mortem Tax Planning Strategies," 34TH ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. 1217.7 (2000); Handler & Chen, "Formula Disclaimers: Procter-Proofing Gifts Against Revaluations by IRS," J. TAX'N (April 2002).

3. "Pick and Choose" Disclaimers. A number of private rulings have permitted disclaimers of percentage undivided interests, even though the executor could use his discretion to choose which assets with which to fund the disclaimer portion. *See, e.g.,* PLR. 8652016. *See also* PLR 8708069 (suggesting that assets must be selected based upon their fair market value on the date of the disclaimer or on a basis that is "fairly representative").

C. Reasons to Consider Disclaimers.

1. Avoiding Inclusion in Beneficiary's Estate. In most cases, a disclaimer is filed so that the property that would otherwise pass to the initial recipient instead passes to the alternate taker, without being subject to transfer tax by the initial recipient. The disclaimer statute is, after all, a gift tax statute that prevents gift tax from applying to the disclaimant. Said another way, if the primary beneficiary does not want the property at issue, but wants to avoid paying gift or estate tax to pass that property to the contingent beneficiary, a disclaimer is the obvious tool of choice. An interesting question in this context may arise if the beneficial interest being disclaimed takes the form of a life estate or a lifetime interest in trust. In most states, disclaimer of the interest has the effect of accelerating the remainder interest. The life tenant is treated as having predeceased the transferor for all purposes. In some jurisdictions, however, a disclaimer simply terminates the beneficial interest of the disclaimant. For example, if a Will places property in trust for X for life, and upon X's death, the property passes to Y's then living children, a disclaimer by X only terminates X's right to receive the benefits of the property. Y's children are not entitled to the property until X's actual death, when the children then living can be determined. *See Stewart v. Johnson*, 362 S.E.2d 849, (N.C. 1987); Frimmer, "Disclaimers," 15 ACPC PROB. NOTES 280, 285 (1990).

2. Avoiding Beneficiary's Creditors. Can a beneficiary disclaim property and thereby prevent the creditors of the beneficiary from attaching the property? Most states permit such a disclaimer,

holding that the disclaimer relates back to the time of death, and treat the property interest as though it passed directly from the transferor to the contingent beneficiary. *See, e.g., Dyer v. Eckols*, 808 S.W. 2d 531 (Tex. App.-Houston [14th Dist.] 1991, no writ); *Estate of Colacci*, 549 P.2d 1096 (Colo. 1976); Lehr *v. Switzer*, 239 N.W. 564 (Iowa 1931); *City Nat'l Bank of Birmingham v. Andrews*, 355 So.2d 341 (Ala. 1978); *Tompkins State Bank v. Niles*, 537 N.E.2d 274 (Ill. 1989); Tex. Prop. Code §112.010(d) (disclaimer effective against claims of disclaimant's creditors). *See also Hinschberger v. Griggs County Social Services*, 499 N.W.2d 876, 879 (N.D. 1993). If a disclaimer is filed before filing bankruptcy the disclaimer may constitute a voidable "transfer of property" under the Bankruptcy Act, depending upon how state law views the disclaimer. If, under state law, the disclaimer relates back to the date of death for all purposes, and the disclaimant is treated as never having owned an interest in property, a disclaimer made before filing the bankruptcy petition would not be a transfer. *Wood v. Bright (In re Bright)*, 241 BR 664 (9th Cir. 2001); *Michael A. Grassmueck, Inc. v. Nistler (In re Nistler)*, 259 BR 723 (Bankr. D. Or. 2001). Property disclaimed *after* a bankruptcy petition is filed will constitute property of the bankruptcy estate if the debtor became entitled to receive the disclaimed property within 180 days after the filing of the bankruptcy petition. *Cornelius v. Cornell (In re Cornell)*, 95 BR 219 (Bankr. WD Okla. 1989); *Geekie v. Watson (In re Watson)*, 65 BR 9 (Bankr. CD Ill. 1986). For inherited property, this rule is applied based upon the date of death, and not the date that the Will is admitted to probate. *Williams v. Chenoweth (In re Chenoweth)*, 132 BR 161, 165 (Bankr. SD Ill. 1991), aff'd, 143 BR 527 (SD Ill. 1992), aff'd, 3 F3d 1111 (7th Cir. 1993). *See* Henkel, ESTATE PLANNING AND WEALTH PRESERVATION, § 53.15 (1997) If the creditor in question is the IRS, the disclaimer is not effective to avoid a tax lien. *Drye v. U.S.*, 528 U.S. 49, 120 S. Ct. 474 (1999) (federal law determines whether the taxpayer's state-delineated rights qualify as "property" or "rights to property" for purposes of Code Sections 6321 and 6331).

3. Disclaimers Involving the Surviving Spouse. Many times, disclaimers are made in order to enable the estate to take advantage of the federal estate tax marital deduction. If property passes to someone other than the surviving spouse, or passes to or for the benefit of the surviving spouse but in a manner that fails to qualify for the marital deduction, a disclaimer may serve to generate the deduction.

a. Disclaimers to Qualify for QTIP Treatment. At times, a bequest may be made to a trust that does not qualify for QTIP treatment. This situation may arise either because of a drafting oversight, or because at the time the trust was drafted, no marital deduction was contemplated for the trust. For example, a trust may provide a mandatory income interest in the surviving spouse, but permit children to be discretionary principal beneficiaries. To qualify the trust for QTIP treatment, the children may disclaim their rights to receive principal distributions. The IRS has ruled that if the interest of the child as a remainder beneficiary and the interest as discretionary beneficiary of principal during the spouse's lifetime are treated as separate interests under state law, then a qualified disclaimer may be made of the lifetime interest without disclaiming the remainder interest. *See* PLR 8704023; 872506; 8706066. *Cf.* TAM 9140004 (spouse was entitled to use of residence until death or remarriage, with remainder to decedent's children; children attempted to disclaim interests in the residence arising during the spouse's lifetime, retaining the right to receive the residence at spouse's death; held disclaimer was not qualified since children attempted to disclaim "temporal part" of remainder which was not separately created by the decedent and which was not an undivided portion of the interest). In other situations, the invalid power may be held by the surviving spouse (such as an inter vivos power of appointment). Having the spouse disclaim the improper power may qualify the trust for QTIP treatment. *See, e.g., Lassiter v. Comm'r*, TC Memo 2000-324.

b. Disclaimers of Powers by Trustee. Some early cases and rulings seemed to condone the disclaimer of powers invalidating a QTIP trust by the trustee holding those powers. *See, e.g., Cleveland v. U.S.*, 88 1 USTC ¶13,766 (C.D. Ill. 1988); TAM 8729002. More recently, the IRS has ruled that since most states preclude a unilateral disclaimer of powers by trustee that affects the rights of a beneficiary unless the trust instrument expressly authorizes the a disclaimer or the affected beneficiary consents, the disclaimer of powers by a trustee is generally not effective. Rev. Rul. 90-110, 1990-2 C.B. 209. *See also* TAM 9818005 (purported disclaimer by trustee of

power to invest in unproductive property and of complete discretion in allocating receipts and disbursements between income and principal not recognized).

4. Disclaiming Non-ascertainable Standard Powers. If an instrument gives a beneficiary a general power of appointment, the final regulations make clear that the power of appointment is a separate property interest which the beneficiary can disclaim without having to disclaim other interests in that property. Treas. Reg. §§ 25.2518-3(a)(1)(iii), 25.2518 3(d), Ex. 21. Less clear is the ability of a beneficiary/trustee who holds a power of appoint not limited by an ascertainable standard to disclaim to an ascertainable standard. For example, may a beneficiary/trustee who is permitted to make distributions for his or her "health, support and happiness" validly disclaim the power only to distribute for her happiness? Under the proposed regulations, an example involved the attempted disclaimer of a power to invade principal for "happiness" while retaining the power to invade for health and maintenance. Prop. Reg. § 25.2518-3(d), Ex. 15. That example was deleted from the final regulations. Can one argue that the omission of this example from the final regulations implies that this sort of disclaimer is qualified? *See* Frimmer, "A Decade Later: Final Disclaimer Regulations Issued Under Section 2518," 1987 UNIV. MIAMI INST ON EST. PL. 600. *See also Goudy v. U.S.*, 851 F.2d 360 (9th Cir. June 28, 1988) reversing 86-2 USTC 13,690 (D. Ore. 1986) (purported disclaimer of general testamentary power of appointment to a limited power of appointment not recognized under pre-Section 2518 law).

5. Disclaimers for GST Purposes. In some instances, the transfer tax at issue in disclaimer planning is not the estate or gift tax, but the generation-skipping transfer tax. Unfortunately, the "deemed to have predeceased" rule usually applied to disclaimants does not have the effect of invoking the "move-up" rule that applies if a child of the transferor actually predeceases the transferor. Treas. Reg. § 26.2651-1(a)(2)(iv). In other words, in a Will that provides "I leave property to my child, but if my child fails to survive, to my grandchild," a disclaimer by the child *would* result in a generation-skipping transfer. There are, however, situations where a disclaimer might be used to advantage for GST purposes. For example, if a Will creates a non-exempt trust otherwise subject to GST taxes on taxable distributions or terminations, the children might disclaim the portion of the trust not covered by the decedent's GST exemption amount, converting the future taxable distribution or termination into a current direct skip. The result would be a substantial savings in GST taxes (although the tax would be accelerated). Treas. Reg. §26.2612-1(e)(3). Conversely, if the decedent failed to fully utilize his or her GST exemption, the children might consider disclaimers to cause property to pass to grandchildren, thereby making full use of the exemption. Note, however, that unlike a surviving spouse, a child cannot disclaim an outright bequest to a trust of which the child is the beneficiary with running afoul of the rule requiring the disclaimed interest to pass to the spouse of the decedent, or to a person other than the person making the disclaimer. If more than the GST exempt amount passes to skip persons, the family may wish to consider disclaimers by the second-generation beneficiaries of the excess if, as a result of the disclaimers, the excess passes to persons who are not skip persons. With proper advanced planning, an interest passing to the surviving spouse might be disclaimed in a fashion that causes it to pass to a QTIP trust. In that situation, if the decedent is otherwise not using all of his or her GST exemption, the spouse might disclaim to the QTIP trust for which a "reverse" QTIP election is made, thereby maximizing the use of the decedent's GST exemption. Finally, in the context of exempt and non-exempt QTIP trusts that mandate tax reimbursement, consider a disclaimer by the surviving spouse (or the surviving spouse's executor) of the right to receive reimbursement of taxes from the exempt QTIP trust. Under the final GST regulations, failure to exercise reimbursement rights is not treated as a constructive addition to the exempt trust by the surviving spouse or the beneficiaries of the surviving spouse's estate. Treas. Reg. § 26.2652-1(a)(6), Ex. 7-8.

D. Tax Apportionment Issues. Whenever a disclaimer is contemplated in the context of a taxable estate, the advisor should carefully consider how estate taxes will be apportioned. For example, in the context of a pecuniary marital, residuary bypass plan, the Will might provide for taxes to be paid from the residue of the estate, without apportionment. If the surviving spouse disclaims, and as a result estate tax is owed, the tax attributable to the disclaimed property may be

charged to the bypass trust, even if the disclaimed property passes elsewhere. Tax apportionment clauses effectively serve as dispositive provisions (or more accurately, "undispositive" provisions). The economic impact of these provisions should always be evaluated before the disclaimer is finalized. The IRS has privately ruled that a disclaimer of a portion of a residuary estate does not convert the disclaimed property into a specific bequest. Instead, a pro rata share of the debts, expenses and taxes should be charged to the disclaimed share. TAM 9502007. It appears that if the recipient of disclaimed property is entitled to be reimbursed for associated death taxes, that right may itself be disclaimed. *See Estate of Boyd v. Comm'r*, 819 F.2d 170 (7th Cir. 1987).

IV. INCOME TAXATION OF DECEDENTS AND ESTATES

A. The Decedent's Final Return. Upon the death of an individual, a final income tax return must be filed. In fact, depending upon the date of death, there may be two returns required for the decedent–one for the last full calendar year of the decedent's life, if that return was not yet filed as of the date of death, and one final return for the year of the decedent's death. Only this last return is the "final" return. The final return of the decedent includes items of income and deductions actually or constructively received or paid (assuming the decedent was on a cash basis) by the decedent before death. Treas. Reg. § 1.451-1(b). The responsibility for preparing and filing the decedent's final income tax return rests with the personal representative of the estate. Treas. Reg. § 1.6012(b)(1).

1. Due Date, Filing Responsibilities, and "Short Year" Issues. A decedent's final return is due on the regular return date, typically April 15th of the year following the date of death. Treas. Reg. § 1.6072-1(b). The executor need not make adjustments to reflect a "short" year. Treas. Reg. § 1.443-1(a)(2). The personal representative need not make further estimated tax payments on behalf of the decedent. Treas. Reg. § 1.6153-1(a)(4). The surviving spouse must, however, continue to make estimated payments unless an amended declaration of payments is filed. Treas. Reg. § 1.6015(b)-1(c)(2). The executor of the estate is responsible for paying the decedent's income tax liability. The executor faces personal liability if he distributes the estate before paying tax obligations of which he had notice, or with respect to which he failed to exercise due diligence. Treas. Reg. § 1.641(b)-2(a); IRC § 6012(b)(1). *See also* 31 U.S.C. § 3713(b) (establishing personal liability of an executor who pays claims ahead of amounts owed to the United States). The distributee may also be held liable. IRC § 6901. If no executor is appointed, the term "executor" means any person in actual or constructive possession of any property of the decedent. IRC § 2203. In relatively modest estates with no formal need for administration, the heirs may claim any refund owed to the decedent by filing IRS Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer.

2. Filing Joint Returns.. The personal representative has the option to file a separate return for the decedent, or to file a joint return with the surviving spouse, provided that the surviving spouse has not remarried before the end of the survivor's tax year. IRC § 6013. A joint return may not be filed if either of the spouses is a nonresident alien at any time during the taxable year. IRC § 6013(a)(1). If no executor has been appointed by the due date of the decedent's final return, the surviving spouse may file the joint return alone. If an executor is subsequently appointed, however, the executor may revoke the surviving spouse's election to file a joint return by filing a separate return for the decedent's estate within one year from the due date of the return, including extensions. IRC § 6013(a)(3).

a. Apportionment of Tax. The joint return will report the decedent's income through the date of death, and the spouse's income for the entire year. The income tax liability between the executor and surviving spouse is apportioned as they agree, or if there is no agreement, as provided by local law. *See* Treas. Reg. § 20.2053-6(f).

b. Joint and Several Liability. The executor, when considering whether to file a joint return with a surviving spouse, must consider not only the possibility of saving income taxes, but also the liability associated with the election. By filing a joint return, the executor becomes jointly and severally liable with the surviving spouse for the taxes and penalties associated with the return. IRC § 6013(d)(3). The executor may thereby be adopting a significant risk of unknown tax liabilities. It is currently unsettled whether the "innocent spouse" rule applies in this context. Many Wills expressly authorize the executor to file a joint return with the spouse on the theory

that the benefits of any resulting tax reduction outweigh any detriment of joint and several liability.

3. Planning Opportunities on the Final Return. Before the end of the tax year of the surviving spouse, several planning opportunities are presented.

a. Using Expiring Losses. The decedent's portion of net operating losses and capital losses can offset income and capital gains of the survivor arising after death. The surviving spouse should be advised to examine opportunities to accelerate recognition of income sheltered by these losses. If not used before the end of the year in which the decedent dies, the net operating losses and capital losses 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. IRC § 172(b)(1)(A)(i). Since the estate is a separate taxpayer, the decedent's estate cannot carry over the decedent's net operating losses and capital losses. Rev. Rul. 74-175, 1974-1 C.B. 52.

b. Reporting Savings Bond Interest. A taxpayer may elect to report all previously unreported Series E or EE Bond interest and thereafter report all Series E or EE Bond Interest as it is accrued. §454(a). The executor may make this election on behalf of the decedent on the final Form 1040. Rev. Rul. 68-145, 1968-1 C.B. 203. The executor may also make this election for bonds held in the decedent's revocable trust at the time of death. Rev. Rul. 79-409, 1979-2 C.B. 208. If the Section 454(a) election is not made, interest will be taxable as income in respect of a decedent ("IRD") to the ultimate recipient. If the interest is IRD, a deduction is available under §691(c) for any estate tax attributable to the interest. Rev. Rul. 64-104, 1964-1 C.B. 223. If the Section 454(a) election is made, no section 691(c) deduction will be applicable, but a deduction for federal estate tax purposes will be generated for the amount of the income tax created on the decedent's final return. Ltr. Rul. 9232006. If federal estate tax is due, making the Section 454(a) election will generally lower the overall tax liability.

c. Partnership and S Corporation Income. If the decedent was a partner or S corporation shareholder, the method of determining the decedent' share of the entity's income may have a substantial effect on the final return. For example, if a substantial portion of partnership or S corporation income is received in a month of the entity's taxable year after the date of death, a portion of the disproportionately high post-mortem partnership income can be shifted to the decedent's final return by making an election to prorate the income on a daily basis. Conversely, if a disproportionately large portion of the partnership or S corporation income was received before the date of the decedent's death, more income can be bunched into the decedent's final return by using a "closing of the books" method to allocate the income between the pre-death and post-death periods. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless all of the partners agree to allocate income on per diem basis. *See* Treas. Reg. § 1.706-1(c)(2)(ii). Conversely, an X corporation shareholder's final return must include the decedent's pro rata share of the S corporation's income for the year on a per diem basis. IRC § 1377(a)(1). If all the shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2).

d. Accelerating Installment Gain. If the decedent participated in an installment sale in the year of death, the executor may decide to elect out of the installment method. IRC § 453(d). Electing out of the installment method would cause the gain to be taxed on the decedent's final return (thereby creating an estate tax deduction for the resulting income tax liability). The election would preclude IRD recognition after death as the note is collected (or if the installment note is later cancelled or forgiven).

B. The Estate's Income Tax Return.

1. Obtaining an Employer Identification Number. The executor must obtain an employer identification number for the estate. Payers of interests, dividends and other income items should be notified of the estate's employer identification number so that these items of income can be accurately attributed to the estate. An executor may obtain a number by filing Form SS-4. Alternatively, the number may be filed online at https://sa2.www4.irs.gov/sa_vign/newFormSS4.do

2. Notifying the IRS of Fiduciary Status. The executor should file with the IRS a Notice Concerning Fiduciary Relationship (Form 56).

This form puts the IRS on notice that the executor has been appointed to handle the decedent's affairs, and apprizes the IRS of the proper address to which correspondence regarding the decedent's tax matters may be directed.

3. Electing a Fiscal Year End. Unlike an individual or a trust, an estate may elect to adopt a year end other than December 31. The only requirements are that the fiscal year must end on the last day of a month, and that the first year does not exceed 12 months. IRC § 441(e); Treas. Reg. § 1.441-1(a).

a. Available to Estates and Electing Trusts. Although the option to elect a fiscal year end does not generally apply to trusts, a revocable trust may elect to be treated as part of the estate and not as a separate trust. If the election is duly made, it applies for all taxable years of the estate beginning the day after the date of decedent's death and ending (1) two years after the date of death if no estate tax return is required, or (2) six months after the date of final determination of estate tax liability if an estate tax return is required. IRC § 645.

b. Method of Election. The election is made on the first income tax return filed by the estate Although IRS Form SS-4 asks for the taxpayer's fiscal year end, as does an Application for Extension of Time to File, the filing of those forms do not establish the fiscal year end for the entity. The election must be made by the due date of the return without regard to extensions. Therefore, the decision may be made up to three and one-half months after the end of the month selected. IRC §§ 441, 443(a)(2), 6072(a); Treas. Reg. § 1.441-(c)(1).

c. Reasons for Adopting Fiscal Year Ends. By adopting a non-calendar year end, an estate (or electing trust) can accomplish a number of objectives.

d. Deferral, Income Splitting and Expense Matching. For example, adoption of a fiscal year end for the estate of a decedent who dies in November 2005 would permit deferral of any income tax due from April 15, 2006 until February 15, 2007 (if an October 31 fiscal year end were selected). By adopting a very short first fiscal year, the estate may be able to split substantial income arising immediately after death (such as the collection of IRD) into two separate years, thereby taking advantage of two uses of the estate's lower marginal brackets (although the compression of rate brackets for estates substantially reduces the benefit of this strategy). Selecting a long first fiscal year may serve to permit enough time to pass for the estate to generate deductions (e.g., the payment of fees) to offset estate income. Alternatively, selection of a fiscal year end may allow substantial excess deductions taken in a last short year to be taken by the estate's beneficiaries. IRC § 642(h).

e. Deferral for Recipients of DNI. As discussed in the next section, when an estate makes a distribution, that distribution will generally carry out the estate's distributable net income to the distributee, causing the estate beneficiary to pay tax on any taxable income earned by the estate, to the extent of the distribution. If the tax year of the estate and the beneficiary differ, the beneficiary reports taxable DNI distributed during the estate's year that ends within his or her tax year. IRC § 662(c). Therefore, if an estate selects a fiscal year end other than December 31, its beneficiaries may defer reporting of income. For example, if an estate selects a January 31 year end, all distributions made from, say February 2005 through January 31, 2006 will be treated as being received by the beneficiary on January 31, 2006. Thus, a beneficiary receiving a distribution in February 2005 could defer paying the tax thereon until April 15, 2007 (the due date of the beneficiary's 2006 tax return), more than two years after receipt. Deferral may result in a bunching of income in the final year of the estate. If the estate in the foregoing example terminated on December 31, 2006, the beneficiary would include 23 months worth of income (February 2005 through December 2006) in 2006. Bunching can be offset by deferring expenses into the last year of the estate, and by keeping the estate's last fiscal year as short as possible, to generate excess deductions for the beneficiary under Section 642(h)(2) of the Code.

C. Ten Things Estate Planners Need to Know About Subchapter J. With apologies to David Letterman, here is my own personal list of the top ten income tax issues that every estate planner should know. I don't pretend to present them in order of importance (or, for that matter, in any particular order). There are certainly other income tax issues that merit consideration. Mastery of these ten, however, should give you a good

background in fundamental income tax issues that arise in the estate planning and administration context. Most estate planners think of an inheritance as being free from income tax. IRC § 102(a). Nevertheless, I start my "top ten list" with four important income tax issues that arise when estate assets are distributed. These areas are the carry out of estate income; the recognition of gain by the estate at the time of funding certain gifts; the impact upon beneficiaries of making unauthorized non-pro rata distributions of assets in kind; and the impact of distributing IRD assets. The income tax effect of estate distributions is an important area both in terms of language included in the governing instrument and the steps taken and elections made by the executor in the administration of the estate.

1. Estate Distributions Carry Out Distributable Net Income. The general rule is that any distribution from an estate will carry with it a portion of the estate's distributable net income ("DNI"). Estate distributions are generally treated as coming first from the estate's current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata.

Example 1: Assume A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. Unless the separate share rule discussed at page 38 below applies, the distributions are treated as coming first from estate income, and are treated as passing to the beneficiaries pro rata. Therefore, A will report income of $80,000 ($100,000 x ($200,000/$250,000)); B will report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate will be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, the estate would have received a $75,000 distribution deduction, and would have reported the remaining $25,000 as income on the estate's income tax return.

Section 663(b) of the Code permits complex trusts to treat distributions made during the first 65 days of the trust's tax year as though they were made on the last day of the preceding tax year. This election enables trustees to take a second look at DNI after the trust's books have been closed for the year, to shift income out to beneficiaries. The Taxpayer Relief Act of 1997 extends the application of the 65 day rule to estates for tax years beginning after August 5, 1997. As a result, for example, the executor of an estate can make distributions during the first 65 days of Year 2, and elect to treat them as though they were made on the last day of Year 1. If the executor makes this election, the distributions carry out the estate's Year 1 DNI, and the beneficiaries include the distributions in income as though they were received on the last day of the estate's Year 1 fiscal year.

The general rule regarding DNI carry-out is subject to some important exceptions.

a. Specific Sums of Money and Specific Property. Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If the executor pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate. As a result, the estate will not receive a distribution deduction for these distributions. By the same token, the estate's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.

(1) Requirement of Ascertainability. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. In the case of the decedent's estate, the governing instrument is the decedent's Will.

(2) Formula Bequests. Under the Treasury Regulations, a marital deduction or credit shelter formula bequest typically *does not* qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, if the executor elects to deduct administration expenses on the estate's income tax return, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction or credit shelter bequest cannot be resolved on the date of the decedent's death, the

IRS takes the position that the bequest will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death *does* carry out distributable net income from the estate.

(3) Payments from Current Income. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's distributable net income. Treas. Reg. § 1.663(a)-1(b)(2)(i).

(4) Distributions of Real Estate Where Title has Vested. The transfer of real estate does not carry out DNI when conveyed to the devisee thereof if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 C.B. 304. State law may provide for immediate vesting either by statute or by common law. *See, e.g,* Tex. Prob. Code Ann. § 27 (Vernon 2004); *Welder v. Hitchcock*, 617 S.W.2d 294, 297 (Tex. Civ. App.–Corpus Christi 1981, writ ref'd n.r.e.). Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate. Otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI. Rev. Rul. 68-49, 1968-1 C.B. 304. Note, however, that the IRS Office of the Chief Counsel has released an IRS Service Center Advice Memorandum (SCA 1998-012) which purports to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).

b. The Separate Share Rule. Generally, in the context of estate distributions made to multiple beneficiaries, DNI is carried out pro rata among the distributees of the estate. For example, in a year in which the estate has $10,000 of DNI, if the executor distributes $15,000 to A and $5,000 to B, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. The Taxpayer Relief Act of 1997 has made a substantial modification to the pro rata rule by applying the "separate share rule" to estates. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's DNI. IRC § 663(c). The Committee Report describing this change provides that there are separate shares of an estate "when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries." The IRS has now issued final regulations applying the separate share rules to estates. See T.D. 8849, 2000-2 IRB 245; Treas. Reg. § 1.663(c)-4. As a result of this change, the executor will have to determine whether the Will (or the intestate succession law) creates separate economic interests in one beneficiary or class of beneficiaries.

Example 2: A Will bequeaths all of the decedent's IBM stock to X and the balance of the estate to Y. During the year, the IBM stock pays $20,000 of dividends. No other income is earned. The executor distributes $20,000 to X and $20,000 to Y. Before the adoption of the separate share rule, the total distributions to X and Y would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata. Under the separate share rules, the distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y. Thus, application of the separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions.

Distributions to beneficiaries who don't have "separate shares" continue to be subject to the former "pro rata" rules. As noted above, application of the separate share rule is mandatory. The executor doesn't elect separate share treatment, nor may it be elected out of. Apparently, application of the separate share rules to estates was simply one of a host of small statutory changes that sought to bring the taxation rules for trusts and estates in line with one another. In practice, however, application of the separate share rules to estates may prove to be very complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone

account for. Under the final Regulations, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share. A bequests of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Section 663(a)(1) of the Code) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares. For a good discussion of some of the complexities associated with the application of the separate share rules to estates, see Cantrell, Separate Share Regulations Propose Surprising Changes, TRUSTS & ESTATES, March 1999, p. 56.

c. Income From Property Specifically Bequeathed. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate. *See, e.g.,* Tex. Prob. Code § 378B(c) (Vernon 2004). Until the adoption of the separate share rules, DNI was distributed on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest . . .", the separate share rules should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income under. In addition, the later distribution should not carry out DNI under the separate share rules, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rules, while complex to administer, have the advantage of making the income tax treatment of estate distributions more closely follow economic reality.

d. Interest on Pecuniary Bequests. State law or the governing instrument may require that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, beginning one year after the date of death. The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under UPIA, the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. Unif. Prin. & Inc. Act § 201(3) (1997). For a discussion of the income tax issues associated with the deductibility of this interest payment by the estate, see page 50, below.

2. An Estate May Recognize Gains and Losses When It Makes Distributions In Kind. Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's DNI. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the *lesser* of the adjusted basis of the property before distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is subject to some important exceptions.

a. Distributions Satisfying the Estate's Obligations. Distributions which satisfy an obligation of the estate are recognition events for the estate. The fair market value of the property is treated as being received by the estate as a result of the distribution, and the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 C.B. 196. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

b. Distributions of Assets to Fund Pecuniary Gifts. A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount," including a formula pecuniary bequest.

Example 3. A formula gift requires an executor to distribute $400,000 worth of property. If the executor funds this bequest with assets worth $400,000 at the time of distribution, but worth only $380,000 at the date of death, the estate will recognize a $20,000 gain.

The rules governing this area should not be confused with the "specific sum of money" rules which govern DNI carry outs. Unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). These gifts are, however, treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a , result, gains or losses we be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f)(1) (no gain or loss recognized unless distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). See also Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 C.B. 286. For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997 repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has declined in value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates as a result of the related party rules of Section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under Section 646 of the Code.

c. Pension and IRA Accounts Used to Fund Pecuniary Bequests. Several commentators have argued that if a pension asset is used to satisfy a pecuniary legacy, the use of that asset will be treated as a taxable sale or exchange, and this treatment will accelerate the income tax due. This analysis is based upon Treasury Regulation 1.661(a)-2(f)(1), which requires an estate to recognize gain when funding a pecuniary bequest with an asset whose fair market value exceeds its basis, as though the asset is sold for its fair market value at the date of funding. See Rev. Rul. 60-87, 1960-1 C.B. 286. If an estate uses an asset constituting income in respect of a decedent to satisfy a pecuniary bequest, application of this principle would cause the gain to be accelerated. In this author's opinion, however, it can be persuasively argued that this acceleration will not occur if the beneficiary is not the estate, but the trustee named in the participant's Will. Three lines of analysis confirm this result:

(1) No Receipt By Estate. The recognition rules under Treasury Regulation Section 1.661(a)-2(f)(1) apply only in the context of a distribution *by the estate* in satisfaction of a right to receive a specific dollar amount. When a "testamentary trustee" is named as the beneficiary of a pension plan or IRA, there is clearly no distribution by the estate, and no acceleration event should occur to the estate. The estate, after all, is subjected to taxation only on income *received by the estate* during the period of administration or settlement of the estate. IRC § 641(a)(3). Pension benefits payable directly to the trustee of the trust established under the Will of the plan participant are never "received by the estate." This fact remains true even if the Will contains instructions directing the testamentary trustee to use these funds in whole or in part to fund a pecuniary bequest. The fact that the executor takes these non-testamentary transfers into account in measuring the amount of *other* amounts needed to fund the pecuniary bequest should not change this result. Since the non-probate pension assets are not subject to administration, the estate cannot properly be said to be the taxpayer with respect to any transaction involving these benefits.

(2) No IRD Transfer by Estate. Separate and apart from the gain recognition rules of Treasury Regulation Section 1.661(a)-2(f)(1) is the IRD recognition rule of Section 691 of the Code. However, the recognition rules of Section 691(a)(2) of the Code, by their terms, apply only if the right to receive income in respect of a decedent is transferred "*by the estate of the decedent* or a person who receives such right by reason of the death of the decedent . . ." (emphasis added). If the testamentary trustee is the beneficiary, there is simply no transfer *by* the estate. Moreover, there is no transfer *by* any "person" who receives the right by reason of the decedent's death. The Code expressly excludes from the definition of "transfer" requiring IRD acceleration any "transmission at death . . . *to* a person pursuant to the right of such person to receive such amount by reason of the death of the decedent . . .". IRC § 691(a)(2) (emphasis added). In that event, the recipient (here, the trust) includes these amounts in gross income not when the right to the payment is received, but only when the payments themselves (i.e., the distributions from the retirement plan) are actually received. IRC § 691(a)(1)(B).

(3) Constructive Receipt Rules. The general rules which describe the timing of recognition for income attributable to an IRD asset are reinforced by the statutes expressly governing pension distributions. Amounts held in qualified plans and IRA's are taxable to the recipient only when actually distributed. IRC §§ 72, 402(a). The mere fact that benefits under the plan or IRA are made available, or that the participant or beneficiary has access to them, is not determinative, since the constructive receipt rules do not apply to these assets. IRC §§ 402(a)(1), 408.

(4) Proper Tax Treatment. Therefore, if the testamentary trustee receives, whether by a spouse's disclaimer or by direct designation by the participant, the right to receive plan distributions, no income tax should be payable until such time as distributions are actually made from the plan or IRA to the trust, even if the assignment of the right to receive plan assets otherwise reduces (or eliminates) the amount that the estate needs to distribute in satisfaction of a pecuniary bequest. Instead, the testamentary trust should be able to defer taxation on pension and IRA proceeds until such time as those accounts are distributed (which may be until they are required to be distributed in accordance with the minimum required distribution rules). See PLR 9630034 (pecuniary disclaimer by spouse of ½ interest in decedent's IRA does not cause recognition to spouse or estate).

d. Section 643(e)(3) Election. The executor may elect under Section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The Section 643(e) election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain or loss on only those assets. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets. Note that if an executor makes a Section 643(e)(3) election in a year that an IRD asset is distributed by the estate, gain would be accelerated, even if the distribution is otherwise subject to a Section 691(a)(2) exception, since the asset representing the IRD will be treated as having been sold by the estate in that year. For fiscal years beginning after August 1, 1997, the Section 643(e)(3) election (or an actual sale to a beneficiary) can cause the estate to recognize gains, but not losses, since under the principles of Section 267 of the Code, the estate and its beneficiary are now treated as related taxpayers. IRC § 267(b)(13).

3. Estate Beneficiaries May Recognize Gains and Losses If the Estate Makes Unauthorized Non Pro Rata Distributions In Kind. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries, the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 C.B. 159.

Example 4: A decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm worth $110,000. At the

date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if the will fails to authorize non-pro rata distributions,* the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" his interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. To avoid this result, the governing instrument should expressly authorize non-pro rata distributions.

See page 51 for a discussion of an analogous issue in the context of non-pro rata divisions of community property between the estate and the surviving spouse.

4. Income in Respect of a Decedent is Taxed to the Recipient. A major exception to the rule that an inheritance is income tax free applies to beneficiaries who receive payments that constitute income in respect of a decedent. IRC § 691.

a. IRD Defined. Income in respect of a decedent ("IRD") is not defined by statute, and the definition in the Treasury Regulations is not particularly helpful. Generally, however, IRD is comprised of items which would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and tax reporting method, is not includible in the decedent's final Form 1040. Examples of IRD include accrued interest; dividends declared but not payable; unrecognized gain on installment obligations; bonuses and other compensation or commissions paid or payable following the decedent's death; and amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981). The estate's basis in an IRD asset is equal to its basis in the hands of the decedent. No step-up is provided. IRC § 1014(c).

b. Recognizing IRD. If the executor distributes an IRD asset in a manner which will cause the estate to recognize gain on the distribution, or if a Section 643(e)(3) election is made and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits the right to an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received. Treas. Reg. § 1.691(a)-4(b)(2). If IRD is to be recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result.

Example 5: In 2008, X dies with a $2.5 million estate. The Will makes a formula marital gift of $500,000 to the spouse, leaving the rest of the estate to a bypass trust. If an IRD asset worth $500,000 but with a basis of $0 is used to fund this marital gift, the estate will recognize a $500,000 gain. The spouse will receive the $500,000 worth of property, but the estate will owe income tax of some $173,900, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $1,526,100 to fund the bypass trust.

Under these circumstances, the testator may wish to consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

c. Deductions in Respect of a Decedent. A concept analogous to income in respect of a decedent is applied to certain deductible expenses accrued at the date of the decedent's death. Those "deductions in respect of a decedent" ("DRD") are allowable under Code Section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowed as deductions in respect of a decedent for income tax purposes to the person or entity paying those expenses. IRC § 691(b). The general rule disallowing both income and estate tax deductions for administration expenses, discussed below at page 43 does not apply to DRD. The theory behind allowing this "double" deduction is that had the decedent actually paid this accrued expense before death, he could have claimed an income tax deduction, and the cash on hand in his estate would be reduced, thereby effecting an estate tax savings as well. Of course, interest, administration expenses, and other items not accrued at the date of the decedent's death are

subject to the normal election rules of Section 642(g) of the Code discussed below.

5. Impact of Death Upon Basis. Most practitioners describing the impact of death upon basis use a kind of short-hand by saying that assets get a "step-up" in basis at death. In inflationary times, this oversimplification is often accurate. However, it is important to remember that the basis of an asset may step up or down. For most assets, the original cost basis in the hands of the decedent is simply irrelevant. It is equally important to remember that the basis adjustment rule is subject to some important exceptions.

a. General Rule. In general, the estate of a decedent receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. IRC § 1014. In most cases, the basis is the date-of-death value of the property. However, if the alternate valuation date for estate property has been validly elected, that value fixes the cost basis of the estate's assets. IRC § 1014(a)(3). The basis adjustment rule also applies to a decedent's assets held by a revocable trust used as an estate surrogate, since they are deemed to pass from the decedent pursuant to Sections 2036 and 2038 of the Code. Although often called a "step up" in basis, various assets may be stepped up *or down* as of the date of death. The adjustment to the basis of a decedent's assets occurs regardless of whether the estate is large enough to be subject to federal estate tax. Original basis is simply ignored and federal estate tax values are substituted. Note that the new cost basis applies not only to the decedent's separate property but also to *both halves* of the community property owned by a married decedent. IRC § 1014(b)(6).

b. Exceptions. There are two important exceptions to the basis adjustment rule.

(1) No New Basis for IRD. Items which constitute income in respect of a decedent receive a carryover basis. IRC § 1014(c). This rule is necessary to prevent recipients of income in respect of a decedent from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his basis in the asset.

(2) No New Basis for Deathbed Transfers to Decedent. Section 1014(e) of the Code provides a special exception for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor as a result of the decedent's death. This rule is presumably designed to prevent avaricious taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

6. The Executor Can Elect to Deduct Many Expenses for Either Income or Estate Tax Purposes (but not Both). An executor is often confronted with a choice of deducting estate administration expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed. IRC § 642(g). Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the estate tax return. Between 1993 and 2003, the analysis was more difficult. Now that the highest income tax bracket for estates is 35%, while the lowest effective estate tax bracket is 45%, the old analysis once again applies.

a. Section 642(g) Expenses. The executor must make an election to take administration expenses as a deduction for income tax purposes by virtue of Section 212 of the Code, or to deduct those same expenses as an estate tax deduction under Section 2053 of the Code. No double deduction is permitted. Expenses to which this election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income. Treas. Reg. § 1.212-1(i). Note, however, that expenses attributable to the production of tax-exempt income are denied as an income-tax deduction to estates, just as they are to individuals, under Section 265(1) of the Code. Interest on estate taxes deferred under Section 6166 of the Code, which now accrues at only 45% of the regular rate for interest on under payments, is no longer allowed as an estate tax or on income tax deduction. IRC §§ 2053(c)(1)(D); 163(k).

b. Method of Election. Technically, the Code and Treasury Regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Section 2053 or 2054 and that all rights to have thos items allowed at any time as deductions under Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors tentatively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter and deductions on the estate tax return have proven unnecessary. This approach can be dangerous, however, if deductions are taken on the estate tax return, and the estate receives a closing letter without examination of or adjustment to the return. Under these circumstances, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

c. Payments From Income. Increased attention has been focused on the interaction of state law and tax rules in determining whether estate administration expenses are chargeable to principal or income. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124 (1997) where the executor charged administration expense to estate income for both state law and tax law purposes. The IRS held that the allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. After litigating the issue all the way to the United States Supreme Court, limited guidance was given. The "plurality" opinion held that, under the facts presented, the executor's decision to charge expenses to income did not constitute a "material limitation" on the interest passing to the surviving spouse. In a somewhat more comprehensible concurring opinion written by Justice O'Connor, she noted that the measure of materiality is a matter within the province of the Commissioner to set forth by regulation. Since the regulations that were in force at the date of death did not establish a test for materiality, and since the Tax Court opinion in this case was consistent with current law and regulations, no loss of the marital deduction was appropriate in this particular case. Justice O'Connor specifically noted, however that "[t]here is no reason why this labyrinth should exist, especially when the Commissioner is empowered to promulgate new regulations and make the answer clear. Indeed, nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation."

d. Regulatory Guidance. Not surprisingly, the Treasury Department, responding to Justice O'Connor's invitation, has announced new regulations providing guidance on this issue. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3; 20.2056(b)-4(d). Unlike the "material limitation" rules under the prior regulations, the new regulations permit deductions depending upon the nature of the expenses in question. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

e. Estate Management Expenses. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i) ; 20.2056(b)-4(d)(1)(i).

f. Estate Transmission Expenses. Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against Will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii); 20.2056(b)-4(d)(1)(ii).

g. Reduction for Unrelated Estate Management Expenses. In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property interest not included in the marital share." Treas. Reg §20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4).

h. Special Rule for Estate Management Expenses Deducted on Estate Tax Return. If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3); 20.2056(b)-4(d)(3). The justification for this position is the language in Section 2056(b)(9) of the Code, which provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent.

Example 6: $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse. The decedent's applicable credit amount had been fully utilized before death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child. Treas. Reg § 20.2056(b)-4(d)(5), Ex.4.

i. Effective Date. The new regulation apply to estates of decedents dying on or after December 3, 1999. Treas. Reg. §§ 20.2055-3(b)(7); 20.2056(b)-4(d)(6).

7. Post-Death Revocable Trusts May Be Separate Taxpayers or Part of the Estate. Trusts used as estate surrogates face issues similar to estates in the context of post-death income taxation. In the words of one author,

> A postmortem successor trust does not spring, Minerva-like, full-blown from the Jovian brow of the grantor trust *eo instante* upon the grantor's death. In most instances, and unless the governing instrument provides otherwise, the postmortem successor trusts (marital deduction, credit shelter or other) will be treated as separate trusts for income tax purposes only when funded. Funding occurs only when the trustee has assigned assets to the trust after careful exploration and prudent exercise of post-mortem tax options and elections available under the Internal Revenue Code of 1986. In the interim, the grantor trust normally functions like an estate pending distribution to its beneficiaries (including successor trusts) and, as such, in a separate taxable entity for income tax purposes.

Becker, "Wills vs. Revocable Trusts - Tax Inequality Persists," 3 PROB. & PROP. No. 4 at 17, 18 (1989). Trust termination rules are governed by paragraph (b) of Treasury Regulation Section 1.641(b)-3, as opposed to paragraph (a). The rules, however, are similar and should give rise to no real substantive difference in timing or treatment.

a. Differences Between Trusts and Estates. Historically, post-death revocable trusts suffered several minor disadvantages when contrasted with an estate for income tax purposes. These included, for example, fiscal year-end selection, holding periods for S stock, waiver of active participation for passive losses, use of the $600.00 allowance in lieu of personal exemption, income tax deductions for charitable set asides, Section 194 amortization of reforestation expenditures, avoidance of estimated tax payment requirements for two years, etc.

b. Election to Unify. For decedents dying after August 5, 1997, the trustee and the executor (if any) may irrevocably elect to treat a "qualified revocable trust" as part of the estate for income tax purposes. IRC § 645(a). A "qualified revocable trust" is a trust that, during the life of the grantor, was treated as a grantor trust because of his or her right of revocation under Section 676 of the Code. IRC § 645(b). The election must be made on the estate's first timely income tax return (including extensions), and, once made, is irrevocable. IRC § 645(c); Treas. Reg. § 1.645-1(e)(1). The election applies until "the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11," or if no

estate tax return is due, two years after the date of death. The final regulations provide that the date of final determination of liability is the date that is six months after the date the closing letter is issued. Therefore, the section 645 election will terminate twelve months after issuance of the closing letter. The regulations further provide that the election period terminates earlier if both the electing trust and the related estate, if any, have distributed all their assets. Treas. Reg. § 1.645-1 (f)(1). The procedures for making the election for decedents who die on or after December 24, 2002 are governed by final Treasury Regulations. Treas. Reg. § 1.645-1(j). If an executor has been appointed, the executor and trustee of the trust make the election by signing and filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." If there is no executor, the trustee of the trust files the election form. Treas. Reg. § 1.645-1(c)(2).

c. Advantages of the Election. If the estate (if any) and the revocable trust make the election, a number of tax benefits may result to the trust, including:

(1) availability of a fiscal year under Section 644. Treas. Reg. § 1.645-1(e)(3)(i).

(2) avoiding the need to make estimated tax payments for two years after the decedent's death. Treas. Reg. § 1.645-1(e)(4).

(3) the ability to obtain a charitable deduction for amounts permanently set aside for charity under section 642(c)(2). Treas. Reg. § 1.645-1(e)(2)(iv) & (e)(3)(i).

(4) the ability to hold S corporation stock for the duration of the administration of the estate, without meeting special trust rules Treas. Reg. § 1.645-1(e)(3)(i); see Rev. Rul. 76-23, 1976-1 C.B. 264 (estate exception applies for the reasonable period of estate administration and applies for entire section 6166 deferral period).

(5) avoidance of the passive loss active participation requirement under Section 469 of the Code for rental real estate for two years after death. Treas. Reg. § 1.645-1(e)(3)(i).

(6) use of the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is a simple or a complex trust). Treas. Reg. § 1.645-1(e)(2)(ii)(A).

(7) allowing losses in funding pecuniary bequests under section 267(b)(13).

(8) simplifying the number of tax returns.

(9) deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven months of additional deferral).

8. When An Estate or Trust Allocates "Income," That Means Fiduciary Accounting Income, Not Taxable Income. Estate planning attorneys that spend too much of their time studying tax rules sometimes forget that not every situation is governed by the Internal Revenue Code. Nowhere is this failure more prevalent that in the area of allocating and distributing estate and trust "income." In general, when a trust (or the income tax rules applicable to estates and trusts) speaks of "income" without any modifier, it means fiduciary accounting income, and not taxable income. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Internal Revenue Code, control. Therefore, estate planners should have a basic understanding of these state law rules. Allocations are generally made pursuant to directions set forth in the governing instrument, or in the absence of those directions, pursuant to the provisions of local law. As of this writing, thirty-nine states and the District of Columbia have adopted the 1997 Uniform Principal and Income Act ("UPIA"). One other state (Massachusetts) has introduced a bill to adopt the Act. Most other jurisdictions utilize a version of the prior Uniform Principal and Income Act, and most have adopted the 1962 version of that Act ("RUPIA 62").

a. Allocation of Income.

(1) General Rules. UPIA provides that a trustee must make allocations between trust income and principal in accordance with the specific provisions of the governing instrument, notwithstanding contrary provisions of the Act. Unif. Prin. & Inc. Act § 103(a)(1) (1997). Provisions in the Will or trust agreement should therefore control allocations of estate and trust income and expense, so long as they are specific enough to show that the testator chose to define a

specific method of apportionment. See *InterFirst Bank v. King*, 722 S.W.2d 18 (Tex. App.–Tyler 1986, no writ). In the absence of specific provisions in the instrument, the provisions of the Act control allocations between income and principal.

(2) Allocations Under Prior Law. Under RUPIA 62, allocations from entities were subject to varying rules, depending upon whether the entity was a corporation, partnership, mutual fund, or some other entity. For example:

(a) Corporate Distributions. Cash dividends from corporations were treated as income. In addition, distributions of securities of corporations other than the distributing corporation were classified as income. Other corporate distributions were generally principal. If the distributing corporation provided the trustee with a statement setting forth any facts relevant to the classification of distributions, the trustee was entitled to rely on that statement. Rev. Unif. Prin. & Inc. Act § 6 (1962). Note that these fiduciary accounting rules paralleled income tax rules quite closely in the context of regular taxable C corporations, but were entirely inconsistent with the tax rules for S corporations. S corporation income is taxed to its shareholders without regard to distributions from the corporation. Rather, distributions from S corporations are generally income tax free to shareholders to the extent of the basis in their stock. Nevertheless, the Act made no distinction between C and S corporation distributions.

(b) Mutual Fund Distributions. Distributions from mutual funds were treated separately from other corporate distributions under RUPIA 62. Section 6(c) of the Act provided that principal included any distribution except from ordinary income by a regulated investment company or real estate investment trust including a distribution from capital gains. This language clearly allocated net long term capital gain distributions to corpus. But what about short term capital gains which, while being treated as gains, are taxed at ordinary income rates? The language of the 1962 Act created some uncertainty as to those distributions. See "Allocation Between Income and Principal of 'Capital Gain' Dividend of Mutual Fund or Investment Trust or Corporation," 98 A.L.R.2d 511 (1964).

(c) Business and Farming Operations (Including Partnerships and LLCs). RUPIA 62 generally adopted generally accepted accounting principles to determine income from proprietorships and partnerships. Unfortunately, this description created a problem not expressly addressed by the former Act. GAAP generally requires entities to measure income on an accrual basis. Generally, however, RUPIA 62 attempted to characterize trust receipts and disbursements on a cash basis. If true GAAP rules were used, the Trustee would have been required to obtain financial statements prepared under those rules to measure income. If, instead, cash basis accounting was utilized, the trustee would not be required to make an internal inspection at the partnership level to determine whether the partnership realized a net profit or loss for the particular year, and the trustee might be able to avoid cash flow problems in making income distributions to income beneficiaries. Cf. Fickert v. Commissioner, 15 T.C. 344, 348 (1950) (trustee adopted cash method of accounting and distributed to income beneficiaries "all of the income that actually came into his hands"). However, even with cash basis accounting the trustee was faced with the issue of how to pay income taxes on undistributed profits that were realized for federal income tax purposes. Charging the tax against income (on the theory that the undistributed net profits would ultimately be distributed and treated as income) had the effect of reducing the amount of income currently distributable to the income beneficiary. Some trustees charged accrued income (and its associated income tax) to principal as it accrued, and "repaid" the accrued amount (less associated taxes) to the income account when the profits were actually distributed. This approach would be analogous to establishing a reserve for unusual charges against income under Section 13(b) of the Act.

(3) Allocations Under UPIA. Under UPIA, a more uniform approach is directed for distributions from entities. The cash basis is expressly used to characterize income from entities.

(a) Distributions from "Entities". Section 401(d) of the 1997 Uniform Principal and Income Act provides a direct answer to the question of how to characterize distributions from "entities," which the Act defines to include corporations, partnerships, LLCs, regulated investment companies (i.e., mutual funds), real

estate investment trusts, and common trust funds. The general rule under UPIA 97 is that all distributions received from these entities are income, subject to four exceptions. First, the Act treats long term capital gain distributions from mutual funds as principal. Second, reinvested corporate dividends are treated as principal (but presumably only if they are reinvested pursuant to the trustee's power under the Act to adjust between income and principal to comply with the duty of impartiality between income and remainder beneficiaries). Third, distributions in kind (as opposed to distributions of money) from partnerships and S corporations are treated as principal. Finally, distributions of money are income unless (i) they are designated by the entity as a liquidating distribution; or (ii) to the extent they exceed 20% of the entity's gross assets before distribution (ignoring money that does not exceed the income tax that the trustee or beneficiary must pay on the entity's income).

(b) Mutual Fund Distributions. Section 401(c)(4) of UPIA 97 provides that principal includes money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. The official comment to the Uniform Act states: "Under the Internal Revenue Code and the Income Tax Regulations, a 'capital gain dividend' from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act."

(c) Business and Farming Operations. UPIA permits a trustee to aggregate assets used in a business or farming operation and to account separately for the business or activity (instead of accounting separately for its various components) if the trustee "determines that it is in the best interest of all of the beneficiaries" to do so. Unif. Prin. & Inc. Act § 403(a) (1997). The trustee is permitted to maintain a reserve from its net cash receipts to the extent needed for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business. Unif. Prin. & Inc. Act § 402(b) (1997).

b. Allocation of Expenses.

(1) General Rule. Like income, expenses may be allocated between fiduciary accounting income and principal based upon the terms of the governing instrument. If the instrument fails to specify how expenses are to be allocated, state law provides guidance.

(2) Allocations Under Prior Law. Section 13 RUPIA 62 set forth several categories of expenses to be allocated to income or principal for purposes of computing fiduciary accounting income. That section also provided that if charges against income were unusual in amount, the trustee could by use of reserves or other reasonable means apportion the charges over a reasonable period of time and withhold from distributions amounts sufficient to regularize distributions.

(a) Charges Against Income. Charges against income included ordinary expenses of administration, management and preservation of property, including recurring taxes, insurance, interest and repairs. Also charged to income was the allowance for depreciation under generally accepted accounting principles. One-half of court costs and attorneys' fees for accountings, and all court costs and attorney fees for other matters concerning income were charged to income, as were expenses incurred for current management of principal and application of income. Taxes on proceeds constituting fiduciary accounting income were charged to that income.

(b) Charges Against Principal. Charges against principal were all those not charged to income, including costs of investing and reinvesting principal, payments on the principal portion of debt, and expenses of preparing property for rent or sale. Also charged to principal were attorneys' fees and costs not reasonably allocable to income including (unless the court directs otherwise) expenses incurred in construing the trust or protecting title to trust assets. Other charges to principal included capital improvements and special assessments, except to the extent of reserves for depreciation charged to income. Finally, taxes on capital gains (even if denominated "income" taxes) and estate, inheritance and other transfer taxes were charged to principal.

(3) Allocations Under UPIA. Section 501 and 502 of UPIA make similar allocations against income and principal.

(a) Charges Against Income. Under the new statute, charges against income include one-half of all trustee fees and commission, (including investment advisor fees) and one-half of expenses for accountings and judicial proceedings that involve both the income and principal beneficiaries. All of the ordinary expenses of administration, management and preservation of property, and the distribution of income, including recurring taxes assessed against principal, insurance, interest and repairs are charged against income. Also charged to income are all court costs and attorney fees for other matters concerning income. Unif. Prin. & Inc. Act § 501 (1997).

(b) Charges Against Principal. Charges against principal are all those not charged to income, including one-half of trustee fees, accountings and judicial proceedings not charged to income, trustee compensation based on acceptance, distribution or termination, of for making property ready for sale, and payments on the principal portion of debt. Also charged to principal are estate, inheritance and other transfer taxes. Unif. Prin. & Inc. Act § 502 (1997).

(c) Income Taxes. UPIA Section 505 adopts in part the prior law, generally charging taxes based upon income receipts to income, and charging taxes on principal receipts to principal, even if denominated as an "income" tax (such as capital gain taxes). The Section then goes on to allocate "tax required to be paid by a trustee on a trust's share of an entity's taxable income," which would presumably include income from partnerships, LLCs and S corporations. The Act requires that these taxes be paid proportionally from income, to the extent that receipts from the entity are allocated to income, and to principal to the extent (i) receipts are allocate to principal; or (2) the entity's taxable income exceeds the total receipts from the entity. Unif. Prin. & Inc. Act § 505(c) (1997). These allocations may be reduced by the amount distributed to a beneficiary for which a distribution deduction is allowed. Unif. Prin. & Inc. Act § 505(d) (1997).

c. "Power to Adjust".

(1) Breadth of the Power. The framers and advocates of UPIA make much of it provision granting the trustee the power to adjust between principal and income "to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines . . . that the trustee is unable to comply with" the general requirement to administer the trust "impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." Unif. Prin. & Inc. Act §§ 103(b), 104 (1997). The power to adjust includes the power to allocate all or part of a capital gain to trust income. This power is seen as many as a panacea to cure all of the ills of trust administration. Unfortunately, however, its application is limited.

(2) Limitations on the Power to Adjust. The power to adjust is not available to all trustees. In particular, the power may not be used to make an adjustment: (1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment; (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion; (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside; (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (7) if the trustee is a beneficiary of the

trust; or (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly. Unif. Prin. & Inc. Act § 104(c) (1997). Many of the trusts with which estate planners struggle fall within category (1) (intended to qualify for the estate tax marital deduction) or (7) (the trustee is a beneficiary). As a result, the power to adjust is simply unavailable in many cases.

d. Equitable Adjustments. UPIA Section 506 permits a fiduciary to make adjustments between principal and income to offset the shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from (i) elections that the fiduciary makes from time to time regarding tax matters; (ii) an income tax imposed upon the fiduciary or a beneficiary as a result of a distribution; or (iii) the ownership by an estate or trust of an entity whose taxable income, whether or not distributable, is includible in the taxable income of the estate, trust or a beneficiary. This sort of adjustment, often referred to as an "equitable adjustment," has been the subject of common law decisions in a variety of jurisdictions.

Example 7: Equitable adjustments can be illustrated by *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956). There, the executor elected under Section 642(g) to take deductions for income tax purposes, which reduced income taxes by $100,000.00, at the cost of $60,000.00 in estate tax savings. Based upon the terms of the Will, the income tax savings inured to the benefit of the income beneficiary, while the loss of estate tax savings came at the expense of the remainder beneficiaries. The court required the benefitted estate to pay $60,000.00 in damages to the remainder beneficiaries as an "equitable adjustment." As a result, the remainder beneficiaries were unharmed, and the income beneficiaries received the net $40,000.00 tax savings.

9. Deduction of Interest Paid on Pecuniary Bequests. State law or the governing instrument may provide that the devisee of a pecuniary bequest is entitled to interest on the bequest beginning one year after the date of death. UPIA provides that this interest is charges against income to the extent that it is sufficient, and thereafter from principal. Unif. Prin. & Inc. Act § 201(3) (1997). For tax purposes, however, payment of this interest is treated not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary. Rev. Rul. 73-322, 1973-2 C.B. 44. Under Section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment. Property held for investment is described by reference to Section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. No case or ruling addresses the allocation of interest expense when an estate incurs an expense as a result of a delay in funding a pecuniary bequest. However, IRS Notice 89-35, 1989-13 IRB 4, provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under that Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by an estate in funding a bequest, perhaps these principles can be applied by analogy to estates. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" was incurred because the estate failed to distribute its assets to fund the pecuniary bequest within one year after letters testamentary were issued. As a result, the estate was able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the Will or local law. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest." It should be noted, however, that in an example contained in the Treasury Regulations relating to the separate share rules, the IRS states (without

explanation) that interest paid on a spouse's elective share that is entitled to no estate income, but only statutory interest, is income to the spouse under Section 61 of the Code, but non-deductible to the estate under Section 163(h). Treas. Reg. § 1.663(c)-5, Ex. 7. The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under Section 163(h) is gratuitous, and in this author's view, erroneous.

10. Non-Pro Rata Divisions of Community Property. Can an executor and the surviving spouse make tax free non-pro rata divisions of community property, so that the beneficiaries own 100% of a community property asset while the spouse succeeds to 100% of other community property assets of equal value? Two 1980 technical advice memoranda suggest that a tax-free division is permissible on these facts. Both rely on Revenue Ruling 76-83, 1976-1 C.B. 213, a ruling involving similar issues in the divorce context. Tech. Adv. Mem. 8016050; Tech. Adv. Mem. 8037124. A more recent ruling seems to confirm this analysis if permitted by the governing instrument or local law. Tech. Adv. Mem. 9429012. Whether local law permits a division is highly dependent upon the law of the particular community property jurisdiction in question. In this author's opinion, for example, Texas law *does* authorize a non pro rata division of community property, even if express language in the Will does not. Frankly, however, the rationale is somewhat tenuous. There is no case or statute directly on point. Since recognition of any gain or loss will be premised upon the rationale of Revenue Ruling 69-486, and since that ruling provides for tax avoidance if the non-pro rata division is permitted by local law *or* by the governing instrument, the better practice is to authorize this form of division in the Will or revocable trust. If the documents do not authorize the division, the client should be cautioned about the possible tax consequences, or a ruling should be obtained.

V. CONCLUSION

Post-mortem estate planning can involve a myriad of tax issues, including sophisticated estate and income tax issues. In addition, the use of qualified disclaimers, one of the most important tools in the post-mortem toolbox, must be well understood. Armed with these tools, however, an executor need not feel that the tax consequences of a particular estate plan are fixed at death. With proper attention and planning, the family can often recognize significant tax savings based upon the actions undertaken after death.