

# Post-Mortem Estate Planning

DELAWARE TRUST CONFERENCE

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# We will cover

- ▶ Final 1040 Elections
- ▶ Protecting the Fiduciary
- ▶ Electing Estate Tax Year
- ▶ Section 645 Election
- ▶ 65-day Rule
- ▶ Allocation of Estimated Taxes
- ▶ Charitable Contributions
- ▶ Portability Election
- ▶ Administrative Expenses
- ▶ Alternate Valuation
- ▶ Section 643(b) Election
- ▶ Estate Tax Deferral
- ▶ QTIP Elections
- ▶ QDOTs
- ▶ Gift Splitting
- ▶ GST Planning
- ▶ Disclaimers
- ▶ Death of a Partner
- ▶ Death of S Corporation Shareholder
- ▶ QSST
- ▶ ESBT

# Filing Status

- ▶ Married filing a joint return may not produce the best result if the decedent had little income and large medical expenses
- ▶ Higher income of surviving spouse may cause higher AGI on a joint return; thus increasing medical deduction threshold

# Medical Expenses

- ▶ General Rule
  - ▶ Section 213(c) allows the executor to deduct medical expenses on the decedent's final income tax return for the year the expense was incurred, if paid by the estate within one year of death. The election must be filed in duplicate, which includes in the statement that a deduction against the gross estate for those expenses has not been taken and waives the right to claim them at any time for estate tax purposes. If the election does not cover all of the medical expenses, those not covered cannot be taken as a claim against the estate.
- ▶ Deduction on 1040 is subject to 10% of AGI floor beginning in 2017 for all taxpayers

# Series E/EE Bonds\*

- ▶ General Rule
  - ▶ Individual can defer recognition of income until the interest is actually received or when the bond matures.
- ▶ Election
  - ▶ Individual, in this case the executor, can elect (on a timely filed return) to begin reporting E/EE\* bond interest on the decedent's final year income tax return. Section 454(a)
  - ▶ Applies only to accrued interest through the date of death, which otherwise would be considered IRD

\* Includes E/EE Bond interest that had been rolled into H/HH Bonds

# Series E/EE Bonds - Continued

- ▶ Election - Continued
  - ▶ Interest accruing after date of death is not IRD and beneficiary is not bound by the election
  - ▶ Income can be reduced by losses, deduction and exemptions that might otherwise be lost, especially if decedent died early in the year
  - ▶ If no election is made – beneficiary, who may be in a higher tax bracket and subject to NIIT, would report the income

# Losses on Final Income Tax Return

- ▶ Capital Losses – No carryover to estate or trust
- ▶ Net-Operating Losses – No carryover to estate or trust
- ▶ Passive Losses – Excess over any basis step-up is deductible

# Election Out of Installment Sale Treatment

- ▶ Report sale directly on Schedule D or Form 4797 and recognize entire gain in the year of sale
- ▶ Must be made on a timely filed return, including extension
- ▶ No special statement is needed
- ▶ May be beneficial if decedent will be in a low tax bracket in final year as opposed to beneficiary or estate

# Protecting the Fiduciary

- ▶ Notice of Fiduciary Relationship – §6903
- ▶ Discharge from Personal Liability – §6905, §2204
- ▶ Request for Prompt Assessment – §6501(d)

# Notice of Fiduciary Relationship - §6903

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

## Discharge from Personal Liability - §6905 - Cont.

- ▶ Fiduciary personally liable for decedent's unpaid income and gift taxes and estate taxes (§2204) if he pays others before paying government the taxes due at death
- ▶ Protection available from personal liability by requesting in writing (Form 5495) a discharge from personal liability
- ▶ IRS has 9 months to assess tax due
  - ▶ No notice, fiduciary discharged
  - ▶ Notice of amount due, fiduciary discharged on payment

# Discharge from Personal Liability - §6905

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

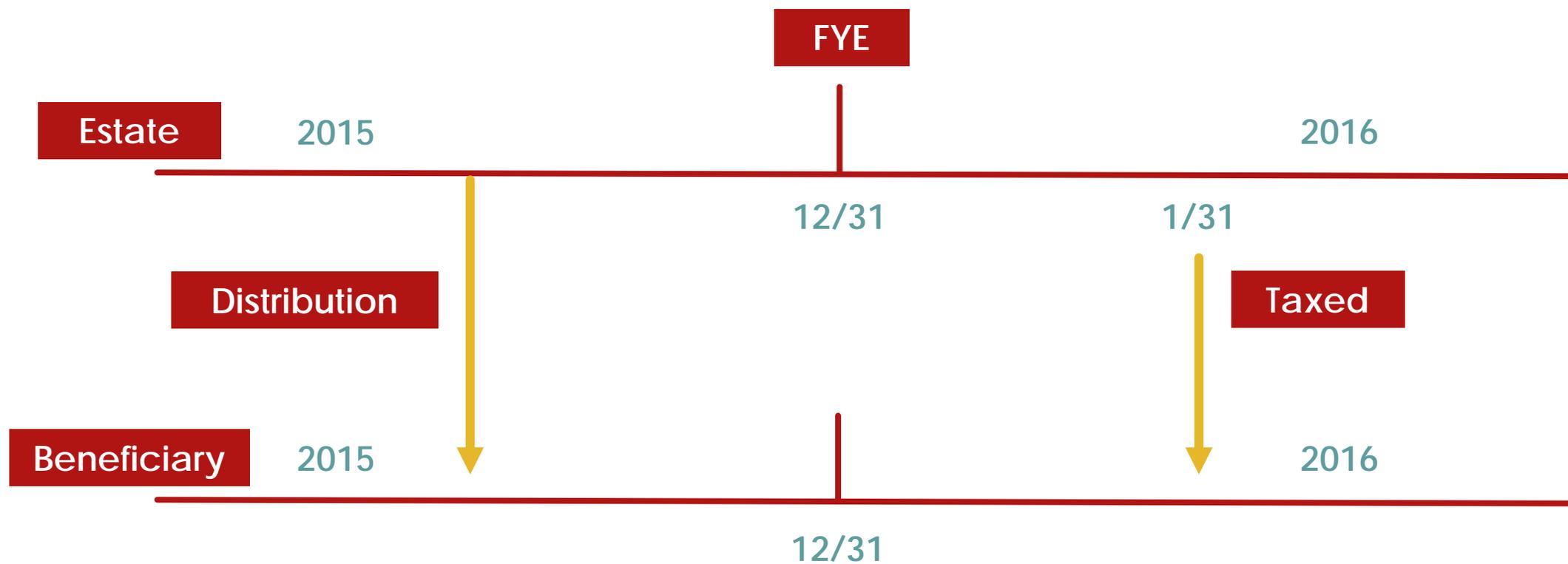
## Request for Prompt Assessment - §6501(d)

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

# Election of Estate's Fiscal Year End

- ▶ Fiduciary may select estate's fiscal year end
- ▶ May be the last day of any month as long as first FYE doesn't exceed one year
  - ▶ Trust **MUST** use calendar year
    - ▶ Trust may get benefit of fiscal year by making a §645 election
- ▶ Election made by filing income tax return with the selected year end
- ▶ May allow deferral of payment of tax
  - ▶ Cut off fiscal year before receipt of substantial income
  - ▶ Distributions from estate are deemed made to beneficiary on last day of estate's taxable year regardless of the actual date of distribution

# Election of Estate's Fiscal Year End – Cont.



## Treating Decedent's Rev. Trusts As Part of Estate - Section 645

- ▶ Allows the trustee to treat a "qualified revocable trust" (basically, a rev. trust owned by the decedent at the time of death) as part of the estate for income tax purposes
- ▶ Both executor and trustees of all revocable trusts making the election must sign on by filing Form 8855 by the due date including extension for filing the estate's first income tax return
- ▶ If no executor or estate, the trustee can sign as the estate
- ▶ Revocable trusts must obtain a new EIN after the decedent's death, even if it had a prior EIN assigned

## Treating Decedent's Rev. Trusts As Part of Estate - Section 645 - Cont.

- ▶ Election effective as of date of death and ends on the earlier of
  - ▶ The date when all assets of the electing trust and estate have been distributed and
    - ▶ If no estate tax return is required – up to the second anniversary of the decedent's death, or
    - ▶ If an estate tax return is filed – the later of 2 years or all taxable years of the estate until 6 months after the final determination of the estate's tax

# Section 645 Election

- ▶ Upon termination, final distribution to a new trust carries out DNI and capital gain of the trust as if the estate was in its termination year
- ▶ Advantages of the Election
  - ▶ Trust can use fiscal year of estate and defer income
  - ▶ Trust can utilize estate's charitable income tax deduction or set-aside
  - ▶ Trust, as part of the estate, can own S Corporation stock
  - ▶ Only one tax return to file
  - ▶ Trust can benefit from estate's \$25,000 rental loss allowance for the first 2 years after death (Section 469(h)(4))
  - ▶ Payment of decedent's medical expenses made by the trust within 1 year after death can be claimed on the decedent's income tax return.

# 65-Day Rule

- ▶ Election to have income distribution made within 65 days after year end to be treated as made on the last day of the preceding tax year of the estate/trust
- ▶ Election can be made for all or a portion of those qualifying distributions
- ▶ Election must be made on a timely filed return, including extensions; and is irrevocable after that date

## 65-Day Rule - Cont.

- ▶ If no return is required to be filed, the election can be filed in the form of a statement with the IRS
- ▶ Can be a valuable tool to assist the executor/trustee to determine whether the income is best taxed to the trust or the beneficiary, including the impact of the NIIT
- ▶ CYA for trustee who forgot to make a distribution before year end.

\* Section 663(b)

# Allocation of Estimated Taxes to Beneficiaries

- ▶ Executor or trustee may elect to treat any portion of an estimated tax made by the estate\*/trust as a payment made by a beneficiary of the estate\*/trust
- ▶ Treated as an estimated payment made by the beneficiary on January 15 of the following year (after the last day of the taxable year of the beneficiary)
- ▶ Election must be made on or before the 65th day after the close of the taxable year of the estate\*/trust

\* Only available to estate in its final year

Section 643(g)

# Treatment of Charitable Contributions Made In Succeeding Tax Year

- ▶ With regard to amounts paid or permanently set aside for a charitable purpose
  - ▶ If a charitable contribution is paid after the close of the tax year, but before the close of the following tax year,
  - ▶ Trust or estate can elect to treat the contribution as paid in the proceeding year
  - ▶ Election must be made by filing a statement (See Reg. Section 1.642(c)-1(b)(3) for details of statement) with tax return for which deduction is being claimed

## Treatment of Charitable Contributions Made In Succeeding Tax Year - Cont.

- ▶ Election can be made up until the due date, including extension, of the succeeding year's tax return
- ▶ Can be made on an amended return if within above time frame after which, the election is irrevocable without IRS consent

Section 642(c)(1); Reg. Section 1.642(c)-1(b)

# Recent Developments Regarding Portability

- ▶ “Vose” case – (2017 OK3 Case No. 115424, decided 1/17/2017)
  - ▶ Executor attempted to “sell” the tax benefit of making the election, but otherwise would not file to elect portability, even though surviving spouse offered to pay the expense of preparation
  - ▶ State of Oklahoma forced executor to elect portability
- ▶ PLR 201722021 – granting Section 9100 relief to make the portability election

## Recent Developments Regarding Portability – Cont.

- ▶ Rev. Proc. 2017-34 (effective 6/9/2017) – simplified method to file for an extension to elect portability
  - ▶ Only applicable if below exclusion amount and filing to elect portability
  - ▶ Must be filed by the later of January 2, 2018 or 2 years after date of death
  - ▶ Extension voided if estate is later found to be required to file Form 706
  - ▶ Existing PLR requests as of 6/9/2017 will be closed and executors must follow the Rev. Proc. Rules
- ▶ Rev. Proc. 2016-49 – making the portability election along with QTIP election will not nullify the QTIP election

# Making the Portability Election

- ▶ Not an affirmative election. A deemed election is made if a timely and complete and properly prepared 706 is filed with DSUE and there is a surviving spouse
- ▶ Election is made by the executor (Form 706, Part 6)
- ▶ Not available to a non-resident surviving spouse who is not a U.S. citizen, except to the extent allowable by treaty with his or her country
- ▶ Assets transferred to a QDOT – calculation is preliminary (Form 706, Part 6, Section B)

# Making the Portability Election - Cont.

- ▶ Election is effective as of date of death
- ▶ Election is irrevocable as of the due date of Form 706
- ▶ Uncertainty of exact amount of DSUE when filing the estate tax return where the election is (deemed) made does not negate the election; only the amount of the DSUE will change
- ▶ SOL is extended with regard to the determination of the DSUE amount until the expiration of the SOL of the surviving spouse's estate

# Generation Skipping Transfer Tax (GSTT)

- ▶ No provision in law to “port” unused GST exemption

# Applicable Exclusion Amount

(Form 706, Line 9a)		Basic Exclusion Amount* (\$5,490,000 in 2017)
(Form 706, Line 9b)	+	DSUE**
(Form 706, Line 9c)		AEA

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\* \$5,000,000 in 2011 and indexed for inflation

\*\* Not indexed for inflation – it is frozen at date of death

# DSUE = Lesser of

- ▶ The basic exclusion amount, or
- ▶ The excess of
  - ▶ The applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
  - ▶ The amount with respect to which the tentative tax is determined under Section 2001(b)(1) on the estate of such deceased spouse

IRC Section 2010 (c)(4)

# Requirements of Return When Making Election

- ▶ Complete and properly prepared in accordance with instructions and regulations
- ▶ Reporting values on Form 706 which is not otherwise required to be filed
  - ▶ Property subject to marital or charitable deduction—only need to report
    - ▶ Description
    - ▶ Ownership
    - ▶ Beneficiary
    - ▶ Information to establish right of estate to the deduction

# Requirements of Return When Making Election - Cont.

- ▶ Rule does not apply to property if
  - ▶ Value needed to determine value passing to another recipient
  - ▶ Value needed to determine eligibility under Section 2032 (alternate valuation), 2032A (farm valuation), or Section 6166 (extension of time to pay tax)
  - ▶ Less than the entire interest in the property is marital or charitable deduction property
  - ▶ A partial disclaimer or partial QTIP election is made with respect to property which is marital or charitable deduction property

# Who is Permitted to Make (or opt-out of) the Election?

- ▶ Duly appointed executor or administrator of the estate
- ▶ If no duly appointed executor – a non-duly appointed executor in actual or constructive possession of any property of the decedent
- ▶ Portability election made by a non-appointed executor cannot be superseded by a contrary election by another non-appointed executor of the same estate
- ▶ What if executor and surviving spouse do not agree?
  - ▶ Consider updating/drafting wills and trusts with specific instructions for electing portability

# Late Elections

- ▶ No relief if estate was otherwise required to file Form 706
- ▶ If filing just to elect Portability
  - ▶ Section 9100 relief may be available
  - ▶ Treasury hesitating to make this relief permanent for fear of executors not making the election until after the surviving spouse's death

# Opting Out of Portability

- ▶ ✓ the box – Form 706, Part 6, Section A
- ▶ Small estates that otherwise do not have to file Form 706, simply do not file anything
- ▶ If a return is otherwise required to be filed, the filing of a late Form 706 is considered opting-out of the portability election (Prop. Reg. Section 20.2010-2(a)(3)(ii))
- ▶ Hazards of not electing portability
  - ▶ Assets grow
  - ▶ Some people actually win the lottery
- ▶ Planning Tip – if executor does not want to file to elect portability – get it in writing!

# Last Deceased Spouse

- ▶ Most recently deceased person who was married to the surviving spouse at the time of that person's death
- ▶ Identity as of day of taxable gift or the date of the surviving spouse's death
- ▶ Re-marriage does not alter the designation of last deceased spouse. Surviving spouse can apply DSUE amount to future lifetime gifts
- ▶ Apply DSUE first; then own BEA
- ▶ Multiple DSUE amounts

# Advantages of DSUE Election

- ▶ Get a second basis step-up at surviving spouse's death
- ▶ Ultimate Federal and state capital gains tax savings
- ▶ Lower administrative expenses
- ▶ Allows for spousal rollover of IRA/retirement plan assets
- ▶ Allows for stretch IRA for non-spousal beneficiaries
- ▶ Control/GPA (limited for retirement plan assets)
- ▶ Income subject to individual tax brackets, not condensed trust brackets
- ▶ Could save/avoid NII tax for same reason

# Advantages of CST

- ▶ Asset protection (generally not available using DSUE)
- ▶ Appreciation exempt from surviving spouse's estate (but no step-up)
- ▶ GST protection

# 2017 Fiduciary Income Tax Rates

Over	Not Over	
0	2,550	15%
2,550	6,000	25%
6,000	9,150	28%
9,150	12,500	33%
12,500		39.6%

# Administration Expenses: Summary #1

- ▶ Deduct on either 706 or 1041
  - ▶ Waiver required if taken on 1041
  - ▶ Administration expenses can be split between 706 and 1041
- ▶ Compare estate tax rate with income tax rate
  - ▶ No 706 due, or 706 due but no tax, deduct on 1041
    - ▶ Exception: if applicable credit amount used, take administration expenses on 706
  - ▶ If estate tax due, deduct on 706

# Administration Expenses: Summary #1 - Cont.

- ▶ Timing
  - ▶ If taken on 706, pay anytime
  - ▶ If taken on 1041, pay in year deduction desired
    - ▶ Caution: in year prior to termination, deductions in excess of income are wasted
    - ▶ If expenses exceed income, pay in year of termination and pay out "excess deductions" to beneficiaries

# Administration Expenses: Summary #2

- ▶ Adjustment between income and principal
  - ▶ If expenses taken on 1041, should income beneficiaries reimburse the remainder beneficiaries for the increase in the estate tax?
- ▶ Optimal marital deduction
  - ▶ Use of administration expenses on 706 reduces size of marital bequest
  - ▶ Use of administration expenses on 1041 decreases size of bypass trust and increases size of marital bequest
- ▶ No bypass trust
  - ▶ If administration expenses taken on 1041, estate tax generated via a circular calculation
  - ▶ If administration expenses taken on 706, not estate tax, no circular computation

# Administration Expenses: Summary #3

- ▶ Subject to 2% floor
  - ▶ Per Knight, only if expenses (e.g. investment advisory fees) uncommon (or unusual or unlikely) for an individual to incur
  - ▶ Can have substantial AMT consequences
- ▶ True double deductions
  - ▶ §691(b) deductions deductible on both 706 and 1041
  - ▶ Distinguish between §691(b) (incurred before death but payable after death) and §642(b) (post-death expenses)

# Alternate Valuation

- ▶ Value as of D/D or 6 months after D/D
  - ▶ Or as of the date property sold, distributed, or disposed of during the 6-month period
- ▶ Must decrease both the value of the gross estate and the amount of estate tax and GSTT
- ▶ Election, which is made by the executor, made by checking box on 706
- ▶ Once made is irrevocable
- ▶ Applies to all property included in gross estate
  - ▶ Can't be made on an asset by asset basis

# Alternate Valuation - Cont.

- ▶ Affects basis property
- ▶ Proposed Regs. (11/17/2011) indicate that alternate valuation election can be made only for post death reduction in value due to market conditions and not due to other post-death events such as a change in ownership structure
- ▶ Election can be made on last estate tax return filed by executor on or before the due date of the return including extensions

# Alternate Valuation - Cont.

- ▶ Late election – Final Regs. issued January 3, 2005
  - ▶ No election if estate tax return is filed more than one year after the 706 due date plus extensions
    - ▶ Thus, A/V election can be made up to 27 months after death; 9 months after D/D plus 6-month maximum extension plus 12 months
  - ▶ If 706 filed within one year after due date plus extensions but no election is made, §9100 relief available even if more than one year has passed at time relief is sought
    - ▶ See, for example, PLR 201118030 where the IRS granted §9100 relief to make a late alternate valuation election more than 1 year after the due date of the return where a timely filed estate tax return omitted making the election due to reasonable reliance on the accountant who prepared the return
- ▶ Permit protective election

# Alternate Valuation - Cont.

- ▶ Unlimited marital deduction – no estate tax, no A/V election available
- ▶ Solution – 2 alternatives:
  - ▶ Spouse could disclaim sufficient amount so a small estate tax is owed
    - ▶ Must disclaim within 9 months
  - ▶ Executor could make partial QTIP election
    - ▶ If 706 is extended, have 15 months (9 months after D/D plus 6-month extension) to decide
    - ▶ Spouse can retain a STPOA with the partial QTIP but not with a disclaimer
- ▶ Caution: watch the effect a disclaimer or partial QTIP election may have on state estate taxes, especially since most state exemptions are lower than the Federal estate tax exemption

# Alternate Valuation - Cont.

- ▶ Allows less to be funded into the marital trust which means less is taxable on surviving spouse's subsequent death
- ▶ Sales and distributions within the 6-month A/V period
  - ▶ Fixes the A/V of that particular asset as of the date of sale or distribution
  - ▶ Funding sub-trusts within the 6-month A/V period will fix A/V
  - ▶ If assets have reached a low during the 6-month A/V period and the executor thinks those assets will appreciate before the end of the 6-month A/V period, sell or distribute those assets during the 6-month period to lock in the low A/V
  - ▶ Sell or distribute assets in the 6-month A/V period to avoid having assets that appreciate during the 6-month A/V period "cannibalizing" the reduction in value of other estate assets

# Alternate Valuation - Cont.

- ▶ A/V election may affect ability to qualify under §303 and/or §6166
  - ▶ §303 allows redemption of closely held stock to be treated as a sale or exchange for amount of state or Federal death (including GST) taxes and funeral and administration expenses
  - ▶ §6166 allows deferral of estate tax attributable to the interest in a closely held business for up to 15 years
- ▶ Both provisions require, among other things, that the value of the included business interest exceed 35% of the value of the adjusted gross estate (gross estate less expenses under §2053 and §2054)
- ▶ A/V election may help or hurt the ability to qualify under §303 and/or §6166

# Special Use Valuation

- ▶ Real estate used in a farm or trade or business can be valued based on its actual use rather than its highest and best use
- ▶ Reduction in FMV can't exceed \$750,000 indexed for inflation – for 2017 the reduction can't exceed \$1,120,000
- ▶ Detailed qualification requirements
  - ▶ Qualifications are complex
  - ▶ Must carefully follow requirements
  - ▶ For summary of requirements, see the instructions for Schedule A, Form 706

## Section 643(e) Election - Residuary Bequest

- ▶ Estate/Trust may *elect*, but is not required, to recognize G/L
- ▶ Distribution carries out, DNI, but amount of DNI depends on whether the Section 643(e) election was made
  - ▶ No election: DNI carried out is *lesser* of basis of FMV of distributed property
  - ▶ Election: DNI carried out is FMV of distributed property
- ▶ Basis of property to beneficiary is basis of property to estate/trust plus or minus any gain or loss the estate/trust elects to recognize on the distribution
- ▶ Holding period tacks if basis is same “in whole or in part” as transferor’s basis, otherwise; holding period starts anew

# Estate Tax Deferral - §6166

- ▶ Allows estate tax deferral for up to 15 years on estate tax attributable to a closely-held business
  - ▶ Interest only for first 5 years
  - ▶ Interest and principal payable in equal installments over next 10 years
- ▶ Requirements:
  - ▶ Must be active trade or business
    - ▶ Sole Proprietorship
    - ▶ Partnership with 45 or fewer partners or decedent with at least 20% capital interest
    - ▶ Corporation with 45 or fewer shareholders or decedent with at least 20% of voting stock

# Estate Tax Deferral - §6166 - Cont.

- ▶ Value of business interest exceeds 35% of adjusted gross estate
  - ▶ If decedent owns two or more businesses, the value of each business in which the decedent owns at least a 20% interest may be aggregated to satisfy the 35% rule
- ▶ Decedent must be a U.S. citizen
- ▶ Interest rate on deferred tax
  - ▶ 2% interest payable on estate tax attributable to the first \$1 million (indexed for inflation - \$1,490,000 for 2017) of the closely held business interest over the estate tax exclusion amount
    - ▶ Amount subject to 2% interest rate for 2017 is \$596,000

# Estate Tax Deferral - §6166 - Cont.

- ▶ Interest rate on balance is 45% of the regular IRS underpayment rate
- ▶ Trade-off for favorable interest rate – no interest deduction
- ▶ Acceleration of deferred estate tax
  - ▶ If payments are not made when due – subject to a 6-month grace period
  - ▶ If there is a sale, disposition or withdrawal of money or other assets at 50% or more of the value of the closely held business
  - ▶ If the estate has undistributed net income
- ▶ Presents the opportunity for a closely-held business to use the cash flow of the business over the deferral period to pay the estate tax
- ▶ Allows estate to, in effect, borrow 40% of the value of the collateral for 14 years

# QTIP Election - Qualifications

- ▶ Surviving spouse is a U.S. citizen
- ▶ Surviving spouse is entitled for life to all income from the property payable at least annually
- ▶ No person, including the surviving spouse, has power exercisable during spouse's life to appoint any part of property to any person other than spouse during spouse's lifetime
- ▶ Executor elects QTIP treatment – automatically made unless executor elects out

# QTIP Election - How and When to Make

- ▶ Made on last estate tax return filed on or before due date of return, including extensions
- ▶ If estate tax return not timely filed, election made on first estate tax return filed after the due date
- ▶ Election on late-filed return is invalid where no election made on previously filed timely return
- ▶ Election made by listing QTIP property on Schedule M and deducting the value
- ▶ Election should be made by formula since QTIP election is irrevocable and value of the estate may change on audit
- ▶ Assets in QTIP receive step-up in basis at the death of both spouses

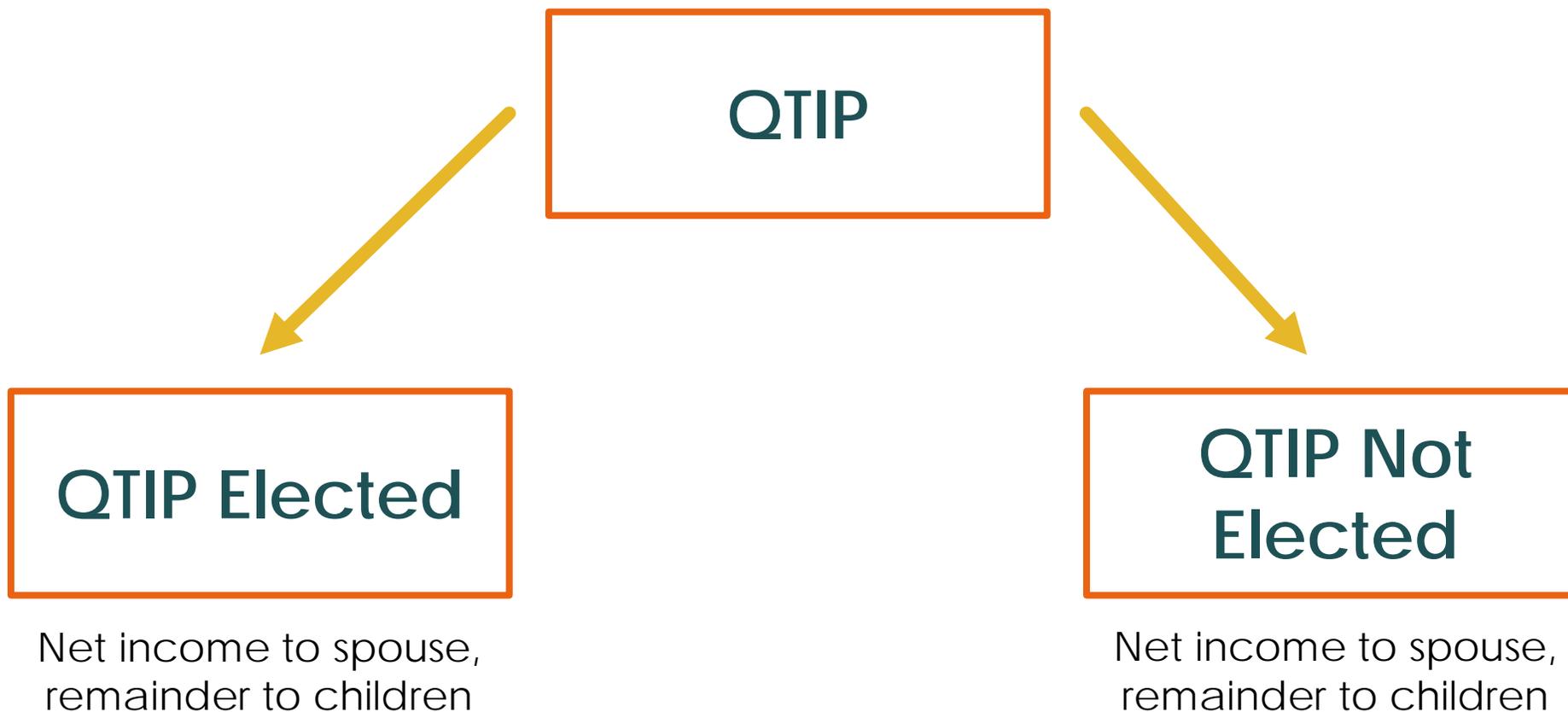
# QTIP Election

- ▶ Partial QTIP election
- ▶ Segregation of elected portion of QTIP
- ▶ Clayton QTIP
- ▶ Qualifying an IRA payable to a trust for the QTIP election

# Partial QTIP Election

- ▶ Must be specific portion, i.e., fractional or percentage share
- ▶ Use formula partial election so the marital deduction is self-adjusting as election is irrevocable and values can change on audit
  - ▶ Numerator is amount needed to reduce the estate taxes to the lowest possible amount and the denominator is the value of the fund against which the fraction is applied
- ▶ If partial QTIP election made and the elected share is not segregated, the amount included in the estate of the surviving spouse is the FMV at the D/D or A/V date of the entire interest times the fractional or percentage share

# Partial QTIP Election



# QTIP – Partial Election

- ▶ Divide QTIP trust for which partial election has been made into separate trusts if authorized by the governing instrument or state law
  - ▶ If QTIP trust is severed, principal distributions to spouse can be made from QTIP portion. If trust not severed, principal distributions may have to be made pro-rate from both QTIP and non-QTIP portion.
    - ▶ Reg. 20.2044-1(d)(3) allows principal distributions to be made from QTIP portion before being made from non-QTIP portion if allowed by the trust document. The severed portion for which the QTIP election is made will be included in the surviving spouse's estate

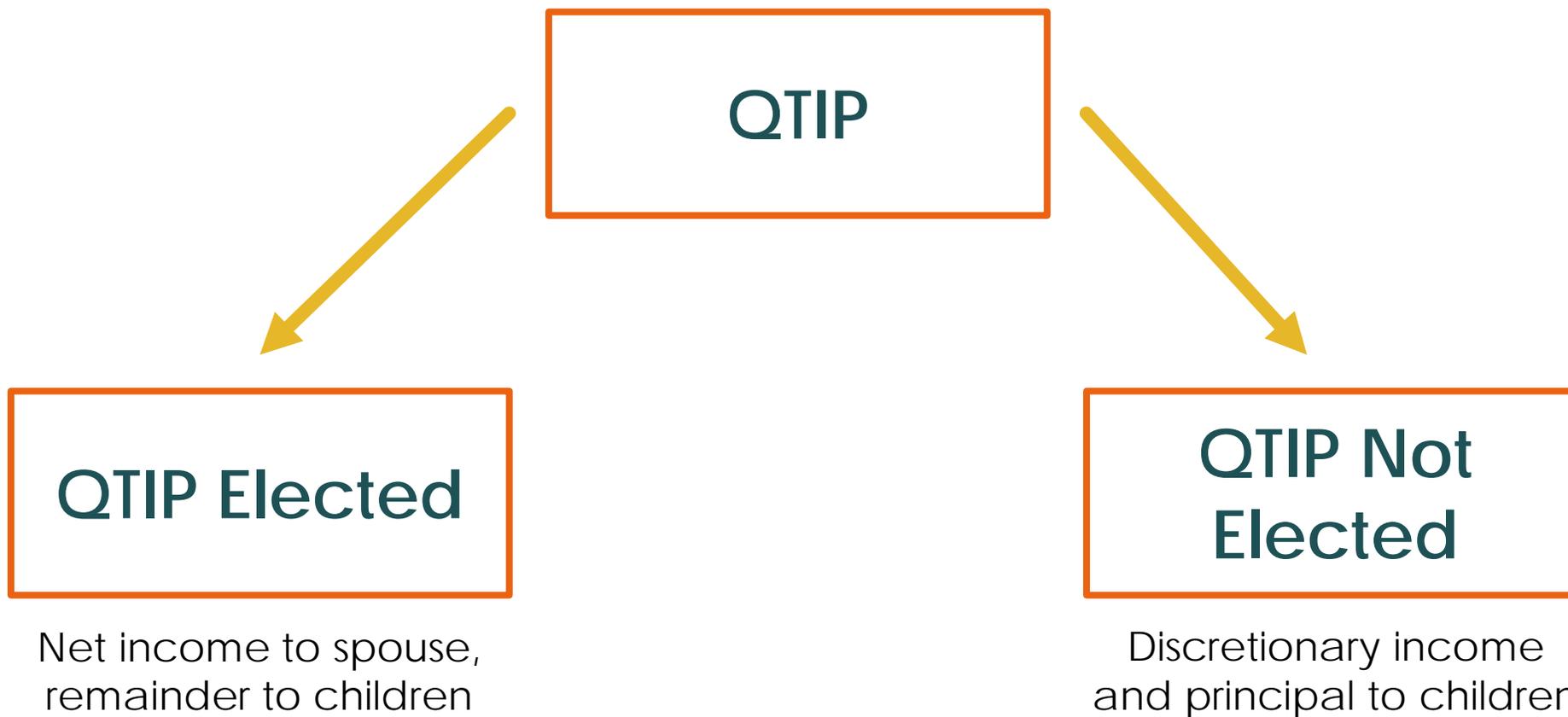
# QTIP – Partial Election – Cont.

- ▶ Severance must be accomplished no later than the end of the period of administration
- ▶ Notice that the portion of the QTIP trust for which the QTIP election is not made remains subject to the provisions of the QTIP trust
  - ▶ Solution: Clayton QTIP which allows portion for which QTIP not elected to benefit non-spouse beneficiaries

# QTIP – Clayton QTIP

- ▶ Portion of trust for which QTIP is not made passes to another trust with potential different provisions, different beneficiaries

# Clayton QTIP



# Qualifying an IRA for the QTIP Election

- ▶ Rev. Rul. 2006-26 – deals with qualification for marital deduction where IRA payable to trust where state law has:
  - ▶ UPIA statute
  - ▶ Unitrust statute
  - ▶ Traditional definition of trust accounting income
- ▶ Note: trust instrument states that spouse can require the trust and IRA to invest in productive assets and spouse has the right to compel the trustee to withdraw the IRA income each year and pay it to the spouse

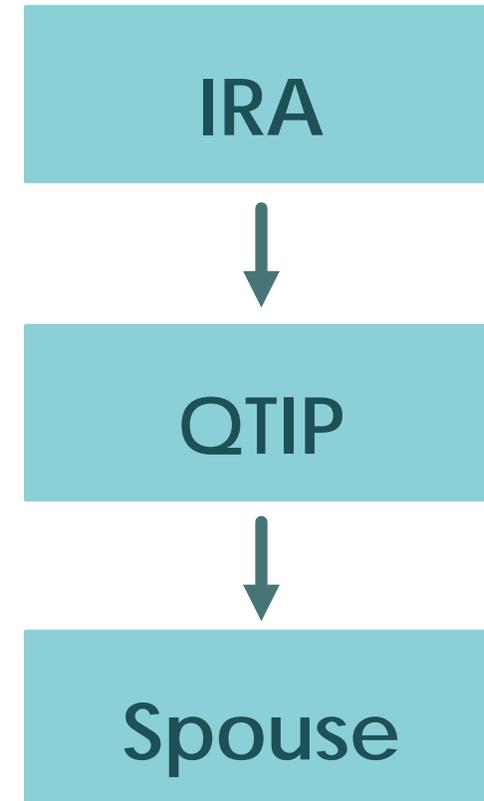
## Qualifying an IRA for the QTIP Election - Cont.

- ▶ Must make QTIP election for both the trust and the IRA
- ▶ Rev. Rul. 2006-26 sets forth how to qualify an IRA payable to a QTIP trust for the marital deduction regardless of whether the state has adopted the UPIA, a unitrust statute, or uses the traditional definition of TAI

# QTIPing And IRA - Rev. Rul. 2006-26

▶ 4 step process

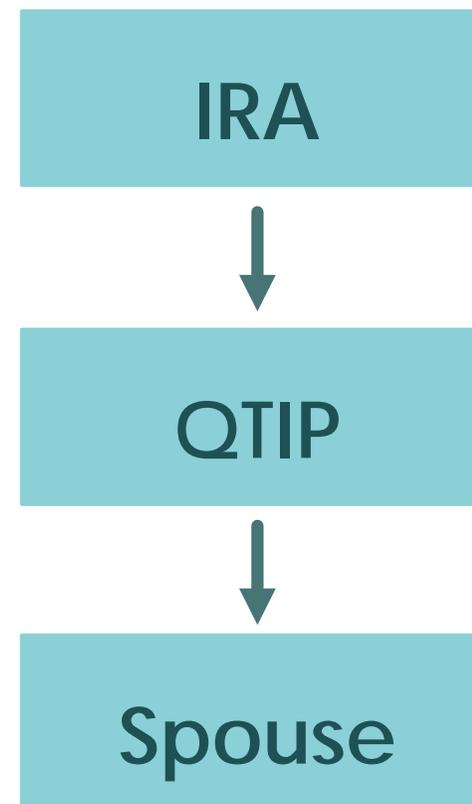
1. Trust instrument states that spouse can require the trust and IRA to invest in productive assets and spouse has the right to compel the trustee to withdraw the IRA income each year and pay it to the spouse
2. Determine total return of trust (exclusive of IRA) and allocate that amount between income and principal. Annually distribute the amount allocated to income to spouse



## QTIPing And IRA - Rev. Rul. 2006-26 - Cont.

▶ 4 step process

3. Determine total return of IRA (exclusive of trust) and allocate that amount between income and principal. If spouse exercises his/her withdrawal power, the trustee must pay the income to the spouse
4. Make QTIP election for BOTH the IRA and QTIP trust



# Rev. Rul. 2006-26 - Alternative Method

- ▶ Marital deduction is allowed if the trust directs trustee annually to withdraw all IRA income and distribute it to the spouse

# Post Mortem Planning with QTIP Election

- ▶ Planning in an uncertain tax environment – what will the exemption amount be in the future?
- ▶ To take full advantage of the applicable exclusion amount e.g. entire estate in trust, income to surviving spouse, remainder to children – make partial QTIP election
- ▶ To maximize use of generation skipping tax exemption, e.g., reverse QTIP election
- ▶ Clayton QTIP – non-elected portion held for benefit of non-spousal beneficiaries

# Post Mortem Planning with QTIP Election – Cont.

- ▶ To equalize the estate tax brackets of both spouses
- ▶ State tax savings – inconsistent QTIP elections at state and Federal level (if permitted by state)
- ▶ QTIP election must be made within 15 months of date of death (filing date of 706 plus a 6-month extension) whereas a disclaimer must be made within 9 months of date of death

# QDOT - Theory

- ▶ Unlimited marital deduction allowed before 1988
- ▶ Congress concerned non-U.S. citizen surviving spouse would relocate outside U.S. taxing jurisdiction
- ▶ After 1988, marital deduction denied for property passing to non-U.S. citizen surviving spouse unless property passes to or is placed in a QDOT
- ▶ To ensure the U.S. can collect estate tax on non-U.S. citizen spouse's assets passed from decedent spouse
- ▶ Effect of QDOT is merely to postpone the decedent spouse's Federal estate tax on property included in the QDOT
- ▶ Governed by Sections 2056(d) and 2056A

# QDOT - Alternative Structures

## Property Passes to:

- ▶ QDOT
- ▶ Non-qualifying trust reformed post-decedent's death into a QDOT
  - ▶ Judicial reformation must be commenced before due date (plus extensions) of estate tax return
- ▶ Surviving spouse not in trust (outright, joint tenancy, etc.)
  - ▶ Surviving spouse actually transfers assets or irrevocably assigns property to QDOT
  - ▶ Surviving spouse can create QDOT after decedent's death and transfer property to QDOT
  - ▶ Surviving spouse's transfer of property to QDOT is treated as a gift of the remainder interest for gift tax purposes unless spouse retains power to make transfer incomplete

# QDOT - Alternative Structures - Cont.

## QDOT Not Needed

- ▶ Surviving spouse becomes a U.S. citizen prior to date decedent's estate tax return is filed
  - ▶ Surviving spouse must be a U.S. citizen resident at all times after the decedent's death and before becoming a U.S. citizen
  - ▶ Surviving spouse must actually become a U.S. citizen before the date on which the decedent's estate tax return is filed
  - ▶ A citizenship application in process is not sufficient
- ▶ Treaty provisions elected

# QDOT Requirements

## Must Qualify for the Marital Deduction

- ▶ Section 2056(b)(5) – Life estate/general power of appointment trust
- ▶ Section 2056(b)(7) – QTIP trust
- ▶ Section 2056(b)(8) – Life estate to spouse/charitable remainder
- ▶ Estate trust
- ▶ Passes outright to spouse

# QDOT - Who Can Create?

- ▶ Citizen spouse
- ▶ Personal representative of deceased citizen spouse
- ▶ Surviving non-citizen spouse

# QDOT - Distributions Exempt From Tax

- ▶ Distributions of “income”
- ▶ Hardship distribution of corpus
  - ▶ No definition of hardship in statute
  - ▶ Relies on Section 401(k) definition of hardship – made to spouse or person spouse is obligated to support in response to an immediate and substantial financial need related to health, education, maintenance, and support. Need to take liquid assets into consideration

## QDOT - Distributions Exempt From Tax - Cont.

- ▶ Reimbursement for federal income tax paid by surviving spouse on QDOT income surviving spouse is not entitled to receive
- ▶ Certain administrative distributions
  - ▶ Income tax
  - ▶ Premiums for bond or letter of credit
- ▶ Distributions for full and adequate consideration

## QDOT - How Tax is Computed (Form 706-QDT)

- ▶ Based on the estate tax return of the decedent who established the QDOT
- ▶ Based on tax rates in effect at time of death of first decedent
- ▶ Result: non-citizen spouse unable to reduce Federal estate tax on assets left to him or her in a QDOT
- ▶ Applicable exclusion amount is not available to the non-citizen spouse for QDOT taxable (lifetime or death) events
  - ▶ Reason: QDOT assets not considered part of non-citizen spouse's tax base

# Consent To Split Pre-Death Gifts

- ▶ Reg. Section 25.2513-2(c) allows the executor or administrator of a deceased spouse to consent to gift-splitting with the surviving spouse with respect to pre-death gifts
- ▶ Note: Surviving spouse may not elect to split gifts with deceased spouse if he/she remarries before the end of the calendar year (Section 2513(a))

# Generation Skipping Tax Planning

- ▶ Reverse QTIP election
  - ▶ Treats decedent as transferor for GST purposes, allowing use of decedent's GST exemption
  - ▶ Partial reverse QTIP election not available
    - ▶ Trust instrument should allow severance of trust – qualified severance allowed at any time
    - ▶ Court petition to sever trust required if trust or state law silent on severance
- ▶ Allocation of GST exemption
  - ▶ May be allocated at any time on or before estate tax return is due, including extensions

# Generation Skipping Tax Planning - Cont.

- ▶ Automatic allocation rules
  - ▶ Allocated first to direct skips made during life unless transferor elects out on a timely filed gift tax return
  - ▶ Allocated next to indirect skips unless transferor elects out on a gift tax return
  - ▶ Allocated next to testamentary direct skips
  - ▶ Allocated next to trusts from which a taxable distribution or taxable termination might be made at or after the death of the decedent
- ▶ Allocation of exemption can be made by formula
- ▶ An allocation of GST exemption greater than the amount needed to have an exclusion ratio of zero is void

# Disclaimers

- ▶ Requirements:
  - ▶ Irrevocable and unqualified refusal to accept property
  - ▶ In writing, identifies property being disclaimed and signed by disclaimant or his legal representative
  - ▶ Delivered to transferor within 9 months of transfer
    - ▶ Exception: if disclaimant under 21, disclaimer must be made within 9 months of attaining age 21
  - ▶ Disclaimant may not accept property or any of its benefits
  - ▶ Disclaimed property passes without direction by disclaimant
    - ▶ Exception: spouse can disclaim property which, as a result of the disclaimer, passes to a trust fbo the spouse so long as the spouse doesn't have a power of appointment over the trust assets

# Disclaimer - Result

- ▶ Assets pass as if the disclaimant predeceased the donor
- ▶ Results in no taxable transfer

# Disclaimer

- ▶ Can do a partial disclaimer
- ▶ Can disclaim specific assets from a trust
  - ▶ If specific trust asset is disclaimed, it must “leave” the trust, i.e., be segregated
- ▶ Can do a formula disclaimer – fraction or percentage
- ▶ Disclaimant who is also a fiduciary
  - ▶ A person who is also a fiduciary can disclaim with the fiduciary retaining the fiduciary power to designate beneficiaries as long as the power is subject to an ascertainable standard
- ▶ Disclaimant cannot retain a power of appointment

# Reason for Disclaimers

- ▶ To avoid overfunding a marital deduction bequest
- ▶ To qualify for the marital or charitable deduction by causing the property to pass to the surviving spouse or qualified charity
- ▶ To full fund a bypass trust
- ▶ To avoid inclusion of assets in a beneficiary's estate

# Death of a Partner - General

- ▶ Partnership year terminates for partner whose interest terminates by death
  - ▶ Partnership tax year as to the deceased partner ends on the date of the partner's death
  - ▶ Deceased partner's share included in his final 1040
  - ▶ Post-death share of partnership income taxed to successor in interest
- ▶ Cash flow issues
  - ▶ Partner makes no withdrawal before death but income to date of death included on 1040
  - ▶ Partner makes withdrawal before death leaving insufficient cash for successor to pay tax

# Death of a Partner - Post-Death Planning

- ▶ Have partnership income for year of death taxed on final 1040
  - ▶ If estate is successor in interest and estate's FYE ends on or before 12/31, executor can distribute entire partnership interest before year-end to spouse and all of that year's partnership income will end up on the decedent's final joint return
  - ▶ If estate is successor in interest and estate's FYE ends on or before 12/31, executor can make distributions of cash or property from estate to the spouse that carry out DNI which will be taxed on the decedent's final joint return

# Death of a Partner - Basis

- ▶ Partner's basis in partnership interest is separate and distinct from partnership's own basis in the underlying assets of the partnership
- ▶ Basis of deceased partner's partnership interest is its FMV as of the D/D or the A/V date
- ▶ Partnership does not receive new basis for partnership assets upon death of a partner
- ▶ Consider the §754 election

# Death of a Partner - Basis - Cont.

- ▶ Ginger and Mary Ann, for a 50/50 partnership
- ▶ Buy an apartment building for \$100,000, each contributing \$50,000
- ▶ Building appreciates to \$1,000,000
- ▶ Ginger dies
- ▶ \$500,000 gets included in Ginger's estate for FET purposes
- ▶ Ginger's basis in her partnership interest is \$500,000
- ▶ The partnership's basis in the building is \$100,000

# Death of a Partner - Basis - Cont.

- ▶ Ginger's successor-in-interest sells her partnership interest for \$500,000
  - ▶ No gain or loss
  - ▶ \$500,000 proceeds less \$500,000 basis stepped-up to FMV as of D/D
- ▶ Partnership sells the apartment building for \$1,000,000
  - ▶ Partnership's gain is \$900,000 (\$1,000,000 proceeds less partnership is \$100,000 basis in the building)
  - ▶ Ginger's successor-in-interest distributive share of the gain on the sale is \$450,000 (\$900,000 gain divided between the two partners)
  - ▶ Note: if Ginger had owned her one-half interest in the property outright rather than in partnership, her estate would have a basis in the apartment building of \$500,000 and would not have had to recognize a gain on the sale

# Death of a Partner - Basis - Cont.

- ▶ Note the problem
  - ▶ Sale of partnership interest – no gain to Ginger’s successor-in-interest
  - ▶ Sale of underlying asset of partnership (apartment building) - \$450,000 gain to Ginger’s successor-in-interest
- ▶ The amount of gain is determined by whether the partnership interest is sold or the partnership’s underlying asset is sold
- ▶ Inequitable result depending on the structure of the transaction

# Death of a Partner - Basis - Cont.

- ▶ §754 election allows partnership to elect to adjust the basis of the underlying assets of the partnership to eliminate the disparity
- ▶ Election may be made on the death of a partner
- ▶ Election is made by the partnership
- ▶ Must be made by due date for partnership return for the year in which the partner dies
- ▶ Requires separate accounting for deceased partner and all other partners

# Death of a Partner - Basis - Cont.

- ▶ Election is made
- ▶ Sale of underlying partnership asset
- ▶ Proceeds \$1,000,000 less \$50,000 surviving partner's basis less \$500,000 deceased partner's basis as a result of the §754 election equals \$450,000 gain
  - ▶ Surviving partner reports entire \$450,000 gain
  - ▶ Deceased partner's successor-in-interest reports no gain
- ▶ Result: same tax treatment regardless of whether partnership interest or partnership's underlying assets sold

# Death of a Partner - Basis - Cont.

- ▶ Alternative option is partnership won't make §754 election
- ▶ §732(d) – any property distributed from the partnership to the estate within 2 years of the partner's death gets a basis equal to the FET value

# S Corporation

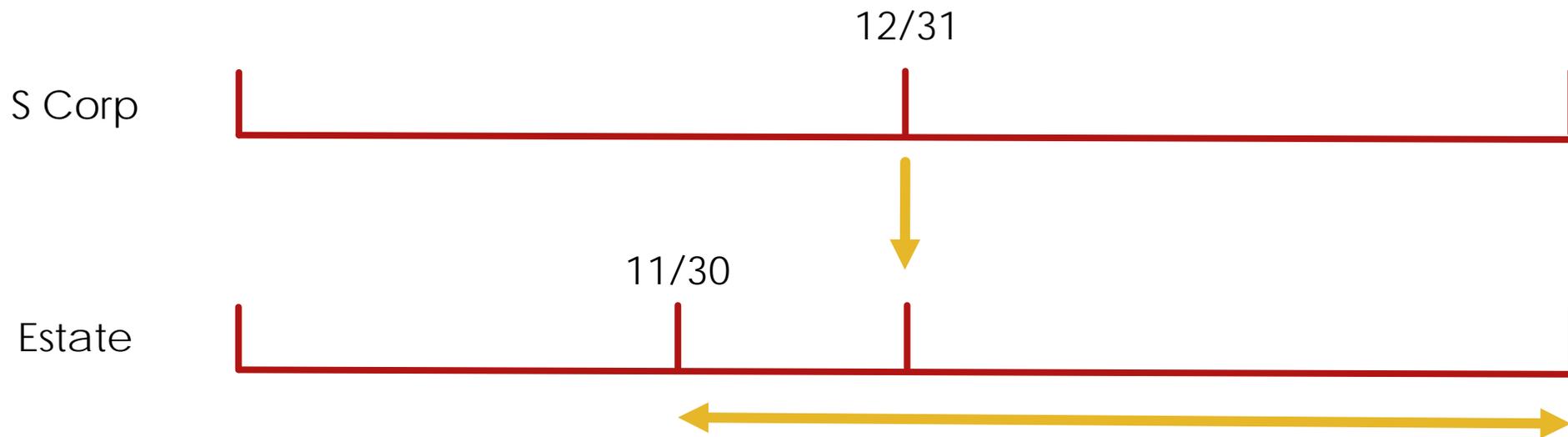
- ▶ An estate may hold S stock indefinitely, subject only to prolonged administration rules
- ▶ Estates may elect S status for corporations that were not operated as a S Corporation by the decedent prior to the decedent's death. Rev. 92-83, 1992-2 C.B. 36.
  - ▶ If if decedent died within 2 ½ months of the beginning of the C Corporation's taxable year, a retroactive S election can be made and have the pre-death income taxed on the decedent's final 1040

# S Corporation - Cont.

- ▶ The estate, not its beneficiaries, is the S Corporation shareholder
  - ▶ Thus, the following disqualified beneficiaries that could not own S Corporation stock could receive the benefit of S Corporation during the administration of the estate:
    - ▶ Non-resident aliens
    - ▶ Complex and sprinkle trusts with multiple beneficiaries (absent a QSST or ESBT election)
    - ▶ Charitable split interest trusts

# S Corporation - Cont.

- ▶ Estate as a S Corporation shareholder allows for a deferral of recognition of S Corporation income
  - ▶ Example: Estate with November 30 FYE doesn't have to recognize December 31 FYE S Corporation income until the following November 30 FYE



# S Corporation - Cont.

- ▶ In addition to estates, only certain trusts are eligible S Corporation shareholders
  - ▶ Grantor trust
  - ▶ Grantor trust after owner's death - 2 years beginning with D/D
  - ▶ Testamentary trust - 2 years after transfer of assets to trust
  - ▶ Voting trust
  - ▶ QSST
  - ▶ ESBT
- ▶ May continue as eligible S Corporation shareholder by electing QSST or ESBT status

# S Corporation - Trusts

- ▶ LE/GTPOA marital trust under §2056(b)(5) is eligible S Corporation shareholder due to grantor trust status
- ▶ QTIP trust under §2056(b)(7) is not an eligible S Corporation shareholder unless a QSST or ESBT election is made
- ▶ QDOT under §2056A cannot qualify as a QSST unless the spouse/beneficiary becomes a U.S. citizen
- ▶ §2503(c) trust qualifies as a QSST as long as the trustee distributes or is required to distribute the income at least annually to the beneficiary
- ▶ CRAT or CUT cannot qualify as a QSST

# S Corporation - Trusts - Cont.

- ▶ Termination of grantor trust at owner's death
  - ▶ If trust distributes outright, determine if distributees are qualified to hold S stock
    - ▶ If distributees are corporation, partnership, ineligible trust or foreign individual or the number of shareholders exceeds 100, S election automatically terminated
  - ▶ If trust continues after owner's death, trust is eligible shareholder for 2 years
    - ▶ Trust would also be eligible shareholder if it qualified as a QSST or ESBT

# S Corporation - QSST

- ▶ Requirements – see §1361(d)(3)
  - ▶ Generally, the benefits of the S Corporation are dedicated to one individual beneficiary and the beneficiary agrees to be treated as the deemed owner of the trust
- ▶ Election by beneficiary needed
  - ▶ Income beneficiary treated as owner of portion of trust consisting of S stock
  - ▶ Separate election for each S Corporation whose stock owned by trust

# S Corporation - ESBT §1361(e)

- ▶ Elections needed by trustee
- ▶ Portion of ESBT that consists of S Corporation stock is separate trust for income tax purposes
  - ▶ ESBT share taxable on S Corporation income at highest trust income tax rate
  - ▶ Normal Subchapter J rules do not apply to S Corporation portion
  - ▶ ESBT allows trust to have 2 or more beneficiaries, accumulate income, make discretionary distributions of both income and principal among the beneficiaries
    - ▶ Cost for distribution flexibility is higher income tax on S Corporation's income

# S Corporation - Taxation

- ▶ Beneficiary's income determined on a pro-rata basis (per share, per day)
- ▶ Decedent's 1040 reports income from beginning of year to D/D
  - ▶ No IRD
- ▶ Successor-in-interest reports income from day after D/D to end of year
- ▶ Special allocation rule under §1377(a)(2) for "termination of interest"
- ▶ Share of income computed as if taxable year consisted of 2 taxable years, the first of which ends on the D/D
  - ▶ Special allocation valuable if income, deductions did not accrue ratably during the year

# Conclusion

- ▶ Estate planning doesn't end when the client walks out the door
- ▶ There are a number of valuable post-mortem elections available
- ▶ Fiduciaries must be aware of the possible elections
- ▶ Realize that the most important estate planning is probably that which occurs AFTER DEATH

Questions?

Thank you!