Chapter 6: Beneficiary and Estate Issues

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Please note. Corrections were made to this workbook through January of 2018. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

Chapter Summary

For 2017, the federal estate tax exclusion is at $5.49 million and only 18 states impose an estate tax or inheritance tax at death. Consequently, the focus has switched to tax planning for larger estates by, for example, "porting" the deceased spouse's unused estate tax exemption to the surviving spouse's estate.

Most assets receive a step-up in basis to fair market value (FMV) at date of death, which can result in significant income tax savings on the subsequent disposition of appreciated property. In community property states, the surviving spouse may get this step-up in basis for all marital property upon the death of their spouse if at least half of the community property was included in the decedent's gross estate for federal estate tax purposes. Additional planning is required to obtain similar treatment for common law property.

A decedent's estate is liable for the decedent's tax deficiency at the time of death. Distributees are liable for the decedent's tax liabilities to the extent of the assets they received.

An estate executor may elect to value estate assets using the FMV on the alternate valuation date (six months after the date of death). However, this election is only available if it lowers the overall estate value, lowers the estate tax, and is used for all assets in the estate.

Estates required to file a federal estate tax return after July 31, 2015, must provide basis information to the IRS and estate beneficiaries. This ensures consistent use of basis for estate assets by all parties. An accuracy-related penalty is imposed on taxpayers who report a basis higher than the amount that the estate reported to the IRS on Form 8971.

Wealthier taxpayers should consider moving to a state with either zero or low state income taxes and low property taxes. Business succession and retirement planning are also important. Bypass trust schemes are more suitable for states like Illinois that have a significant estate tax and a non-portable exemption.

Generally, estates or trusts compute taxable income the same way as individuals, with certain modifications. There are also some unique applications of the passive loss limitations to estates and trusts.

Income from a terminated estate or trust is taxable to the beneficiaries even if it has not been distributed to them. Excess deductions from the estate or trust's last tax year flow to the beneficiaries, who can claim them as itemized deductions.

Valuation discounts are important succession planning tools. Discounts from FMV of 30-45% are common in closely held entities.

The life estate/remainder arrangement is a common estate and succession planning technique. It avoids probate because property automatically passes to the remainder-interest holder.

About the Author

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OVERVIEW

The year 2013 marked the beginning of major changes in estate planning and its impact on estates and beneficiaries. Significant changes were made to the transfer tax system before 2013, particularly within the provisions of the Economic Growth and Tax Relief Recovery Act of 2001 (EGTRRA). The EGTRRA changes expired after 10 years. Extensions of EGTRRA provisions were temporary until the enactment of the American Taxpayer Relief Act of 2012 (ATRA). ATRA increased taxes on the wealthiest taxpayers and increased the tax rates on capital gains, dividends, and transfer taxes. ATRA's changes are permanent.

> **Note.** For detailed information about ATRA, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Under ATRA, the transfer tax system was characterized by four key components beginning in 2013.

- Permanency
- Indexing
- Unification of the estate and gift tax systems
- Portability of the unused portion of the applicable exclusion at the death of the first spouse

Effective for tax years beginning after 2012, the Patient Protection and Affordable Care Act imposed an additional 3.8% tax on passive sources of income under IRC §1411. This has important implications for the structuring of business entities and succession planning, particularly for taxpayers with passive sources of income.

PRE-2013 PLANNING

Before the changes to the transfer tax system beginning in 2013, much of estate planning for moderate and high-wealth clients involved the use of lifetime asset transfers. Often, these asset transfers were accomplished through trusts that typically involved the use of life insurance. However, such a strategy came at a cost. A recipient of lifetime transfers does not receive a "stepped-up" basis under IRC §1014. That was often only a minor concern for the transferor because the strategy was to avoid estate tax for the transferor. The strategy made sense, particularly when the estate tax exemption was significantly lower than the 2017 amount of $5.49 million[1] and estate tax rates were significantly higher than income tax rates. For example, before 2002, the top estate and gift tax rate was 55% and did not drop to 45% until 2007. Currently, the top income tax rate is 39.6%, with the potential for an additional 3.8% on passive sources of income (for a combined 43.4%), and the top estate tax rate is 40%.

1. Rev. Proc. 2016-55, 2016-45 IRB 707.

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The standard pre-2013 estate plan for many higher-wealth clients had the following common pattern.

- A lifetime taxable gift uses the estate tax exemption equivalent, thereby removing all future appreciation attributable to that property from the decedent's future estate tax base. In many instances, the gifted property was used to fund an intentionally defective grantor trust (IDGT).

  An IDGT is drafted to invoke the grantor trust rules with a deliberate flaw ensuring that the individual continues to pay income taxes (i.e., the grantor is treated as the owner of the trust for income tax purposes but not the owner of the assets for estate tax purposes). Thus, the grantor's estate is decreased by the amount of the assets transferred to the trust. An IDGT is part of an estate "freeze" technique. In a typical sale to an IDGT, the grantor sells appreciating assets at their fair market value (FMV) to the trust in exchange for a note at a very low interest rate. The installment note is treated as full and adequate consideration if the minimum interest rate charged on the installment note is at least the applicable federal rate (AFR) and all the formalities of a loan are followed. The goal is to remove future asset appreciation, above the mandated interest rate, from the grantor's estate.

Note. For more information about IDGTs, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Wealth Accumulation and Preservation.

- Using trusts (such as a "dynasty trust") and other estate planning techniques avoids including assets in the gross estate for as long as possible. This is accomplished by leveraging the generation-skipping transfer tax (GSTT) and establishing a GSTT trust in a jurisdiction that has abolished the rule against perpetuities. If the trust was established in a state without an income tax, the trust income also avoids income taxation.

Observation. The typical pre-2013 estate plan deemphasized the income tax consequences of the plan. The emphasis focused on avoiding federal estate tax. Additionally, post-2010, the temporary nature of the transfer tax system and the lateness of legislation dealing with expiring transfer tax provisions persuaded many clients to make significant gifts late in the year based on the fear that the estate tax exemption would drop significantly. Moreover, the decedent's and the beneficiaries' states of residence at the time of the decedent's death were typically of little concern because there was a large gap in the tax rates applicable to gifts and estates and those applicable to income at the state level.

ESTATE TAX DATA[2]

According to IRS data, the number of Forms 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* filed declined nearly 76% from 49,050 in 2006 to 11,917 in 2015. That reduction was the result of the gradual increase in the filing threshold from $2 million in 2006 to $5.43 million in 2015. In 2015, the total net estate tax reported on all estate tax returns filed for the year was $17.1 billion. California had the highest number of estate tax returns filed in 2015, followed by Florida, New York, Texas, and Illinois. Stock and real estate made up more than half of asset holdings for 2015 estate tax returns. Taxable estates for decedents with total assets of $20 million or more held a greater share of their portfolio in stocks (over 38%) and lesser shares in real estate and retirement assets than did decedents in other asset categories.

Note. The IRS statistics reveal that the estate tax is of particular concern to farm and ranch estates and other small businesses. It also reveals that the primary asset likely to be included in a generation-skipping ("dynasty") trust is stock rather than agricultural land.

2. *Estate Tax Returns Filed for Wealthy Decedents, 2006–2015.* IRS. [www.irs.gov/pub/irs-soi/2015estatetaxonesheet.pdf] Accessed on May 15, 2017.

THE CHANGED LANDSCAPE — POST-2012

The changes in estate planning beginning in 2013 are characterized by the following.

- Continuing trend of states repealing taxes imposed at death

> **Note.** As of the beginning of 2017, 18 states (and the District of Columbia) have some variation of an estate tax or inheritance tax imposed at death. Those states are as follows: Connecticut, Delaware, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington.[3]

- Increase in the amount of the applicable exclusion and indexing of the amount (With moderate inflation, the exclusion is anticipated to be approximately $6.5 million by 2023 and $9 million by 2033.)
- Reunification of the estate and gift tax
- Permanency of portability of the deceased spouse's unused exclusion
- Permanency of transfer taxes

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Other changes that began in 2013 that influence estate planning include the following.

- An increase in the top federal ordinary income tax rate to 39.6%
- An increase in the highest federal long-term capital gain tax rate to 20%
- An increase in the highest federal qualified dividend income tax rate to 20%
- The 3.8% net investment income tax (NIIT) under §1411

> **Note.** For agricultural estates, land values more than doubled from 2002 to 2012, and continued to increase post-2010. From 2009–2013, the overall increase in agricultural land values was 31% ($2,090 in 2009 and $2,730 in 2013).[4] In the "corn belt," from 2006–2013, the average farm real estate value increased by 229.6%.[5] During that same period, the applicable exclusion increased 262.5%. For the year ending June 1, 2016, corn-belt farm real estate values declined 0.9%.[6] That decline is in response to lower farm earnings due to declines in crop and livestock revenue. It is anticipated that corn-belt farm real estate values will trend slightly downward in 2017. This all means that even with the increase in the applicable exemption to $5.49 million (for 2017) and subsequent adjustments for inflation, many agricultural estates still face potential estate tax issues.

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3. *State Death Tax Chart.* Jul. 7, 2017. American College of Trust and Estate Counsel. [www.actec.org/resources/state-death-tax-chart/] Accessed on Jul. 17, 2017.

4. *Land Values 2016 Summary.* USDA. Aug. 2016. [usda.mannlib.cornell.edu/usda/current/AgriLandVa/AgriLandVa-08-05-2016.pdf] Accessed on Jul. 17, 2017.

5. Ibid.

6. *Farmland Value.* Apr. 10, 2017. USDA. [www.ers.usda.gov/topics/farm-economy/land-use-land-value-tenure/farmland-value/] Accessed on May 16, 2017.

STATE-LEVEL IMPACTS AND INCOME TAX RAMIFICATIONS

At the state level, the landscape has dramatically changed. At the time EGTRRA was enacted in 2001, almost every state imposed taxes at death that were tied to the federal state estate tax credit. Since that time, however, the federal state estate tax credit has been replaced with a federal estate tax deduction under IRC §2058. Currently, only 18 states (and the District of Columbia) impose some type of tax at death (a state estate tax or a state inheritance tax). In those jurisdictions, the size of the estate exempt from tax (in states with an estate tax) and the states with an inheritance tax have various statutory procedures that set forth the amount and type of bequests that are exempt from tax.[7]

The following table sets forth the various state estate tax exemptions and tax rates as of July 7, 2017.[8]

States Imposing an Estate Tax			States Imposing an Inheritance Tax		
State	**Exemption Amount**	**Maximum Tax Rate**	**State**	**Exemption Amount**	**Maximum Tax Rate**
CT	$2,000,000	12%	IA	Varies	15%
DE	5,490,000	16%	KY	Varies	16%
DC	2,000,000	16%	MD	$0	16%
HI	5,490,000	16%	NE	Varies	18%
IL	4,000,000	16%	NJ	0	16%
ME	5,490,000	12%	PA	0	15%
MD	3,000,000	16%			
MA	1,000,000	16%			
MN	2,100,000	16%			
NJ	2,000,000	16%			
NY	5,250,000	16%			
OR	1,000,000	16%			
RI	1,515,156	16%			
VT	2,750,000	16%			
WA	2,129,000	20%			

Maryland and New York gradually will increase the exemption until it becomes equal to the federal estate tax exemption effective January 1, 2019. However, in New York, the exemption is phased out for estates with values exceeding 105% of the applicable exemption amount. The Minnesota exemption gradually increases until 2020, at which time it will be set at $3 million.[9]

> **Note.** Connecticut is the only state that imposes a gift tax. The gift tax lifetime exclusion is $2 million (as of 2017).[10]

Seven states have no state income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). Tennessee and New Hampshire only tax dividend and interest income. Other states such as California, Hawaii, Minnesota, New Jersey, New York, and Oregon have a relatively high state income tax burden compared to other states with an income tax.[11]

7. *State Death Tax Chart.* Jul. 7, 2017. American College of Trust and Estate Counsel. [www.actec.org/resources/state-death-tax-chart/] Accessed on Jul. 17, 2017; *Where Not to Die in 2017.* Eberling, Ashlea. Oct. 25, 2016. Forbes. [www.forbes.com/sites/ashleaebeling/2016/10/25/where-not-to-die-in-2017/#5635e571e374] Accessed on Aug. 1, 2017.

8. Ibid.

9. Ibid. Qualified farms are exempt up to $5 million.

10. *Estate, Inheritance, and Gift Taxes in Connecticut and Other States.* Connecticut General Assembly, Office of Legislative Research. [www.cga.ct.gov/2016/rpt/pdf/2016-R-0224.pdf] Accessed on Jul. 19, 2017.

11. *State Individual Income Tax Rates and Brackets for 2017.* Scarboro, Morgan. Mar. 9, 2017. Tax Foundation. [taxfoundation.org/state-individual-income-tax-rates-brackets-2017/] Accessed on Jul. 17, 2017.

Generally, post-2012 estate planning is characterized by lower transfer tax costs, higher income tax rates, and greater disparity among the states between transfer taxes and income taxes.

Note. Post-2012, **income tax issues** play a greater role in estate planning. Planners should consider whether it is possible for a client to minimize the overall tax burden for a particular client or family by moving to a state with a reduced or eliminated income tax and no transfer taxes. In general, planners with clients domiciled in relatively higher income tax states should place an emphasis on ensuring a basis step-up at death. For clients with family businesses, pre-death transition/succession planning is important.

ESTATE PLANNING POST-2012

The key issues for estate planning beginning in 2013 and later years appear to be the following.

- The client's life expectancy
- The client's lifestyle
- The potential need for long-term health care and whether a plan is in place to deal with that possibility
- The size of the potential gross estate
- The type of assets the decedent owns and their potential for appreciation in value
- For farm estates, preserving the eligibility for the estate executor to make a special-use valuation election
- For relatively illiquid estates (commonplace among agricultural estates and other estates for small business owners), preserving qualification for various liquidity planning techniques such as installment payment of federal estate tax and properly making the installment payment election on the estate tax return

Caution. IRC §6166(d) specifies that the installment payment election is made on a timely filed (including extensions) return in accordance with the regulations. The regulations[12] are detailed, and require that the appropriate box on Form 706 be checked and a notice of election be attached to the return.

The notice of election must contain certain information. In *Estate of Woodbury v. Comm'r,*[13] the estate filed for an extension of time to file and included a letter that expressed the estate's intent to make an installment payment election. It estimated that approximately $10 million in tax would be paid in installments. The estate made a subsequent request for an additional extension along with another letter containing some of the required information for a §6166 election. The IRS denied the second extension and informed the estate that it must file by the previously extended due date. The estate ultimately filed its estate tax return 2½ years late and attached a proper notice of election to pay the tax in installments. The IRS rejected the election for lack of timely filing, but the estate claimed that it substantially complied. The court determined that the estate's letters did not contain all of the information required by the regulations to make the election, particularly valuation information to allow the IRS to determine if the percentage qualification tests were satisfied. Thus, the estate did not substantially comply with the regulations and the election was disallowed.

- Whether a basis increase at death will be beneficial/essential
- Where the decedent resides at death
- Where the beneficiaries reside at the time of the decedent's death

12. Treas. Regs. §§20.6166-1 and 20.6166A-1; see instructions for Form 706.
13. *Estate of Woodbury v. Comm'r,* TC Memo 2014-66 (Apr. 14, 2014).

- If the decedent has a business, whether succession planning is needed
- Entity structuring and whether multiple entities are necessary
- For agricultural clients, the impact of farm program eligibility rules on the business structure
- Asset protection strategies, including the use of a spousal lifetime access trust (SLAT)
- General economic conditions and predictions concerning the future (For agricultural clients, land values, commodity prices, and marketing strategies are important factors to monitor.)

The uncertain future of the federal estate tax (and whether basis step-up will be retained) means that existing estate planning documents should be reviewed to make sure they are in accordance with the present exemption amount and the availability of portability (discussed later in this chapter). Existing estate plans should also be reviewed if the federal estate tax system is eliminated or modified and if the basis step-up rule is either modified or eliminated.

For instance, formula clauses in existing documents should be examined. The classic bequest to a credit shelter trust of the maximum amount possible without incurring estate tax may result in the entire estate passing to the credit shelter trust if the estate tax is repealed. This may not conform to the original intent of the estate plan. In addition, formula general power of appointment (GPOA) clauses might be impacted if the federal estate tax is repealed. For example, if the GPOA ties its existence to not causing the estate to incur **any** estate tax to be paid by the holder of the power, federal estate tax repeal would trigger the operation of the power. In other words, repeal would trigger the application of the GPOA and cause inclusion of the property subject to the GPOA in the decedent's estate. If the step-up basis rule is repealed along with the estate tax, the results would be even more adverse.

Impact of Coupling

Because of the "coupled" nature of the estate and gift tax systems and the portability of the unused exclusion at the death of the first spouse, it is often desirable to use as little as possible of the applicable exclusion during an individual's life to cover taxable gifts. For many taxpayers, the applicable exclusion shelters the entire value of their gross estate, and the inclusion of assets in the estate at death allows for an increased basis for the heirs. Thus, for most taxpayers, there is little or no transfer tax cost. This fact causes many taxpayers to place an emphasis on preserving the income tax basis step-up at death. If there are asset transfers pre-death, such transfers generally occur in the context of business succession/transition planning. However, for many taxpayers, gifting assets during life takes on diminished importance.

Portability

An election can be made under which the amount of the estate tax applicable exclusion that is not used in the estate of the first spouse to die is available to be used in the estate of the surviving spouse. This process is referred to as "portability." The amount available to be "ported" to the estate of the surviving spouse is the deceased spouse's unused exclusion (DSUE).[14]

The DSUE amount is available to the surviving spouse as of the date of the deceased spouse's death. It is applied to gifts and the estate of the surviving spouse before their own exemption is used. Accordingly, the surviving spouse may use the DSUE amount to shelter lifetime gifts from gift tax or to reduce the estate tax liability of the surviving spouse's estate at death.[15]

Portability of the DSUE has become a key aspect of post-2012 estate planning. The Treasury Department issued proposed and temporary regulations addressing the DSUE under IRC §§2010(c)(2)(B) and 2010(c)(4) on June 15, 2012. The proposed regulations applied until June 15, 2015, and were then replaced with final Treas. Reg. §20.2010-2.

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14. IRC §2010(c)(4); Treas. Reg. §20.2010-2.

15. Treas. Reg. §20.2010-3(b)(ii).

The portability election must be made on a timely filed Form 706 for the first spouse to die.[16] This also applies for nontaxable estates and the return is due by the same deadline (including extensions) as for taxable estates. The deadline for filing is nine months after the decedent's date of death. The election is revocable until the deadline for filing the return expires.

While an affirmative election is required by statute, part 6 of Form 706 (which is entirely dedicated to the portability election, the DSUE calculation, and roll forward of the DSUE amount) provides that "a decedent with a surviving spouse elects portability of the DSUE amount, if any, by completing and timely-filing the Form 706. No further action is required to elect portability…"[17] This election, therefore, is made by default if there is a DSUE amount and an estate tax return is filed. This is the case as long as the box in section A of part 6 is **not checked.** Checking the box affirmatively **elects out** of portability.

In Rev. Proc. 2014-18,[18] the IRS provided a simplified method for certain estates to obtain an extended time to make the portability election. The 2014 relief expired, and then it was extended by Rev. Proc. 2017-34.[19] The portability election must be submitted with a complete and properly filed Form 706 by the later of January 2, 2018, or the second anniversary of the decedent's death. After January 2, 2018, the extension is two years. The extension is only available to estates that are not otherwise required to file an estate tax return. Other estates can only obtain an extension under Treas. Reg. §301.9100-3. Form 706 must state at the top that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

Caution. An estate that files late, but within the extended deadlines of Rev. Proc. 2017-34, **cannot rely** on the revenue procedure if it later learns that it **should have filed a Form 706.** If a valid late election is made and results in a refund of estate or gift taxes for the surviving spouse, the time period for filing for a refund is not extended from the normal statutory periods. In addition, a claim for a tax refund or credit is treated as a protective claim for a tax credit or refund if it is filed within the time period of §6511(a) by the surviving spouse or the surviving spouse's estate in anticipation of Form 706 being filed to elect portability under Rev. Proc. 2017-34.

The regulations allow the surviving spouse to use the DSUE before the deceased spouse's return is filed (and before the amount of the DSUE is established).[20] However, the DSUE amount is subject to audit until the statute of limitations expires on the surviving spouse's estate tax return.[21] The regulations do not address whether a presumption of survivorship can be established. Thus, there is no guidance on what happens if both spouses die at the same time and the order of death cannot be determined. In that situation, the question remains as to whether the IRS would respect estate planning documents that include a provision for simultaneous deaths. If the IRS does not respect the will or trust language, guidance would be needed to determine which estate is allowed a DSUE amount.

Example 1. Earl and Alice, a married couple, died in a plane crash. Their estate planning documents provide that Alice is presumed to have survived Earl. If the IRS respects the documents, Alice's estate could add the DSUE amount from Earl's estate to her exclusion amount. Also, if their estate plans established a qualified terminable interest property (QTIP) trust in favor of Alice's children (Alice has children from a prior marriage), the ported-over DSUE from Earl would likewise be sheltered.

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16. IRC §2010(c)(5)(A); Treas. Reg. §20.2010-2(a)(1).
17. See Form 706.
18. Rev. Proc. 2014-18, 2014-7 IRB 513.
19. Rev. Proc. 2017-34, 2017-26 IRB 1282.
20. Treas. Reg. §20.2010-3(ii).
21. Temp. Treas. Regs. §§20.2010-3T(c)(1) and 25.2505-2T(d)(1).

Form 706 Requirements. Treas. Reg. §20.2010-2 requires that the DSUE election be made by filing a complete and properly prepared Form 706. Treas. Reg. §20.2010-2(a)(7)(ii)(A) permits the "appointed" executor who is not otherwise required to file an estate tax return to use the executor's "best estimate" of the value of certain property and then report on Form 706 the gross amount in aggregate, rounded up to the nearest $250,000.[22]

Treas. Reg. §20.2010-2(a)(7)(ii) sets forth **simplified reporting** for particular assets on Form 706, which allows for good faith estimates. The simplified reporting rules apply to estates that do not otherwise have a filing requirement under IRC §6018(a). Consequently, if the **gross estate exceeds the basic exclusion amount ($5.49 million in 2017), simplified reporting cannot be used.**

Simplified reporting is only available for marital and charitable deduction property (under IRC §§2056, 2056A, and 2055). It is **not available** for such property if **any** of the following conditions apply.[23]

- The value of the involved property relates to, affects, or is needed in order to determine the value passing from the decedent to another recipient.
- The value of the property is needed to determine the estate's eligibility for alternate valuation, special-use valuation, estate tax deferral, or other Code provisions.
- Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property.
- A partial QTIP election or a partial disclaimer is made with respect to the property that results in less than all of the involved property qualifying for the marital or charitable deduction (i.e, property passing outright to the surviving spouse or a charity).

Assets reported under the simplified method are listed on the applicable Form 706 schedule without any value entered in the column for "Value at date of death."[24] The sum of the asset values included in the return under the simplified method are rounded up to the next $250,000 increment and reported on lines 10 and 23 of part 5 of Form 706 (as assets subject to the special rule of Treas. Reg. §20.2010-2(a)(7)(ii)).

In addition to listing the assets on the appropriate schedules, the regulations require that the following must be provided for each asset.[25]

1. Property description
2. Evidence of ownership of the property (i.e., a copy of a deed or account statement)
3. Evidence of the beneficiary of the property (i.e., copy of beneficiary statement)
4. Information necessary to establish that the property qualifies for the marital or charitable deduction (i.e., copy of the trust or will)

> **Caution.** These documentation requirements are not included in the Form 706 instructions, but the **regulations require the reporting of these items.** Example 1 under Treas. Reg. §20.2010-2(a)(7)(ii)(C) provides that a return is **properly** filed if it includes such documentation and proof of ownership. The question arises as to whether this means, at least by implication, that a return is not properly filed if it does not contain such documentation.

22. See Instructions for Form 706.
23. Treas. Reg. §20.2010-2(a)(7)(ii)(A).
24. See Instructions for Form 706.
25. Treas. Reg. §20.2010-2(a)(7)(ii)(A).

The statute of limitations for assessing additional tax on the estate tax return is the later of three years from the date of filing or two years from the date the tax was paid. The IRS can examine the DSUE amount at any time during the period of the limitations as it applies to the estate of the deceased spouse. Treas. Reg. §20.2010-2(d) allows the IRS to examine the estate and gift tax returns of each of the decedent's predeceased spouses. Any materials relevant to the calculation of the DSUE amount, including the estate tax (and gift tax) returns of each deceased spouse, can be examined. Consequently, a surviving spouse needs to retain appraisals, work papers, documentation supporting the good-faith estimate, and all intervening estate and gift tax returns to substantiate the DSUE amount.

Note. Because the election to utilize portability allows the IRS an extended timeframe to question valuations, the use of a bypass/credit shelter trust that accomplishes the same result for many clients may be a preferred approach.

Example 2. Herman and Miriam were married for 12 years when Herman died in February 2014. Their marriage was the second one for each of them. Herman and his first wife did not have any children, while Miriam has three children with her first husband. Miriam's first husband was an executive with a large U.S. corporation and died with a significant investment portfolio, including shares of his employer. His estate was very well planned and his assets were allocated between Miriam and a standard bypass trust. Miriam's assets (excluding assets in the bypass trust) are now valued at approximately $7 million. Herman died with $630,000 in assets. Due to the recent rise in the stock market, Miriam realizes that her estate will likely be liable for federal estate tax. Her tax advisor suggested that Herman's estate should have elected portability. Miriam, as executor of Herman's estate, may make a late election under the provisions of Rev. Proc. 2017-34.

Herman's will bequeathed his property to nieces and nephews due to Miriam's strong financial position. At death, the value of his assets are as follows.

Cash	$200,000
Stocks and bonds	190,000
Condo at Lake of the Ozarks	240,000
Gross estate	$630,000

Herman made no taxable gifts during his lifetime. The calculation of the DSUE is shown on part 6 of the following Form 706.

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For Example 2

FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER SECTION 2010(c)(5)(A)

Form **706** (Rev. August 2013)
Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

▶ Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2012.
▶ Information about Form 706 and its separate instructions is at *www.irs.gov/form706.*

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any): **Herman**	1b Decedent's last name: **Hermitt**			2 Decedent's social security no.: **999 88 7777**
3a City, town, or post office; county; state or province; country; and ZIP or foreign postal code.	3b Year domicile established: **1960**	4 Date of birth: **11/10/1932**		5 Date of death: **Feb 10, 2014**
6a Name of executor (see instructions): **Miriam Hermitt**	6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code) and phone no.			
6c Executor's social security number (see instructions)	Phone no.			

6d If there are multiple executors, check here ☐ and attach a list showing the names, addresses, telephone numbers, and SSNs of the additional executors.

7a Name and location of court where will was probated or estate administered: **Circuit Court Lincoln County Illinois**

7b Case number: **14P109**

8 If decedent died testate, check here ▶ ☒ and attach a certified copy of the will.
9 If you extended the time to file this Form 706, check here ▶ ☐
10 If Schedule R-1 is attached, check here ▶ ☐
11 If you are estimating the value of assets included in the gross estate on line 1 pursuant to the special rule of Reg. section 20.2010-2T(a) (7)(ii), check here ▶ ☐

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5—Recapitulation, item 13)			1	630,000
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 24)			2	
3a	Tentative taxable estate (subtract line 2 from line 1)			3a	630,000
b	State death tax deduction			3b	0
c	Taxable estate (subtract line 3b from line 3a)			3c	630,000
4	Adjusted taxable gifts (see instructions)			4	0
5	Add lines 3c and 4			5	630,000
6	Tentative tax on the amount on line 5 from Table A in the instructions			6	203,900
7	Total gift tax paid or payable (see instructions)			7	0
8	Gross estate tax (subtract line 7 from line 6)			8	203,900
9a	Basic exclusion amount	9a	5,340,000		
9b	Deceased spousal unused exclusion (DSUE) amount from predeceased spouse(s), if any (from Section D, Part 6—Portability of Deceased Spousal Unused Exclusion)	9b	0		
9c	Applicable exclusion amount (add lines 9a and 9b)	9c	5,340,000		
9d	Applicable credit amount (tentative tax on the amount in 9c from Table A in the instructions)	9d	2,081,800		
10	Adjustment to applicable credit amount (May not exceed $6,000. See instructions.)	10	0		
11	Allowable applicable credit amount (subtract line 10 from line 9d)			11	2,081,800
12	Subtract line 11 from line 8 (but do not enter less than zero)			12	0
13	Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	13			
14	Credit for tax on prior transfers (from Schedule Q)	14			
15	Total credits (add lines 13 and 14)			15	
16	Net estate tax (subtract line 15 from line 12)			16	0
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)			17	
18	Total transfer taxes (add lines 16 and 17)			18	0
19	Prior payments (explain in an attached statement)			19	
20	Balance due (or overpayment) (subtract line 19 from line 18)			20	0

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here
▶ Signature of executor ▶ Date
▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 20548R Form **706** (Rev. 8-2013)

For Example 2

Form 706 (Rev. 8-2013)

Estate of: Herman Hermitt | Decedent's social security number 999 88 7777

Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE)

Portability Election

A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount.

Section A. Opting Out of Portability

The estate of a decedent with a surviving spouse may opt out of electing portability of the DSUE amount. Check here and do not complete Sections B and C of Part 6 only if the estate opts **NOT** to elect portability of the DSUE amount. ☐

Section B. QDOT

	Yes	No
Are any assets of the estate being transferred to a qualified domestic trust (QDOT)?		X

If "Yes," the DSUE amount portable to a surviving spouse (calculated in Section C, below) is preliminary and shall be redetermined at the time of the final distribution or other taxable event imposing estate tax under section 2056A. See instructions for more details.

Section C. DSUE Amount Portable to the Surviving Spouse (To be completed by the estate of a decedent making a portability election.)

Complete the following calculation to determine the DSUE amount that can be transferred to the surviving spouse.

1	Enter the amount from line 9c, Part 2—Tax Computation	1	5,340,000
2	Reserved	2	
3	Enter the value of the cumulative lifetime gifts on which tax was paid or payable (see instructions)	3	0
4	Add lines 1 and 3	4	5,340,000
5	Enter amount from line 10, Part 2—Tax Computation	5	0
6	Divide amount on line 5 by 40% (0.40) (do not enter less than zero)	6	0
7	Subtract line 6 from line 4	7	5,340,000
8	Enter the amount from line 5, Part 2– Tax Computation	8	630,000
9	Subtract line 8 from line 7 (do not enter less than zero)	9	4,710,000
10	DSUE amount portable to surviving spouse (Enter lesser of line 9 or line 9a, Part 2 – Tax Computation)	10	4,710,000

Role for Traditional Bypass/Credit Shelter Trusts. Portability, at least in theory, can allow the surviving spouse's estate to benefit from a step-up in basis with little (and possibly zero) transfer tax cost. A traditional bypass/credit shelter trust approach can largely accomplish the same result. Under this approach, an amount tied to the applicable estate tax exclusion at the time of death is left to the surviving spouse in trust for life. The balance in the estate of the first spouse to die passes to the surviving spouse outright and qualifies for the marital deduction. The result is that the estate of the first spouse to die escapes estate tax. In addition, the property passing to the credit shelter trust is included in the estate of the first spouse to die and qualifies for a basis step-up in the hands of the surviving spouse.

While traditional bypass/credit shelter trust estate plans still have merit, for many clients (married couples whose total net worth does not exceed twice the applicable exclusion), such trusts could result, over time as the applicable exclusion increases by inflation, in the underfunding of the marital trust.

For wealthy clients with large estates that are above the applicable exclusion (or are expected to be at the time of death), one planning option might be to use the DSUE in the **surviving spouse's estate** to fund a contribution to an IDGT. The DSUE is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's applicable exclusion amount. Thus, an IDGT would provide the same estate tax benefits as the bypass trust but the assets would be taxed to the surviving spouse as a grantor trust. Therefore, the trust assets would appreciate outside of the surviving spouse's estate.

Note. Portability planning is slightly less appealing to couples in community property states because, as discussed later, all community property gets a step-up in basis at the first spouse's death.

Multiple DSUEs. A surviving spouse can utilize multiple DSUEs by outliving multiple spouses when the DSUE election is made in each of those spouse's estates. To accomplish this, the surviving spouse must make gifts and exhaust the DSUE of the last deceased spouse before the next spouse dies.[26]

Example 3. Harry died in 2011 and is survived by Wilma.[27] Neither Harry nor Wilma made any taxable gifts during Harry's lifetime. Harry's executor elected portability of his DSUE amount. The DSUE amount as calculated on Harry's estate tax return was $5 million. In 2012, Wilma made taxable gifts to her children valued at $2 million. She reported the gifts on a timely filed gift tax return. Wilma is considered to have applied $2 million of Harry's DSUE amount to the 2012 taxable gifts. Therefore, Wilma owed no gift tax.

Wilma has an applicable exclusion amount of $8.12 million ($3 million of Harry's remaining DSUE + $5.12 million of Wilma's 2012 exclusion amount).

In 2013, Wilma married George. George died on June 30, 2015. George's executor elected portability of the DSUE amount, which was properly computed on George's estate tax return as $2 million.

The DSUE amount included in determining the applicable exclusion amount available to Wilma for gifts during the second half of 2015 is $4 million. The amount is calculated by adding George's $2 million DSUE amount and Harry's $2 million DSUE amount that was applied by Wilma to her 2012 taxable gifts. Thus, Wilma's applicable exclusion amount during the balance of 2015 is $9.43 million ($4 million DSUE + $5.43 million of Wilma's basic exclusion amount for 2015).

TRANSFER TAX COST VS. BASIS STEP-UP

As noted previously, an initial estate planning step for many taxpayers is determining the potential transfer tax costs as compared to the income tax savings from a step-up in basis. The comparison is imperfect because the applicable exclusion will continue to be adjusted for inflation or deflation. The rate of inflation or deflation and the client's remaining lifespan are uncontrollable variables. Additionally, as indicated previously, the tax structure of the state in which the decedent and beneficiaries are domiciled is a factor.

Under current law, the majority of estates are not subject to federal estate tax at death. However, a basis increase under IRC §1014 for assets included in the gross estate is typically viewed as more important than avoiding federal estate tax. Under §1014, the basis of property in the hands of the person acquiring the property from a decedent or to whom the property passed from a decedent "shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death."[28] The only exceptions to the FMV at date of death rule are for property subject to a special-use valuation election, an alternate valuation date election, or to the extent property is excluded from the gross estate by virtue of a qualified conservation easement.[29]

The federal estate tax and basis step-up are not necessarily connected. The federal income tax was enacted in 1913 and the federal estate tax was enacted in 1916. As originally enacted, neither the income tax nor the estate tax made any provision for the basis of assets received from a decedent's estate. It was not until the Revenue Act of 1921 that there was a rule concerning the basis of assets passing at death. Later, Congress added various "string" provisions to the federal estate tax, and the basis rules began to track the estate tax.

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26. Treas. Reg. §25.2505-2(c).
27. Example adapted from Treas. Reg. §25.2505-2(c).
28. IRC §1014(a)(1).
29. IRC §1014(a).

> **Observation.** It is possible that future legislation could eliminate the federal estate tax and retain basis step-up at death. In that case, ensuring a basis increase at death for the decedent's assets will be of primary importance to heirs. However, while §1014(b)(9) covers all property included in a decedent's gross estate under Chapter 11 and probate assets are covered by §1014(b)(1), Congress would have to clarify the type of nonprobate assets to which basis step-up applies.[30]

BASIS STEP-UP BENEFITS

The only way to capture the income tax benefits of the stepped-up basis adjustment is for the recipients of those assets to dispose of them in a taxable transaction. This raises several questions that the estate planner must consider.

- Is the asset of a type (such as a farm, ranch, or other closely held family business) that the heirs may never sell, or may sell in the very distant future?
- Is the asset depreciable or subject to depletion?
- Is the involved asset an interest in a pass-through entity such as a partnership or an S corporation?

Exceptions to the Basis Step-Up Rule

As noted previously, there are exceptions to the general rule that basis is determined as of the date of death.

- If the estate executor elects alternate valuation under IRC §2032, then basis is established as of the alternate valuation date.
- If the estate executor elects special-use valuation under §2032A, the value of the elected property as reported on the federal estate tax return establishes the basis in the hands of the heirs. This is true even though the executor and the IRS agree to value the elected land at less than what would otherwise be allowed by statute (for deaths in 2017, the maximum statutory value reduction for elected land is $1.12 million).[31]

> **Caution.** In *Van Alen v. Comm'r,*[32] the petitioners were children of a decedent who died in 1994. They were beneficiaries of a residuary testamentary trust that received most of the decedent's estate, including a 13/16 interest in a cattle ranch. The ranch value was reported on the estate tax return at substantially less than FMV, in accordance with §2032A. The petitioners signed a consent agreement agreeing to personal liability for any additional taxes imposed as a result of the sale of the elected property or cessation of qualified use. The IRS disputed the reported value, but the matter was settled.
>
> Years later, the trust sold an easement on the ranch that restricted development. The gain on the sale of the easement was reported with reference to the §2032A value. Schedules K-1, *Beneficiary's Share of Income, Deductions, Credits, etc.,* were issued showing that the proceeds were distributed to the beneficiaries. The beneficiaries did not report the gain as reflected on the Schedules K-1. They asserted that the ranch was undervalued on the estate tax return and that the gain reportable should be reduced by using a FMV tax basis. The court determined that the §2032A value establishes the basis of the elected property via §1014(a)(3). The court upheld the consent agreement. An accuracy-related penalty was imposed because tax advice was sought only after the petitioners failed to report any gain.

30. This includes assets in a revocable trust, assets subject to a general power of appointment by the decedent to appoint the assets to the decedent's creditors or estate, and assets that would have been included in the estate by virtue of IRC §§2034–2042. Also, whether assets included in a QTIP trust would be entitled to a basis step-up at the time of the surviving spouse's death would need to be clarified by an amendment to §1014(b).

31. Rev. Proc. 2016-55, 2016-45 IRB 707.

32. *Van Alen v. Comm'r,* TC Memo 2013-235 (Oct. 21, 2013).

- A carryover basis applies to land subject to a qualified conservation easement that is excluded from the gross estate under IRC §2031(c).[33]
- Property that constitutes income in respect of a decedent (including unrecognized interest on U.S. savings bonds, accounts receivable for cash basis taxpayers, qualified retirement plan assets, and IRAs) does not receive a basis step-up.
- There is also no basis step-up for appreciated property (determined on the date of the gift) that was gifted to the decedent within one year of death that is then transferred back to the original donor of such property (or the spouse of the donor). In this situation, the donor receiving the property back takes the basis that the decedent had in the property immediately before the date of death.[34]

Community Property Considerations

Estates in community property states have an advantage over estates in separate property states. The ownership portion of a couple's community property that is attributable to the surviving spouse by virtue of §1014(b)(6) gets a new basis when the **first** spouse dies if at least half of the community property is included in the decedent's estate for federal estate tax purposes. This means that there is a basis adjustment of both the decedent's and surviving spouse's half of community property at death if at least half of the community property was included in the decedent's gross estate for federal estate tax purposes. If future legislation repeals the federal estate tax, a question will arise as to whether the so-called "double basis step-up" for community property will survive.

> **Note.** The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Two common-law property states, Alaska and Tennessee, allow couples to convert or elect to treat their property as community property.[35] In these states, resident and nonresident couples can classify property as community property by transferring the property to a qualifying trust. For nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary, and specific trust language declaring the trust asset as community property.

Currently, sixteen states (Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming) have enacted the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA).[36] Under the UDCPRDA, when the first spouse dies, half of the community property is considered the property of the surviving spouse and the other half is considered to belong to the deceased spouse. However, a couple can change their interests in the property[37] and can adopt an estate plan that controls the inheritance of their property. One drawback is that there are not any cases or IRS rulings on the impact of the UDCPRDA on basis step-up under IRC §1014(b)(6).[38]

> **Observation.** Because the unlimited marital deduction under IRC §2056 essentially gives couples in community property states the ability to avoid transfer taxes on the first spouse's death, this step-up in basis provides an immediate income tax savings for the surviving spouse's benefit. This changes the planning dynamic as compared to similarly situated taxpayers in noncommunity property states.

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33. IRC §1014(a)(4).
34. IRC §1014(e).
35. *Marriage & Property Ownership: Who Owns What?* NOLO. [www.nolo.com/legal-encyclopedia/marriage-property-ownership-who-owns-what-29841.html] Accessed on Aug. 1, 2017.
36. *Legislative Fact Sheet – Disposition of Community Property Rights at Death Act (1971).* Uniform Law Commission. [www.uniformlaws.orgLegislativeFactSheet.aspx?title=Disposition%20of%20Community%20Property%20Rights%20at%20Death%20Act%20(1971)] Accessed on Jul. 18, 2017.
37. UDCPRDA, Sec. 8.
38. Preamble to Uniform Disposition of Community Property Rights at Death Act.

Suggested Approach. The following is a suggested estate planning approach for married couples in community property states when the emphasis is on achieving a stepped-up basis.

- There should be minimal gifting of assets during the lifetimes of both spouses so that the maximum value of assets is included in the estates, where they will be eligible for a basis increase under §1014(b)(6).
- After the death of the first spouse, if the value of the survivor's gross estate exceeds the available applicable exclusion, strategies should be utilized to reduce the potential estate tax in the survivor's estate consistent with the surviving spouse's goals. Such strategies may involve income tax planning, planning to avoid or at least take into account the NIIT, gifting, the use of entities to create minority interest and lack of marketability discounts, and discounts for built-in capital gain (applicable to S corporations).

PLANNING TECHNIQUES TO ACHIEVE INCOME TAX BASIS STEP-UP

The disparate treatment of community and common law property has motivated estate planners to come up with techniques designed to achieve a basis step-up for the surviving spouse's common law property at the death of the first spouse. These techniques are summarized as follows.

- General power of appointment is given to each spouse over the other spouse's property that causes, on the death of the first spouse, the deceased's spouse's property to be included in the decedent's estate by virtue of IRC §2033 (if owned outright) and IRC §2038 (if owned in a revocable trust). The surviving spouse's property is also included in the decedent's estate by virtue of IRC §2041. The power held by the first spouse to die terminates upon the first spouse's death and is deemed to have passed at that time to the surviving spouse.[39]
- Both spouses contribute their property to a joint exempt step-up trust (JEST)[40] that holds the assets as a common fund for the benefit of both spouses. Either spouse may terminate the trust while both are living, in which case the trustee distributes half of the assets back to each spouse. If there is no termination, the JEST becomes irrevocable upon the first spouse's death. Upon the first spouse's death, all assets are included in that spouse's estate and assets equal in value to the first spouse's unused exclusion are used to fund a bypass trust for the benefit of the surviving spouse and descendants. These bypass trust assets receive a stepped-up basis and are not included in the surviving spouse's estate. Any asset in excess of the funding of the bypass trust goes into an electing QTIP trust. If the deceased spouse's share of the trust is less than the available exclusion, then the surviving spouse's share is used to fund a bypass credit shelter trust. These assets avoid estate taxation at the surviving spouse's death.

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39. *The Optimal Basis Increase and Income Tax Efficiency Trust.* Morrow III, Edwin P. Jan. 2016. [https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436964] Accessed on Aug. 4, 2017.

40. *Jest Offers Serious Estate Planning Plus for Spouses—Part 1.* Gassman, Alan; Denicolo, Christopher; and Hohnadell, Kacie. Oct. 22, 2013. Gassman, Crotty, & Denicolo, PA. [http://gassmanlaw.com/wp-content/uploads/2013/10/JEST-Offers-Serious-Estate-Planning-Plus-for-Spouses.pdf] Accessed on Jun. 7, 2017.

Note. IRC §1014(e) may operate to prevent the planning benefits of these techniques. Under §1014(e), property with an FMV that exceeds its basis at the time of the transfer may be ineligible for a basis step-up. The property is ineligible if the transferee dies within one year of the transfer and, as a result of the transferee's death, the transferred property is "acquired from" the transferee by the original transferor or "passes from" the transferee to the original transferor under §1014(e). The primary question is whether §1014(e) applies to the GPOA held by a deceased spouse over the surviving spouse's interest in trust property.

The IRS ruled against this technique in a 1993 letter ruling.[41] The IRS disallowed a basis increase to the surviving spouse's half interest in a trust because §1014(e) requires relinquishment of dominion and control over the property transferred to the decedent at least one year before death. Because the surviving spouse (the donor) could revoke the joint revocable living trust at any time, the surviving spouse had dominion and control over the trust assets during the year before and up to the time of the decedent spouse's death.

The IRS ruled similarly in Ltr. Rul. 200101021.[42] Although the 1993 letter ruling has been criticized,[43] there is also support for the IRS's position.[44] Clearly, complex planning is required to achieve the desired result.

The administration of trusts always requires care. The level of care is elevated for estate planning techniques designed to increase basis for common law property equivalent to community property.

- Many married couples have the traditional bypass/credit shelter trust estate planning arrangement. Many of those couples now have assets less than the estate tax exemption amounts. In a traditional bypass/credit shelter trust, the assets held in the bypass trust normally receive a step-up in basis upon the death of the first spouse. No step-up in basis would occur on the second spouse's death. A strategy to obtain a stepped-up basis on assets held in the bypass trust on the second spouse's death involves making QTIP and DSUE elections on a federal estate tax return for the first spouse to die. This strategy assumes the bypass trust is eligible for the QTIP election.[45]

Estate of Olsen v. Comm'r[46] illustrates the perils of not properly administrating trusts. In the case, a married couple had revocable living trusts with identical terms that would be split on death into a marital trust and then two marital subtrusts. Mrs. Olsen's trust contained assets valued at approximately $2.1 million at the time she died. At that time, the federal estate tax exemption was $600,000. The trust specified that the trust assets were to be divided into a pecuniary marital trust and a residuary credit shelter trust. Mr. Olsen, in his role as executor, did not transfer the assets as directed. In addition, the marital trust was to be divided into GSTT-exempt and non-exempt trusts. Mr. Olsen (the decedent in this case) had a limited power of appointment over principal from the credit shelter trust to appoint principal to his children, grandchildren, or charities. After his wife's death, Mr. Olsen made over $1 million in withdrawals from the revocable living trust principal for charitable distributions and claimed charitable deductions on his personal return. He also withdrew other funds for distribution to his children and grandchildren.

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41. Ltr. Rul. 9308002 (Nov. 16, 1992).

42. Ltr. Rul. 200101021 (Oct. 2, 2000).

43. *See, e.g.,* Zaritsky, *Running With the Bulls: Estate Planning Solutions to the "Problem" of Highly Appreciated Stock*, 31-14 University of Miami Law Center on Estate Planning §1404; Williams, *Stepped-Up Basis in Joint Revocable Trusts*, Trusts & Estates (June 1994).

44. *See, e.g.,* Keydel, *Question and Answer Session II of the Twenty-Eighth Annual Institute on Estate Planning*, 28-20, University of Miami Law Center on Estate Planning §2007.

45. Rev. Proc. 2016-49, 2016-42 IRB 462.

46. *Estate of Olsen v. Comm'r,* TC Memo 2014-58 (Apr. 2, 2014).

After Mr. Olsen's death in 2008 (when the exemption was $2 million), the revocable living trust contained over $1 million in assets. The estate took the position that all withdrawals had been from the marital trust (which were subject to an ascertainable standard) such that Mr. Olsen's gross estate value was zero. The IRS claimed that withdrawn amounts were attributable to the credit shelter trust and included in Mr. Olsen's gross estate or, in the alternative, were pro rata withdrawals. The IRS assessed an estate tax deficiency of $482,051.

The Tax Court determined that the charitable gifts were from the credit shelter trust via Mr. Olsen's limited power of appointment. It also determined that the other distributions were from the marital trust as discretionary distributions. The Tax Court rejected the estate's argument that Treas. Reg. §20.2044-1(d)(3) applied. The court also determined that Mr. Olsen's limited power of appointment to donate to charity from the credit shelter trust was exercisable during his life. The court noted that distributions from principal could only come from the marital trust. The value of Mr. Olsen's gross estate was determined by subtracting all personal withdrawals from the value of remaining trust assets. The end result was an increase in tax liability of approximately $250,000.

As mentioned earlier, there is uncertainty over the future of the federal estate tax and basis step-up. If the estate tax is repealed along with basis step-up (i.e, no estate tax and carryover basis), the planning process will require additional considerations such as the following.

- Lifetime transfers of appreciated assets would not lose a basis adjustment at the transferor's death.
- A carryover basis system could have a serious negative impact on taxpayers that have depreciated assets, refinanced their assets, or engaged in a tax-deferred exchange. If the assets were currently liquidated, the income tax liability could be large, and there would be no opportunity to escape that tax liability by achieving a basis step-up at death.

TRANSFEREE LIABILITY

Upon a decedent's death, any liabilities for deficiencies on the decedent's tax returns do not disappear. The decedent's estate, in essence, is liable for the decedent's tax deficiency at the time of death. Individuals receiving assets from a decedent take the assets subject to the claims of the decedent's creditors — including the government. Asset transferees are liable for taxes due from the decedent to the extent of the assets that they receive. A trust can be liable as a transferee of a transfer under IRC §6901 to the extent provided in state law.[47]

The courts addressed transferee liability issues in several recent cases.

- In *U.S. v. Mangiardi,*[48] the court held that the IRS could collect estate tax more than 12 years after taxes were assessed. Mr. Mangiardi died in 2000. He owned a revocable trust worth approximately $4.58 million and an IRA worth $3.86 million. The estate tax was approximately $2.48 million. Four years of extensions were granted due to a market value decline of publicly traded securities. The estate paid estate taxes of $250,000, and the trust had insufficient assets to pay the balance. The IRS sought payment of tax from the transferee of an IRA under IRC §6324. The court held that the IRS was not bound by the 4-year assessment period of IRC §§6501 and 6901(c) and could proceed under IRC §6324 (10-year provision). The 10-year provision was extended by the 4-year extension period previously granted to the estate, and IRA transferee liability was derivative of the estate's liability. The court held that it was immaterial that the transferee may not have known of the unpaid estate tax. The amounts withdrawn from the IRA to pay the estate tax liability were also subject to income tax in the transferee's hands. The court also held that while an income tax deduction for estate taxes attributable to the IRA was available under IRC §6901(c), the deduction could be limited due to the failure to match the tax years of the deduction and the income.

47. See, e.g., *Frank Sawyer Trust of May 1992 v. Comm'r,* TC Memo 2014-59 (Apr. 3, 2014).

48. *U.S. v. Mangiardi,* 9:13-cv-80256 (S.D. Fla. Jul. 22, 2013).

- In *U.S. v. Tyler,*[49] a married couple owned real estate as tenants by the entirety (a special form of marital ownership recognized in some states). Mr. Tyler owed the IRS $436,849 in income taxes. He transferred his interest in the real estate to his wife for $1, and the IRS then placed a lien on the real estate. Mr. Tyler died with no distributable assets and no other assets with which to pay the tax lien. Mrs. Tyler died within a year of her husband's death and the property passed to their son, the defendant in the case. Mr. Tyler was named as a co-executor of his mother's estate. The IRS claimed that the tax lien applied to the real estate before legal title passed to Mrs. Tyler and that the executors had to satisfy the lien out of the assets of her estate. The executors conveyed the real estate to Mr. Tyler for $1 after receiving letters from the IRS asserting the lien. Mr. Tyler later sold the real estate and invested the proceeds in the stock market, subsequently losing his investment. The IRS brought a collection action for 50% of the sale proceeds from the executors. The trial court ruled for the IRS and the appellate court affirmed. Under the federal claims statute, the executor has personal liability for the debts and obligations of the decedent. The fiduciary who disposes of the assets of an estate before paying a governmental claim is liable to the extent of payments for unpaid governmental claims if the fiduciary distributes the estate assets, the distribution renders the estate insolvent, and the distribution takes place after the fiduciary had actual or constructive knowledge of the liability for unpaid taxes.
- *U.S. v. Whisenhunt*[50] is another case that points out that an executor has personal liability for unpaid federal estate tax when the estate assets are distributed before the estate tax is paid in full. IRC §7402 controlled, and the executor was personally liable for $526,507 in delinquent federal estate tax and penalties, which was the amount of the distribution at the time of the decedent's death.

IRS GUIDANCE ON DISCHARGING ESTATE TAX LIENS

In Treasury Memo SBSE-05-0417-0011, issued on April 5, 2017, the IRS provided interim guidance to its estate tax lien advisory group concerning applications or requests for discharge of the federal estate tax lien that are made after June 2016.

Upon death, the assets in a decedent's gross estate are subject to a federal estate tax lien under IRC §6324(a). The lien arises before any estate tax is assessed and is an unrecorded ("silent") lien that exists for 10 years from the date of a decedent's death. The lien is in addition to the regular federal estate tax lien of IRC §6321, which arises upon the assessment of tax. The lien can be discharged by making a request via Form 4422, *Application for Certificate Discharging Property Subject to Estate Tax Lien.* The lien is discharged if the IRS determines that it has been fully satisfied or provided for. Form 792, *United States Certificate Discharging Property Subject to Estate Tax Lien,* is used to discharge the lien from particular property under IRC §6325(c). The lien is typically "waived" in approximately 10 days.

However, beginning in June 2016, all applications for discharge of liens are processed through Specialty Collection Offers, Liens and Advisory, in the estate tax lien group. When the IRS accepts a filed Form 4422, the entire net proceeds of estate asset sales are either to be deposited with the IRS or held in escrow by the estate's legal counsel until the IRS issues a closing letter or determines that the federal estate tax return will not be audited. The amount deposited with the IRS or held in escrow is the full amount of net proceeds remaining after the amount necessary to pay tax on the proceeds of sale.

The interim guidance to the Special Advisory Group explains how to handle lien discharge requests. Under applicable regulations, if the appropriate official determines that the tax liability for the estate has been fully satisfied or adequately provided for, a certificate that discharges the property from the lien may be issued. The interim guidance provides instructions on who within the IRS is consulted and will provide assistance in handling lien discharge requests. It also states which Code sections apply. The interim guidance also notes that Letter 1352, *Request for Discharge of Estate Tax Lien,* is issued when an estate does not have a filing requirement. Additionally, the interim guidance notes the procedures utilized to substantiate facts for nontaxable estates. The interim guidance also notes the circumstances when an escrow or payment will or will not be required.

49. *U.S. v. Tyler,* No. 12-2034, 2013 U.S. App. LEXIS 11722 (3rd Cir. Jun. 11, 2013).

50. *U.S. v. Whisenhunt,* No. 3:12-CV-0614-B (N.D. Tex. Mar. 25, 2014).

BASIS OF ASSETS IN ESTATES

DATE OF DEATH VALUATION AND ALTERNATE VALUATION

Under the general rule, the basis of an inherited asset from a decedent is the FMV of the asset on the decedent's date of death. There are exceptions to this general rule, including income in respect of the decedent (IRD) and certain gifts of appreciated property acquired by the decedent by gift within one year of death.[51]

> **Note.** For an extensive discussion regarding basis for inherited assets, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. The chapter includes sections on inherited assets, inheriting retirement assets, inheriting a partnership interest, and inheriting S corporation stock. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The executor of an estate may choose to use the FMV on the date of death **or** on the **alternate valuation date** when filing Form 706.[52] The alternate valuation date is six months after the date of death. The alternate valuation election may only be made if it lowers the overall value of the estate, lowers the estate tax, and is used for all assets in the estate. If the executor makes an alternate valuation date election, the beneficiary's basis is equal to the FMV of the property as of the alternate valuation date.

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Because the executor can make an alternate valuation election only if the value of the property in the gross estate **and** the federal estate tax liability are both reduced by making the election,[53] the decedent's gross estate must be a taxable estate. The purpose of alternate valuation is to reduce the federal estate tax burden if values decline in the 6-month period immediately following death. In that event, the estate can be valued up to six months after death.

> **Observation.** If an estate is not subject to federal estate tax, an alternate valuation election could allow the estate's heirs to obtain a higher income tax basis on property included in the gross estate if values increased after the decedent's death. That is not permissible.

Alternate valuation is usually straightforward — there is one value as of the date of death and a different value six months after death.[54] However, in some estates, events can occur during the 6-month period immediately following the decedent's death that add complications to the valuation. This is a particular concern for an agricultural estate. For example, a decedent may have planted a crop shortly before death that was harvested and sold within six months after death. Or, perhaps the decedent had cows that were bred before the date of death, calved after death, and were sold after the 6-month period following death. Determining whether these types of property are subject to alternate valuation requires a determination of "included" and "excluded" property for purposes of the election. **Included property** is all property that is in existence at the decedent's death. Under an alternate valuation election, included property is valued six months after death or as of the date of sale, whichever comes first. Thus, crops that are growing as of the date of death and are harvested and sold after death are valued as of the earlier of six months after death or the date of sale.

51. IRC §1014.

52. IRC §2032.

53. Treas. Reg. §§20.2032-1(a)(1) and (b)(1).

54. Treas. Reg. §20.2032-1(d).

A unique situation exists for property that is included as of the date of death and is disposed of gradually during the 6-month period after death. For example, in the case of silage that is used as feed during the 6-month period following death, every day's feeding event is a disposition. Thus, a calculation must be made not only as to the value, but as to how much was used. The same is true of shelled corn, hay, or similar items. The inventory must show the usage over that time period, and some value must be attached to it.[55]

Conversely, property that came into existence after the decedent's death, but during the alternate valuation period, such as crops planted after death, are ignored for purposes of alternate valuation. This property is termed **excluded property.**[56]

BASIS CONSISTENCY RULES

The Surface Transportation and Veterans Health Care Improvement Act of 2015 (Act) added IRC §6035 to the Code. IRC §6035 specifies that estates required to file a federal estate tax return (Form 706) after July 31, 2015,[57] must provide basis information to the IRS and estate beneficiaries. The information must be provided by the earlier of 30 days after the due date of Form 706 (including extensions, if granted) or 30 days after the actual filing date of Form 706. This ensures that beneficiaries of estate assets use the same basis amounts when they subsequently sell the assets that were used in the decedent's estate.

The IRS moved the initial statutory filing deadline of August 31, 2015, forward to February 29, 2016,[58] and then to March 31, 2016.[59] However, the IRS failed to timely issue proposed regulations (and a temporary regulation). It waited until early March 2016 (in the middle of tax filing season) to do so, mere days before the filing deadline.[60] As a result, practitioners had very little time to study the proposed regulations. Consequently, in late March, the IRS delayed the filing deadline to June 30, 2016.[61]

The new rules include the following.

1. Specify that the basis of property subject to the new rules cannot exceed the final value as determined for estate tax purposes in a decedent's estate[62]
2. Impose a reporting requirement with regard to the value of property included in a decedent's gross estate[63]

Filing Requirement

IRC §6035(a)(1) requires an executor of an estate that is required to file a Form 706 (other than for the sole purpose of electing portability) to furnish a statement to the IRS and each person acquiring any interest in the estate property. The statement should provide the value of each interest in the inherited property as reported on Form 706, along with any other information that the IRS might require.[64]

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55. Ibid.
56. Ibid.
57. IRS Notice 2015-57, 2015-36 IRB 294.
58. By statute, the filing deadline was August 31, 2015, for executors who either filed or should have filed Form 706 on August 1, 2015 (PL 114-41, §2004). However, there was no way to comply with the law without forms on which to report the required information, which had not been released. Thus, the IRS issued Notice 2015-57 stating that any reports due before February 29, 2016, should not be filed before that date.
59. IRS Notice 2016-19, 2016-09 IRB 362.
60. REG-127923-15, 2016-12 IRB 473 and Temp. Treas. Reg. §1.6035-2T were issued Mar. 4, 2016. Temp. Treas. Reg. §1.6035-2T merely specifies the due date of the relief that was provided in IRS Notice 2016-19, 2016-9 IRB 362.
61. IRS Notice 2016-27, 2016-15 IRB 567.
62. IRC §1014(f)(1).
63. IRC §6035(a).
64. IRC §6035(a)(2). Any statement filed under IRC §6035 is subject to the failure to file penalties contained in IRC §§6721 and 6722.

An estate executor must:[65]

1. Furnish a statement (Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent,* and the accompanying Schedule A) to the IRS identifying the reported value of each asset that was included in the gross estate; and

2. Provide that information (Schedule A of Form 8971) to each person who acquired the interests and identify those individuals in the report to the IRS.

Form 8971

Information required to be furnished to the IRS and beneficiaries is reported on Form 8971. A filed Form 8971 should include a copy of each Schedule A. The beneficiaries must also receive Schedule A. Form 8971 and the attached Schedules A are not to be filed with Form 706.

As mentioned earlier, Form 8971 is filed within the earlier of 30 days of the due date of the Form 706 or within 30 days of when Form 706 is actually filed.[66] The Form 8971 instructions state that basis information statements are due within 30 days of the filing date if Form 706 is not filed in a timely manner. In addition, if an adjustment is made to Form 706, a supplemental basis information statement must be filed within 30 days of filing the adjusted Form 706.

Note. In many situations, estates (and trusts that are related to estates) have not proceeded through the administration process sufficiently within 30 days of filing the Form 706 to be able to determine the heirs that are to receive particular assets. Determining value is one task, but interpreting will and trust language to determine who gets each item of property is a completely different task.

The Form 8971 instructions direct an executor to report **all** of the **potential** assets that a beneficiary **might** inherit on Schedule A.[67] In addition, after the executor knows the actual asset allocation to the beneficiaries, the executor files an updated Form 8971.[68]

Observation. For large estates, any beneficiary could receive a rather lengthy Schedule A and might assume that they are inheriting all the assets listed on the schedule. This assumption is corrected when they receive the updated Form 8971.

It would make sense to statutorily change the due date of Form 8971 to either after the time when the actual assets to be distributed to a particular beneficiary are determined or after the distribution to a beneficiary is actually made.

The instructions for Form 8971 state that the form does not need be filed if the only reason for filing it is to elect the GSTT or make a GSTT allocation. However, the instructions are silent on portability. IRC §1014(f)(2) states that the new basis consistency rules only apply to property that increases the estate's federal estate tax liability (reduced by any credits allowed against the tax). Property passing outright to a surviving spouse that qualifies for the marital deduction and property passing to a charity are not subject to the basis consistency rules because they do not trigger estate tax. Estates that file Form 706 for the **sole purpose of electing portability** of the unused estate tax exclusion at the death of the first spouse are **not required to file Form 8971.**

65. IRC §6035; see instructions for Form 8971 and Schedule A.

66. IRC §6035(a)(3)(A).

67. This is consistent with Prop. Treas. Reg. §1.6035-1(c)(3). This will result in duplicate reporting of assets on multiple Forms Schedule A. Also, assets do not have to be reported if they are not "property for which reporting is required."

68. Instructions for Form 8971.

Proposed Regulations[69]

As mentioned earlier, IRC §1014(f)(2) specifies that the application of the basis consistency rule is limited to property that would increase the liability for estate tax (reduced by allowable credits against the tax) if it were included in the decedent's estate.[70] This rule, however, applies only for purposes of the basis consistency rule; it does not apply to the information reporting requirements. Likewise, Prop. Treas. Reg. §1.1014-10(b)(2) states that property for which an appraisal is not required under Treas. Reg. §20.2031-6(b) is not subject to the basis consistency requirement.[71] In addition, the basis consistency rule does not apply to a nontaxable estate even when Form 706 is required to be filed.[72] Thus, if the estate owes no federal estate tax, the basis consistency rules do not apply to any of the estate assets. However, if the taxpayer is over the filing threshold, they must file Form 8971 and Schedule(s) A.[73]

Note. Example 1 in Prop. Treas. Reg. §1.6035-1(b)(2) indicates the appraisal exception applies to any individual asset that is valued at less than $3,000. However, Treas. Reg. §20.2031-6(b) applies if the total value of articles having marked artistic or intrinsic value exceeds $3,000. The instructions to Form 706 state that an appraisal is required for "works of art," etc., if any item is valued at more than $3,000.

The proposed regulations allow for post-death changes in basis[74] and also apply the basis consistency rules to property that was omitted from Form 706.[75] If the omission is discovered and the omitted property is reported on a supplemental Form 706 before the period of limitation on assessment of tax expires, nothing changes. The normal rules on final value apply.[76] If the omission is discovered **after** the statute of limitations expires for assessing estate tax, the beneficiary of the property receives a basis of zero.[77]

Note. There is no statutory authority in §1014(f) for the position taken in the proposed regulations of adjusting basis to zero for omitted assets discovered after the statute of limitations on assessment expires. Additionally, for assets discovered after Form 706 is filed but before the statute of limitations expires, practitioners may not find it worthwhile to file a supplemental Form 706 to avoid a zero basis. This is because no duty exists to report property discovered later with respect to an estate for which Form 706 was filed in good faith. This rule could put an estate executor in conflict. It is not advantageous for the estate to report the newly discovered asset, but the beneficiary will want the asset reported in order to obtain a date-of-death basis.[78]

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69. Prop. Treas. Reg. §1.1014-10.

70. The corresponding regulation is Prop. Treas. Reg. §1.1014-10(b)(1). This means that the basis consistency rule applies to property that is included in a decedent's estate under either IRC §2031 or IRC §2106 that triggers a federal estate tax that exceeds allowable credits (except for the credit for prepayment of estate tax).

71. Prop. Treas. Reg. §20.2031-6(b) requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000." Thus, the appraisal requirement generally applies to jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary vases, oriental rugs, and coin or stamp collections.

72. Prop. Treas. Reg. §1.1014-10(b)(3).

73. IRC §6034A(a).

74. Prop. Treas. Reg. §1.1014-10(a)(2). The estate tax value of the property sets the upper limit on the initial basis of the property after the decedent's death.

75. Prop. Treas. Reg. §1.1014-10(c)(3).

76. Prop. Treas. Reg. §1.1014-10(c)(3)(i)(A).

77. Prop. Treas. Reg. §1.1014-10(c)(3)(i)(B).

78. *Basis Consistency Temporary and Proposed Regulations.* Akers, Steve. R. Mar. 8, 2016. Bessemer Trust. [www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Basis%20Consistency%20Proposed%20Regulations%20Summary%2004%2004%2016.pdf] Accessed on May 22, 2017.

The proposed regulations are the sole guidance on the basis consistency rules. As such, they must be relied upon for both the preparation of Form 8971 and the preparation of income tax returns of heirs receiving property subject to the basis consistency rules until final regulations are published.

The proposed regulations on the reporting issue include the following provisions.[79]

- The values reported are the "final values" as reported on Form 706 (or as the IRS later determines or as agreed to or determined by a court). The final value establishes the initial basis with the normal post-death basis adjustments remaining available. If the basis is later determined to be less than the initial reported value, the recipient of the property so valued cannot rely on the value that was listed in the original statement and could have a deficiency and underpayment attributable to the difference.[80]
- For final values that later change, the estate must file a supplemental information return with the IRS and furnish a supplemental statement to the beneficiary.
- Basis reporting for a nonresident, noncitizen decedent applies only to property in the estate that is subject to federal estate tax.
- If property is subject to nonrecourse debt, the basis of the property is its gross value (rather than the net value that is reported on Form 706).[81]
- Only the decedent's half of community property is subject to the basis consistency reporting requirement. However, both halves of the community property receive a basis adjustment in accordance with §1014(b)(6).
- Generally, all property reported on Form 706 must be reported on Form 8971. However, there are exceptions for IRD property,[82] cash (other than collectible coins and bills) or property for which an appraisal is not required (personal effects of the decedent, for example),[83] or property that the estate disposed of that triggered recognition of a capital gain or loss.
- If the executor has not identified the property that will be transferred to each beneficiary as of the reporting deadline, the executor must give the beneficiary a list of every asset the beneficiary might receive. After the bequest is funded, a supplemental Schedule A need not be filed with the IRS or the beneficiary.[84]
- The executor must include a statement concerning any beneficiaries that cannot be located and explain efforts undertaken to locate them. A supplemental filing is required if the property is ultimately distributed to someone else. A supplemental filing is also required to be filed within 30 days of locating the previously unascertained beneficiary.[85]
- A supplemental Form 8971 must be filed with the IRS and each beneficiary must receive a supplemental Schedule A if previously reported information turns out to be incorrect or incomplete, unless the erroneous information is merely an inconsequential error or omission. As stated in the Form 8971 instructions, an error on Form 8971 that relates to a taxpayer identification number, a beneficiary's surname, or the value of the asset that a beneficiary is receiving is not inconsequential. Likewise, errors on Schedule A to Form 8971 that relate to the value of an asset that a beneficiary receives from an estate or relate to a "significant item in a beneficiary's address" are not inconsequential.

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79. Prop. Treas. Regs. §§1.6035-1 and 2.

80. Prop. Treas. Regs. §§1.6035-1(a)(1); 1.1014-10(c); and 1.1014-10(c)(2).

81. Prop. Treas. Regs. §§1.1014-10(a)(2) and 1.1014-10(e), Example 4.

82. It may not always be the case that IRA funds are not subject to the basis reporting rules. For example, an account could consist of nondeductible contributions and part of the amounts in the account may not be IRD.

83. However, works of art or an item or collection of items with an artistic or collectible value exceeding $3,000 as of the date of death must be reported.

84. Prop. Treas. Reg. §1.6035-1(c)(3).

85. Prop. Treas. Reg. §1.6035-1(c)(4).

> **Note.** Generally, a 30-day rule applies to supplemental returns. Such returns are due 30 days after the final value is determined, 30 days after the executor discovers incomplete or incorrect information, or 30 days after a supplemental Form 706 is filed.[86]

Contingent Beneficiaries

For a contingent beneficiary, the executor's reporting requirement is triggered when the contingent beneficiary actually receives the property from the estate.[87] Thus, for a life tenant who is the beneficiary of a life estate, the executor must send Schedule A of Form 8971 to the life tenant and the remainder holders as the beneficiaries of the remainder interest. In addition, any change in a beneficiary due to a contingency must be reported. For example, if a remainder holder dies before a life tenant, the executor must file a supplemental report with the IRS and the new remainder holder.

> **Note.** This rule appears to subject an estate executor to a continuing duty to provide supplemental reports into the future.

Entity Beneficiaries

For beneficiaries that are entities, the executor files the basis information (Schedule A of Form 8971) with the appropriate entity representative of a trust or an estate (i.e., the trustee or executor) or directly with a business entity that is a beneficiary. Supplemental reporting could be triggered if the entity transfers the asset and the carryover basis rule applies.[88]

Transfers by Beneficiaries

If a beneficiary receives property (that is subject to a basis reporting requirement) from an estate and then transfers the property to a related party[89] and the transferee's basis is determined at least partially by the transferor's basis, the beneficiary that transfers the property must file a supplemental Schedule A with the IRS. Additionally, they must give the transferee a copy that reports the change in ownership and the final estate tax value of the property.[90] The supplemental Form 8971 for such transfers is due within 30 days after the date of the transfer.[91] Thus, when a beneficiary subsequently gifts the inherited property, for example, the basis reporting rule applies and Form 8971 must be filed within 30 days of the transfer.

> **Note.** The position taken in the proposed regulations is contrary to §6035, which imposes the basis reporting requirement **solely** on the party responsible for filing Form 706.[92]

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86. IRC §6035(a)(3).

87. Prop. Treas. Reg. §1.6035-1(c)(1).

88. Prop. Treas. Reg. §1.6035-1(c)(2).

89. A "related party" for this purpose is any member of the transferee's family as defined in IRC §2704(c)(2), any controlled entity, and any trust of which the transferor is the deemed owner for income tax purposes. A grantor trust is considered a related party, but **not** a nongrantor trust. For grantor trusts, it appears that when the trust makes a distribution to a beneficiary, the trustee need not file a basis information statement with the IRS and beneficiary. Prop. Treas. Reg. §1.6035-1(f).

90. Prop. Treas. Reg. §1.6035-1(f). Thus, the rule would also apply in situations that involve, for example, a like-kind exchange of the property or an involuntary conversion of the property.

91. There is no specification in the proposed regulations that gifts covered by the present interest annual exclusion are excluded from the reporting requirement, and there is also no de minimis amount specified that would be exempt from the reporting requirement.

92. See IRC §6035(a)(1).

Subsequent transfers can require further actions.

- If the original recipient transfers the property before the estate is required to file a Form 8971, the original recipient still must file Form 8971 but only needs to report the change in ownership.[93]
- If the basis of the property changes after being distributed to the beneficiary, the transferor must report the original basis as received from the decedent's estate and has the option of providing information on the change of the asset's basis while in the transferor's hands.[94]
- If a subsequent transfer occurs before a final value is determined, the transferor must provide the executor with a copy of the supplemental statement that is filed with the IRS. The executor must provide any required basis notification statement to the transferee.[95]
- If an individual beneficiary transfers the property to a grantor trust (a nontaxable event), the transferor must file a basis information statement with the IRS and the trustee of the trust (probably the transferor). A similar requirement does not apply if the transfer is made to a nongrantor trust.[96]

ACCURACY-RELATED PENALTY[97]

An accuracy-related penalty is imposed on taxpayers who report a basis higher than the amount that the estate reported on Form 8971.

Observation. The new basis information reporting rules are designed to address situations in which property is reported for federal estate tax purposes at one value (which establishes the basis of the assets included in the decedent's estate) and then gain is reported for tax purposes based on an entirely different income tax basis. The solution as proposed in the regulations has shortcomings. Hopefully, final regulations will resolve the problems that the proposed regulations create. In any event, the administration of many decedents' estates has become more complicated.

PRACTICAL ESTATE PLANNING

MODERATE-WEALTH TAXPAYERS

For individuals with 2017 estates of less than $5.49 million[98] ($10.98 million for married couples), the possibility of estate tax is largely nonexistent. Estate planning for these individuals should focus on basic matters such as income tax basis planning and plans to avoid common errors. In addition, divorce planning and protection may be necessary. A determination must be made as to whether asset control and creditor protection is necessary.

Moreover, the income tax benefits of family entities to shift income (subject to family partnership rules of IRC §704(e)) and qualifying deductions to the entity may need to be considered. The entity may have been created for estate and gift tax discount purposes but now could provide income tax benefits. In any event, family entities, such as family limited partnerships (FLP) and limited liability companies (LLC) continue to be valuable estate planning tools for many moderate-wealth clients.

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93. Prop. Treas. Reg. §1.6035-1(f).
94. REG-127923-15, 2016-12 IRB 473.
95. Prop. Treas. Reg. §1.6035-1(f).
96. Prop. Treas. Reg. §1.6035-1(f); IRC §2704(c); IRC §2701(b)(2)(A).
97. Prop. Treas. Reg. §1.6662-8.
98. Rev. Proc. 2016-55, 2016-45 IRB 707.

Most of the moderate-wealth taxpayers will likely fare better by not making gifts and retaining the ability for the heirs to achieve a basis step-up at the taxpayer's death. Additionally, consideration should be made as to whether insurance is still necessary to fund any potential estate tax liability. It also may be possible to recast insurance to fund state death taxes and serve investment and retirement needs, minimize current income taxes, etc.

Other estate planning pointers for moderate-wealth taxpayers include the following.

- Trust-owned life insurance — Clients should be cautioned to not cancel a policy before evaluating such factors as the amount of premiums that have been paid, what coverage would be lost if it were canceled, what was the original purpose of buying it, etc.
- Pension-owned life insurance — If the taxpayer's estate is safely below the $5.49 million exemption (in 2017), the adverse estate tax consequences may be avoided.
- Irrevocable trusts — Such trusts should be evaluated to determine if they can be modified or terminated.
- For durable powers of attorney, the limitation on gifted amounts (the annual exclusion is $14,000 for 2017)[99] should be examined to make sure there is no inflation-adjusting reference to the annual exclusion. If there is an inflation-adjuster clause in a power of attorney, then it may end up authorizing a large amount of gifts that the principal never intended.
- For qualified personal residence trusts (QPRT) that were created when the estate tax exemption was $2 million, the conventional advice was to deed the house from the QPRT to the children or a remainder trust (which might have been a grantor trust), with a written lease agreement in favor of the parent/donor who would continue to live in the house. Now, it may be desirable to have the home included in the estate for basis step-up purposes.
- While FLPs and LLCs may have been created to deal with the IRC §2036 issue (a Code section that illustrates the government's concern about lifetime transfers being used as a substitute for testamentary transfers), it may not be wise to simply dismantle them because a taxpayer is no longer liable for estate tax. A taxpayer may actually want to trigger the application of IRC §2036 and cause inclusion of the FLP interest in the parent's estate. This can be accomplished by revising the partnership or operating agreement and having the parent document control over the FLP. Then, an IRC §754 election can be made, which can allow the heirs to get a basis step-up.

HIGH NET-WORTH TAXPAYERS

Planning considerations for a high-net-worth individual include many factors such as if the taxpayer is middle-aged with a growing business or a widow(er) with an estate in excess of the $5.49 million (for 2017) exclusion and a portable exemption amount. The relatively higher income tax rates and fewer deductions (post-2012) on wealthier taxpayers could encourage such taxpayers to establish residency in a state with either no state income taxes or relatively low income taxes (as well as property taxes). For these taxpayers, creditor protection is often a major concern. If a small business is involved, business succession and retirement planning is important. Common bypass trust schemes may no longer address the complexity of the current transfer tax system, which includes the permanency of portability. Bypass trust schemes remain appropriate in a state (like Illinois) that has a significant estate tax with an exemption that is not portable.

> **Observation.** Estate plans of high-net-worth individuals that rely simply on portability forfeit the GSTT exemption in the estate of the first spouse to die. Thus, if grandchildren are included in the estate plan and the assets exceed the applicable exclusion, sole reliance on portability is not optimal for estate and GSTT purposes.

99. Ibid.

TAXABLE INCOME OF TRUSTS AND ESTATES

RETURN FILING AND SELECTING TAX YEAR

Upon a taxpayer's death, the decedent's assets become property of the decedent's estate, which is a separate entity from the decedent for income tax purposes. Any income those assets generate is also part of the estate and may trigger the requirement to file an estate income tax return. In general, an estate's net income, less deductions for the value of property distributed from the estate to heirs, is taxed to the estate.

> **Observation.** Examples of assets that generate income to the decedent's estate include savings accounts, certificates of deposit, stocks, bonds, mutual funds, and rental property.

A Form 1041, *U.S. Income Tax Return for Estates and Trusts,* is required if the estate generates more than $600 in annual gross income.[100]

The decedent and the decedent's estate are **separate taxable entities.** Before filing Form 1041, the executor must obtain an employer identification number (EIN) for the estate. The application is made using Form SS-4, *Application for Employer Identification Number (EIN).* The estate's EIN is in the format 12-345678X. An application for the EIN can be made online, or via fax or regular mail.[101] Form SS-4 asks for the yearend of the trust or estate. An estate's executor is not held to what is selected as the yearend on Form SS-4. Any yearend can be chosen that fits the estate's needs.

Tax Year Determination

For **calendar year** estates and trusts, Form 1041 and Schedules K-1 (which report distributions to beneficiaries) must be filed on or before April 15 of the year immediately following the year of death. For **fiscal year** estates and trusts, Form 1041 must be filed by the 15th day of the fourth month following the close of the tax year.[102] If more time is needed to file Form 1041, an automatic 5½-month extension of time to file can be obtained using Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns.*[103]

A trust must generally adopt a calendar year. However, a qualified revocable trust can make an election in accordance with IRC §645, under which the trust is treated and taxed as if it were part of the estate. The election is made using Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*. If the election is made, the estate (and, hence, the trust) can file using a fiscal year if the fiscal yearend is not later than the end of the month before the month of death.[104] By filing a timely extension for the estate (or trust if no probate estate exists), the Form 8855 receives an extended due date, thereby also extending the trust.[105] The fiscal yearend is established when the first Form 1041 is filed. The election period begins on the date of the decedent's death and ends two years after the decedent's death if Form 706 is **not** required. If Form 706 is required, the election period ends at the later of:

- Two years after the date of the decedent's death, or
- Six months after the final determination of liability for estate tax.[106]

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100. Instructions for Form 1041.

101. *Deceased Taxpayers—Filing the Estate Income Tax Return, Form 1041.* Feb. 7, 2017. IRS. [www.irs.gov/businesses/small-businesses-self-employed/deceased-taxpayers-filing-the-estate-income-tax-return-form-1041] Accessed on Jun. 12, 2017.

102. Instructions for Form 1041.

103. Instructions for Form 7004.

104. For example, if the date of the decedent's death is May 5, the fiscal yearend must end by the following April 30.

105. Instructions for Form 8855.

106. IRC §645.

If the decedent had multiple revocable trusts, they can be combined with the decedent's estate and a consolidated estate income tax return is filed for the combined entities. In this instance, both the executor and the trustee must indicate that they have elected consolidated reporting.[107]

> **Note.** For more information about the §645 election to treat a qualified revocable trust as part of an estate for income tax purposes, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust and Estate Taxation.

The executor or personal representative of an estate may elect **any** yearend provided it ends on the last day of the month and the initial year does not exceed 12 months in length. The election of a yearend is made by filing an initial Form 1041.

Common considerations for determining an estate's yearend include the following.

- The ability to defer income to the next tax year is particularly important if the decedent's estate holds an interest in a partnership or other pass-through entity.
- Managing tax rates can be an issue if the tax rates were different the year after the decedent's death.
- It is important to consider the capacity to pay tax (particularly if the estate will be open or the trust will be administered over a longer period) and to minimize the number of returns that need to be filed. A fiscal year ending a couple of months after the decedent's date of death is generally preferred if estate administration is anticipated to last longer than a year. This allows the $600 exemption to be claimed each year, for example.
- A calendar yearend may work better for estates that consist primarily of investment accounts if the decedent died early in the year. This facilitates reconciliation of Forms 1099.

Calculating the Tax

The taxable income of an estate or trust is computed the same way that it is for individuals, with certain modifications.[108]

For an individual, gross income is reduced by the cost of producing that income. The result is adjusted gross income (AGI). Taxable income is calculated by reducing AGI by certain other deductions. A tax table or rate schedule is then applied to taxable income, and the resulting tax is reduced by applicable credits. The same computational scheme is applied to estates and trusts. Gross income to an individual is also gross income to an estate or trust.[109] Expenses that an individual can deduct are generally deductible by estates and trusts.[110] AGI for a trust is only computed for limited purposes under IRC §67(e), but it is determined in the same manner as that prescribed for determining the AGI of individuals.

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107. IRC §645(a); Treas. Reg. §1.645-1. An election to consolidate is irrevocable. IRC §645(c).

108. See, e.g., IRC §§67(e) and 641(b).

109. See, e.g., Treas. Reg. §1.641(a)-2.

110. IRC §641(b). For example, these expenses include court costs, attorney and fiduciary fees, taxes, etc. See Treas. Regs. §§1.212-1(i) and 1.641(b)-1; and IRC §164.

Trust and estate taxable income is modified in several ways.

- Trusts that are required to distribute all of their income currently are entitled to a $300 personal exemption deduction.[111] For all other trusts, the personal exemption deduction is limited to $100. Estates are allowed a $600 exemption.
- Estates and trusts are not entitled to the standard deduction.[112]
- In general, estates and trusts must deduct distributions to beneficiaries when determining taxable income but only to the extent of distributable net income (DNI).[113]
- A trust is not entitled to a charitable contribution deduction under IRC §170, but amounts that are paid via the terms of a trust or an estate for public charitable purposes are deductible by both estates and trusts. In addition, amounts that are permanently set aside for a charitable purpose are deductible by estates and certain trusts.[114]
- Estates and trusts can deduct miscellaneous itemized deductions to the extent that such deductions exceed 2% of the trust's AGI.[115] However, IRC §67(e) provides that an estate or trust, in arriving at AGI, is entitled to a deduction for 100% of the "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate."

Note. For a more thorough discussion about trust and estate taxation, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust and Estate Taxation.

For more information about trusts, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Trust Accounting and Taxation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

PASSIVE ACTIVITY LOSS LIMITATIONS

IRC §469 generally limits deductions and credits derived from passive activities to the amount of income derived from all passive activities. This loss limitation rule applies to estates and trusts, and there are some unique applications of the rule to estates and trusts.

An activity is generally deemed passive if it involves the conduct of any trade or business and the taxpayer does not materially participate in the activity.[116] An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in their capacity as such, is involved in operations of the activity on a regular, continuous, and substantial basis.[117] For a grantor trust, material participation is determined at the grantor level.[118]

While the IRS's position is that only the trustee of the trust can satisfy the material participation tests of IRC §469, this position was rejected by the one federal district court that ruled on the issue.[119] In 2014, the U.S. Tax Court also rejected the IRS's position.[120] The Tax Court held that the conduct of the trustees acting in the capacity of trustees counts toward the material participation test as well as the conduct of the trustees as employees. The Tax Court also implied that the conduct of nontrustee employees would count toward the material participation test.

111. IRC §642(b).

112. IRC §63(c)(6)(D).

113. IRC §661.

114. IRC §642(c).

115. IRC §67(a) and (e).

116. IRC §469(c)(1).

117. Senate Report No. 99-313, 1986-3 CB 735.

118. See IRC §671.

119. *Mattie Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D. Tex. 2003). The IRS, while not appealing the court's opinion, continued to assert its judicially rejected position.

120. *Frank Aragona Trust v. Comm'r,* 142 TC 165 (Mar. 27, 2014).

Rental activities are considered passive, regardless of whether the taxpayer materially participates. However, for tax years of an estate that end less than two years after the date of the decedent's death, up to $25,000 of the passive activity losses attributable to all rental real estate activities in which the decedent actively participated before death are allowed as deductions.[121] Any unused losses and/or credits are deemed "suspended" passive activity losses for the year and are carried forward indefinitely until there is rental income (or other passive income) to deduct them against or the interest is entirely disposed of.[122]

> **Note.** The $25,000 offset for rental real estate activities is reduced by the amount of the exemption "allowable to the surviving spouse of the decedent for the tax year ending with or within the taxable year of the estate."[123]

Other issues concerning passive activity losses include the following.

- Losses from passive activities are first subject to the "at-risk" rules of §465.[124] Thus, if the losses are deductible under the at-risk rules, the passive activity limitations must be applied.
- Passive losses only offset passive income. They cannot be offset against actively earned income. Thus, portfolio income of an estate or trust must be accounted for separately and may not be offset by losses from passive activities. Portfolio income generally includes interest, dividends, royalties not derived in the ordinary course of business, and income from annuities.[125]
- If a trust or estate distributes its entire interest in a passive activity to a beneficiary, the basis of the property is increased (no deduction is allowed) by the amount of any suspended losses generated by that passive activity. Gain or loss to the trust or estate and the basis of the property to the beneficiary is then determined under the rules set forth in IRC §643(e).[126]

TAX RATE SCHEDULE

Estate and trust income that is **not distributed to beneficiaries** is subject to the following tax rates for 2017.[127]

If Taxable Income Is			
Over	But Not Over	The Tax Is	Of the Amount Over
$ 0	$2,550	15.0%	$ 0
2,550	6,000	382.50 + 25.0%	2,550
6,000	9,150	1,245.00 + 28.0%	6,000
9,150	12,500	2,127.00 + 33.0%	9,150
12,500 [a]		3,232.50 + 39.6%	12,500

[a] For taxable income above $12,500, the additional 3.8% net investment income tax of IRC §1411 applies.

> **Note.** Generally, net long-term capital gains are taxed at a maximum rate of 20%.[128]

121. IRC §469(i).
122. IRC §469(b).
123. IRC §469(i)(4)(B).
124. IRS Pub. 925, *Passive Activity and At-Risk Rules.*
125. IRC §469(e).
126. IRC §469(j)(12).
127. Rev. Proc. 2016-55, 2016-45 IRB 707.
128. IRC §1(h).

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) applies to trusts and estates.[129] The lowest applicable AMT rate is 26% and the maximum is 28%.[130] Trusts and estates are entitled to a $22,500 exemption.[131] The exemption is phased out if the trust or estate has alternative minimum taxable income (AMTI) that exceeds $75,000, with the phase-out rate set at 25% of AMTI exceeding $75,000.[132]

ESTIMATED INCOME TAX PAYMENTS

Trusts and estates must make quarterly estimated income tax payments in the same manner as individuals except that estates and revocable trusts are exempt from making estimated payments during the first two tax years.[133] For estates, estimated tax payments must be made on a quarterly basis for tax years that end two or more years after the date of the decedent's death. The rule is the same for revocable trusts that receive the grantor's residuary estate under a pour-over will or, if no will is admitted to probate, to a trust that is primarily responsible for paying the decedent's debts, taxes, and administration expenses.[134] However, an estate does not need to make estimated income tax payments for income earned before the decedent's death when the payments are due after death.[135]

> **Example 4.** George Knight died on December 15, 2016. His will stated "I give all of my property to the Trustee of the Knight Family Revocable Living Trust, which I created on August 5, 1989." The trust reports its income on a calendar year basis, but the executor of George's estate elected to report the estate's income using a fiscal year ending November 30.
>
> No estimated income tax payments are required for the estate for the fiscal years ending on November 30, 2017, and November 30, 2018. The trust is not required to make estimated income tax payments for the trust tax years ending December 31, 2016, and December 31, 2017. Estimated tax payments are required for the trust tax year ending December 31, 2018.

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> **Note.** Penalties for underpayment of quarterly estimated income tax apply to fiduciaries as well as individuals.[136]

Under IRC §643(g)(1)(a), "the trustee may elect to treat any portion of a payment of estimated tax made by such trust for any taxable year of the trust as a payment made by a beneficiary of such trust." The election must be made via Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries,* on or before the 65th day after the close of the trust's tax year.[137] Estates may also make this election, but only in the "taxable year reasonably expected to be the last taxable year" of the estate.[138] Thus, an estate may find itself in the position of claiming a refund of an overpayment of estimated taxes in a year other than its final year while the estate's beneficiary will incur an underpayment penalty in the same year. The beneficiary's underpayment penalty may result from an estate distribution during that year that is not taken into account for estimated income tax purposes.

When a trust elects to attribute the estimated income tax payment to the trust beneficiary, the payment made by the trust is "treated as a payment of estimated tax made by such beneficiary on January 15 following the taxable year."[139] The amount of tax attributed to the beneficiary is treated as a distribution by the trust (and is deductible by the trust in computing its income tax liability) and as taxable income to the beneficiary.[140]

129. IRC §59(c).
130. IRC §55(b)(1)(A).
131. IRC §55(d)(1)(D).
132. IRC §55(d)(3)(C).
133. IRC §6654(l)(2).
134. Ibid.
135. Ltr. Rul. 9102010 (Oct. 10, 1990).
136. See Instructions for Form 2210 and IRC §6654(l).
137. IRC §643(g)(2).
138. IRC §643(g)(3).
139. IRC §643(g)(1)(C)(ii).
140. Instructions for Form 1041-T.

BASIS CONSIDERATIONS FOR IN-KIND DISTRIBUTIONS

Under §643(e), the basis of property that is distributed in-kind by an estate or a trust is the "adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for…any gain or loss recognized to the estate or trust on the distribution." The estate or trust can make an election whether or not to recognize a gain or loss. Thus, an estate or trust has the option of treating an in-kind distribution as if it had been sold to the distributee at FMV. FMV is determined at the time of the distribution.[141]

The estate or trust recognizes a gain if the distributed property's value has appreciated or a loss if the distributed property's value has declined.[142] If the election is made, it applies to all distributions made during the tax year. However, losses may not be deductible. IRC §267(a) denies loss recognition on the sale of property between certain related parties. A trust and its beneficiaries are related parties under IRC §267.[143] Thus, if a property is distributed from a trust having an FMV less than its basis and the trust made the election under §643(e)(3), the trust cannot recognize the loss. However, an estate and its beneficiaries are not related taxpayers under IRC §267.

> **Note.** An election under §643(e) is made on the estate or trust's return for the tax year.[144] The election does not apply if the trust or estate has no DNI or the cash distributed from the estate or trust absorbs the DNI. In either of those situations, the trust or estate has no distributions that may be treated as taxable to the beneficiaries.

SPECIFIC BEQUESTS

IRC §643(e) has no application to property that is distributed in-kind to satisfy a specific bequest.[145] Thus, the basis of such property to the beneficiary is the same as it was in the hands of the estate or trust.[146] In essence, the transaction is treated as a sale or exchange.

Sale or Exchange

Appreciated property that is distributed in-kind to satisfy a pecuniary bequest (the gift of a specific sum of money) is treated as a sale or exchange by the trust or estate.[147] The transaction is treated as if the executor/trustee distributed cash and the beneficiary purchased the property with the cash. If there is a loss on the transaction, an estate can recognize the loss, but a trust cannot.[148]

> **Observation.** If a decedent funded a revocable trust during their life and directed the trustee (under the terms of the trust) to distribute a pecuniary bequest to the surviving spouse and there is a loss on the transaction, the trust cannot claim the loss. However, the trustee could sell the loss property, realize the loss for income tax purposes, and satisfy the surviving spouse's pecuniary bequest with cash.[149]

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141. IRC §643(e)(3)(A)(ii).

142. The distribution of loss property carries out DNI only to the extent of the property's FMV. In the case of an estate, the distributee assumes the basis of the property in the hands of the estate unless the estate elects to recognize the loss.

143. IRC §267(b)(6).

144. IRC §643(e)(3)(B).

145. IRC §643(e)(4). The requirements of IRC §663(a) must be satisfied.

146. IRC §643(e)(1).

147. Treas. Reg. §1.661(a)-2(f)(1).

148. IRC §§643(e) and 267.

149. Ibid.

SALE OF A DECEDENT'S PERSONAL RESIDENCE

Upon death, an executor may face the need to dispose of a decedent's personal residence. The basis of the residence must be determined under the IRS standard: FMV as of the date of the decedent's death under the "willing buyer, willing seller" test. The FMV is determined based largely on sales of comparable properties and requires more than a simple market analysis by a real estate agent.[150]

If the decedent was the first spouse to die, the executor must determine how the residence was titled at death. For a residence held in joint tenancy or tenancy in common, only the value of the decedent's share of the residence is included in the decedent's estate. The decedent's share receives a basis step-up to FMV under IRC §1014.[151]

For joint tenancies involving only spouses, the property is treated at the death of the first spouse as belonging 50% to each spouse for federal estate tax purposes.[152] This is known as the "fractional share" rule.[153] Thus, half of the value is taxed at the death of the first spouse and half receives a new income tax basis. The "consideration-furnished rule" is an important exception.

In 1992, the Sixth Circuit Court of Appeals applied the "consideration-furnished rule" of IRC §2040(a) to a pre-1977 husband-wife joint tenancy who included the entire value of land in the estate of the first spouse to die.[154] The consideration-furnished rule applied for joint tenancies created before 1977. Decedent's estates valued joint tenancy property by determining each spouse's contribution of funds to acquire the jointly owned property. Thus, if one spouse had no income over a period of time prior to the acquisition of the property, the other spouse's estate would include 100% of the value of the joint tenancy property in that spouse's estate. The full value was subject to federal estate tax but was covered by the 100% federal estate tax marital deduction. The entire property received a new income tax basis, which was the objective of the surviving spouse. Other federal courts have reached the same conclusion.[155]

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If the residence is community property, the decedent's entire interest receives a basis step-up to FMV. If the residence is held in joint tenancy with rights of survivorship, the decedent's interest is passed to the designated survivor.[156]

Observation. If a surviving spouse sells the marital home shortly after the first spouse's death, the survivor often realizes a loss largely due to the expenses incurred from the sale. If the survivor realizes a gain, the survivor is eligible for the $250,000 gain exclusion under IRC §121. The exclusion is a maximum of $500,000 if the sale occurs within two years of the first spouse's death.

150. Treas. Reg. §25.2512-1.

151. IRC §2040(b).

152. Ibid.

153. IRC §2040(a); and Treas. Reg. §20.2040-1(a)(1).

154. *Gallenstein v. U.S.,* 975 F.2d 286 (6th Cir. 1992).

155. *Anderson, et al. v. U.S.,* 96-2 USTC (D. Md. 1996); *Wilburn v. U.S.,* 97-2 USTC (D. Md. 1997); *Patten v. U.S.,* 116 F.3d 1029 (4th Cir. 1997); *Baszto v. U.S.,* No. 95-1319-CIV-T-23B (D. M.D. Fl. 1997).

156. IRC §1014(b)(6).

RESIDENCE HELD IN REVOCABLE TRUST[157]

A revocable trust is a common estate-planning tool. A decedent's personal residence held in a revocable trust and passed to a surviving spouse upon the first spouse's death continues to be held in a trust. The house receives a full step-up (or down) in basis to the current FMV at the death of the surviving spouse. If a house is distributed outright to a beneficiary and the beneficiary immediately sells the home, any loss is generally a nondeductible personal loss unless the home is first converted to a rental property before it is sold.

RESIDENCE SOLD BY ESTATE OR TRUST

If the residence must be sold by the estate or trust to pay debts or to pay cash distributions to beneficiaries, any loss on the sale might be deductible. That loss could potentially offset other income of the trust or estate, or it could flow through to the beneficiaries. However, the IRS's position is that an estate or a trust cannot claim such a loss unless the residence is a rental property or is converted to a rental property before it is sold.[158] This position has not been widely supported by the courts, which have determined that a trust or estate can claim such a loss if no beneficiaries use the home as a residence after the decedent's death and before it is sold.[159]

TERMINATION OF ESTATES AND TRUSTS

Once the administration of an estate is finished or a trust is deemed to be terminated for federal income tax purposes, the income of the estate or trust is taxable to the beneficiaries even if it has not been distributed to those beneficiaries.[160] The determination of whether a trust is terminated depends on whether the trust property has, in fact, been distributed to the trust beneficiaries.[161]

The period of administration of an estate is the "period actually required…to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests..."[162]

EXCESS DEDUCTIONS

If an estate or a trust, in its last tax year, incurs tax-deductible expenses that exceed the income of the estate or the trust, excess deductions result.[163] The personal exemption and any charitable deductions are not counted in calculating the excess deductions.[164] Any excess deductions flow through to the beneficiaries of the estate or trust.[165] The beneficiary can claim these excess deductions as itemized deductions on the beneficiary's income tax return for the tax year in which the estate or trust tax year ended.[166]

> **Note.** Estate administration expenses are deductible in computing the federal estate tax or the estate's income tax. However, such expenses are not deductible for both purposes.[167]

157. IRS Pub. 559, *Survivors, Executors, and Administrators.*
158. SCA 198-012 (Apr. 7, 1998).
159. See e.g. *Campbell v. Comm'r,* 5 TC 272 (Jun. 18, 1945); *Carnrick v. Comm'r,* 9 TC 756 (Oct. 23, 1947); *Crawford v. Comm'r,* 16 TC 678 (Mar. 30, 1951).
160. Treas. Reg. §1.641(b)-3(d).
161. Treas. Reg. §1.641(b)-3(b).
162. Treas. Reg. §1.641(b)-3(a).
163. IRC §642(h)(2).
164. Treas. Reg. §1.642(h)-2(a).
165. IRC §642(h)(2).
166. Instructions for Form 1041.
167. IRC §642(g).

The 2% Rule

In general, "excess deductions" in the final year of an estate or trust are miscellaneous itemized deductions (as defined in IRC §67(b)) in the hands of a beneficiary. It is possible that excess deductions that are allocated to a beneficiary would be allowed only to the extent that the aggregate of the deductions exceeds 2% of AGI.[168] IRC §67(e), however, provides that the 2% rule is not applicable to "deductions for costs which are paid or incurred in connection with the administration of an estate or trust and which would not have been incurred if the property were not held in such trust or estate."

In 2008, the U.S. Supreme Court in *Knight v. Comm'r,*[169] provided a broad test for the exception to the 2% floor for trusts and estates. The Court's test is whether the expense at issue is **commonly** or **customarily** incurred **outside** of a trust or an estate. If so, then the 2% floor applies and the exception does not. In *Knight*, the Court reasoned that because investment advisory fees are commonly incurred by individuals (not only trusts and estates), they do not qualify for the exception to the 2% rule (i.e., the 2% floor applies). However, the Court noted that it is possible that some types of advisory fees may exclusively relate to trusts and estates, in which case the 2% floor would not apply. Incurring advisory fees simply to comply with fiduciary "prudent investor" rules (i.e., the fiduciary obligation of investment advisors) is not sufficient to qualify for an exception to the 2% rule.

Shortly after the Supreme Court issued its opinion in *Knight*, the Treasury issued proposed regulations that became final regulations applicable to tax years beginning on or after January 1, 2015.[170] Under the general rule,[171] a cost incurred to defend a claim against a trust or an estate is commonly and customarily incurred by an individual but not if the claim challenges the trust's validity, administration, or existence.

The final regulations describe the applicability of the 2% floor to five specific types of costs.

1. Ownership costs that a trust or an estate incurs because of its ownership of property are deemed to be expenses that an individual owner would incur.[172] Therefore, such costs are subject to the 2% floor.
2. Certain tax preparation fees are **not** subject to the 2% floor. Those fees include preparation fees for estate tax returns, GSTT returns, fiduciary income tax returns, and a decedent's final individual income tax return. However, the cost of preparing all other types of returns is subject to the 2% floor.[173]
3. Investment advisory fees are generally subject to the 2% floor. However, in certain situations, the **excess** portion of the fee is not subject to the 2% floor. Those situations include incremental costs of investment advice that go beyond what a normal investor would be charged. This is advice rendered to an estate or a trust caused by an unusual investment objective or a need for balancing the interests of the parties that makes a reasonable comparison with individual investors improper. The excess portion of the fee (i.e., the amount that normally would not be charged) is not subject to the 2% floor.[174]
4. Certain types of appraisal fees are not subject to the 2% floor. These include FMV appraisals at date of death or at the alternate valuation date (six months after death); appraisals to ascertain a value when making trust distributions; and appraisals required for return preparation (estate, trust, or GSTT). All other appraisal fees are deemed those that an individual would incur (including insurance-based appraisals) and are therefore subject to the 2% floor.[175]
5. Certain fiduciary expenses are specifically listed as not subject to the 2% limitation. These include probate court fees and costs, fiduciary bond premiums, costs of providing notice to creditors and/or heirs, costs of providing certified copies of the decedent's death certificate, and costs of maintaining fiduciary accounts.[176]

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168. Treas. Reg. §1.642(h)-2(a).
169. *Knight v. Comm'r,* 552 U.S. 181 (2008).
170. TD 9664, 2014-32 IRB 254.
171. Treas. Reg. §1.67-4(b)(1).
172. Treas. Reg. §1.67-4(b)(2).
173. Treas. Reg. §1.67-4(b)(3).
174. Treas. Reg. §1.67-4(b)(4).
175. Treas. Reg. §1.67-4(b)(5).
176. Treas. Reg. §1.67-4(b)(6).

Bundled fees could end up with mixed treatment. If a single fee is paid that covers costs that are not subject to the 2% floor and others that are, the fee must be allocated between the two types of costs. Fiduciary fees, attorney fees, and accountant fees may be subject to mixed treatment.[177]

For fees that are **not** charged on an hourly basis, only the portion of the expense that relates to investment advice is subject to the 2% limitation.[178] This exception allows professional fiduciaries who calculate their fees as a percentage of the assets that they manage from being required to separate their fee into the categories of the various types of services that they provide. Thus, a fee schedule can be established for "investment management" (subject to the 2% limitation) and "other fiduciary services" (not subject to the 2% limitation).[179]

Any payments made to third parties out of a bundled fee that would have been subject to the 2% limitation if paid directly by an estate or trust are not required to be allocated. Similarly, no allocation is necessary for expenses assessed by a payee of the bundled fee for services that are commonly or customarily incurred by an individual.[180] Any reasonable method can be used to allocate fees between those subject to the 2% floor and those that are not. Treas. Reg. §1.67-4(c)(4) lists certain factors that can aid in making the allocation.

NET OPERATING LOSSES[181]

The final tax year of the decedent closes at the date of death. A net operating loss (NOL) in the final short year can be carried back to offset income from earlier years. However, carrying an NOL forward presents a problem. An NOL carryforward does not transfer to a decedent's estate.[182]

The NOL deduction available to estates and trusts is computed in a manner similar to NOLs for individuals. However, because an NOL computation is a measurement of economic business loss, NOLs tend to be fairly uncommon for estates and trusts. This is because NOLs can only result when business activities are conducted within the entity. Estates are more likely to incur NOLs than trusts because estates more frequently must deal with the closing of a business entity on behalf of a decedent.

NOL Computation

Certain expenses deducted on a fiduciary income tax return may be allocable partially to business income and partially to nonbusiness income. Examples include real estate taxes, interest expense, legal fees, and court costs. Only the portion of these expenses allocable to business income can generate an NOL.

Legal fees paid during the course of probate administration often generate a fiduciary NOL. In calculating a fiduciary NOL, the assets of the estate must be examined to determine which portion of these fees relates to business income and which portion relates to nonbusiness income.

> **Note.** An NOL cannot be generated by fiduciary fees because a fiduciary's administrative responsibilities to the estate or trust do not constitute an active trade or business for purposes of IRC §172.

177. Treas. Reg. §1.67-4(c)(1).

178. Treas. Reg. §1.67-4(c)(2).

179. Treas. Reg. §1.67-4(c).

180. Treas. Reg. §1.67-4(c)(3).

181. This section is adapted from the 2016 Iowa Bar Association Tax Manual by A. David Bibler, et al., and is used with permission.

182. Rev. Rul. 74-175, 1974-1 CB 52.

Example 5. John Stevens, a retired farmer, died on October 5, 2015. At the time of his death, his estate was composed of several tracts of farm real estate (operated on a crop-share basis), several life insurance policies upon which John retained ownership, and an investment portfolio that included stock, mutual funds, certificates of deposit, and annuities. The first fiduciary income tax return filed for John's estate covered the period from October 5, 2015, through September 30, 2016. It reflected taxable income of $18,500, upon which the estate paid federal and state income taxes.

The second fiduciary income tax return covered the year ended September 30, 2017. The estate return reflects the following income and expense information.

Interest income	$ 1,196	
Capital gain (Schedule D) — sale of farm equipment	752	
Net farm income (Form 4835/Schedule E)	1,636	
Form 4797 (§1245 recapture)	1,021	
Total income	$ 4,605	$ 4,605
Real estate taxes (farm)	$ 140	
Legal fees (probate administration)	12,236	
Court costs (administration)	1,735	
Total expenses	($14,111)	(14,111)
Adjusted total income (loss)		($ 9,506)
Less: exemption		(600)
Taxable income (loss)		($10,106)

Because the estate reports a net loss for the year ended September 30, 2017, an NOL computation should be prepared to determine if an NOL exists that could be carried back to the first fiduciary return filed for the estate to obtain a refund.

Claim for Refund

If an estate or trust elects to carry back an NOL, it can file a claim for refund by using either Form 1045, *Application for Tentative Refund,* or an amended Form 1041 under rules similar to those for individual taxpayers. Generally, an NOL can be carried back two years and forward 20 years. The estate or trust may also elect to forgo the carryback of the NOL.[183]

> **Note.** The special carryback periods for certain types of losses also apply to activities of estates and trusts (e.g., three years for casualty and theft losses and five years for farm losses).

Effect on Beneficiaries

NOL carrybacks may have the effect of reducing DNI previously reported by income beneficiaries. Thus, when an NOL is carried back, income beneficiaries may be entitled to a refund on their individual return because the amount previously included in their gross income from the carryback year is limited to the estates' or trusts' DNI after application of the NOL carryback.[184] The correction in DNI applicable to the beneficiary is reflected on an amended Schedule K-1 when the estate/trust prepares its Form 1045 or amended Form 1041, *U.S. Income Tax Return for Estates and Trusts,* to carry back its NOL.

Income beneficiaries must file an amended return within three years of the due date of the return (including extensions) of the tax year of the NOL (i.e., a 2013 refund claim resulting from a 2014 calendar year estate/trust NOL carryback generally must be filed by April 15, 2018, if the 2014 estate/trust return was not extended).

183. IRC §172 (b)(3).

184. Rev. Rul. 61-20, 1961-1 CB 248.

Example 6. In 2014, the Sam White Trust had DNI of $35,000, which it distributed to Sam's wife, Mildred, the trust's sole beneficiary. In 2016, the trust sustained a $20,000 NOL that it carried back to 2015. The carryback results in the reduction of the trust's DNI for 2015 to $15,000 ($35,000 – $20,000). In 2017, Mildred files Form 1040X to claim a refund based on the reduction in taxable DNI reported on the trust's fiduciary income tax return after the NOL carryback. Mildred attaches her amended Schedule K-1 to Form 1040X to substantiate her claim.

Unused NOLs Upon Termination of an Estate or Trust

Any unused NOL carryovers existing upon termination of an estate or trust pass through to the beneficiaries of the estate or trust upon termination.[185] The unused NOL carryovers retain their character as NOLs on the beneficiaries' individual returns and can offset a beneficiaries' income over any remaining carryover life. If the final tax year of the estate or trust is the last tax year to which an NOL can be carried over (i.e., the 20th year under current carryover rules), any remaining NOL constitutes an excess deduction on termination.[186]

EXECUTOR/ADMINISTRATOR FEES RECEIVED[187]

An executor (or trust administrator) must include fees paid to them from an estate or trust in their gross income. If the executor is not in the trade or business of being an executor (determined under the regular, continuous, and substantial standard of IRC §469(h)), the fees are reported on the executor's Form 1040, line 21 (other income). If the executor is in the trade or business of being an executor, the fees received from the estate are reported as self-employment (SE) income on the executor's Schedule C, *Profit or Loss From Business,* or Schedule C-EZ, *Net Profit From Business.*

If the trust or estate operates a trade or business and the executor (or trustee) materially participates in the trade or business in their fiduciary capacity, any fees received that relate to the operation of the trade or business are reported as SE income on Schedule C (or Schedule C-EZ) of the executor/administrator's Form 1040.

VALUATION DISCOUNTING VIA FAMILY LIMITED PARTNERSHIPS

Note. In August 2016, the IRS issued proposed regulations under IRC §2704 that could have seriously impaired the ability to generate valuation discounts for the transfer of family-owned entities. On April 21, 2017, President Trump issued Executive Order 13789, a directive to the Treasury Secretary to reduce regulatory tax burdens by identifying regulations that either imposed an undue tax burden on taxpayers, added undue tax complexity to the Code, or exceeded the statutory authority of the IRS. The IRS identified the IRC §2704 proposed regulations for either simplification or repeal.

Valuation discounts are important succession planning tools. Discounting is a well-recognized concept by the Tax Court and other federal courts and is commonplace in the context of closely held businesses regarding lifetime transfers of interests in the business or transfers at death. Discounts from FMV in the range of 30–45% are common for minority interests and lack of marketability in closely held entities.[188]

185. IRC §642(h).

186. Treas. Reg. §1.642(h)-2(b).

187. IRS Pub. 559, *Survivors, Executors, and Administrators.*

188. See *Estate of Watts v. Comm'r,* TC Memo 1985-595 (Dec. 9, 1985) (35% discount of partnership interest for nonmarketability for federal estate tax purposes); *Peracchio v. Comm'r,* TC Memo 2003-280 (Sep. 25, 2003) (gifts of FLP interests discounted 6% for minority interest and 25% for lack of marketability).

While discounting can apply to interests in corporations, one of the most common vehicles for discounting is the FLP. The principal objective of an FLP is to carry on a closely held business in which management and control are important. In addition to nontax advantages, FLPs have the significant tax advantage of transferring present value as well as future appreciation with reduced transfer tax.[189] In many family businesses, the parents contribute most of the partnership assets in exchange for general and limited partnership interests. Discounts from the underlying partnership value can result from the nature of the partnership interest itself in terms of whether the transfer creates an assignee interest (an interest giving the holder the right to income from the interest, but not ownership of the interest) with the assignee becoming a partner only upon the consent of the other partners. A discount can also be a function of state law and provisions in the partnership agreement that restrict liquidation and transfer of the partnership interest.[190]

Observation. As use of FLPs has expanded, so has the focus of the IRS on methods to avoid or reduce the discounts. In general, FLPs have withstood IRS attacks and produce significant transfer tax savings. However, there are numerous traps for the unwary.

Example 7. Tom and Mary own a family business. They establish an FLP with the general partner owning 10% of the company's value and the limited partner interest owning 90%. Every year, Tom and Mary give each of their children limited partnership shares with a market value that does not exceed the gift tax annual exclusion amount. Mary and Tom progressively transfer business ownership to their children consistent with the present interest annual exclusion for gift tax purposes and significantly lessen or eliminate estate taxes at death. Even if the limited partners (children) together own 99% of the company, the general partner (parents) retain all control, and the general partner interest is the only partnership interest with unlimited liability.

The IRS has successfully limited or eliminated valuation discounts upon a finding of certain factors, such as formation shortly before death when the sole purpose for formation was to avoid estate tax or depress asset values with nothing of substance changed as a result of the formation.[191] However, while an FLP formed without a business purpose may be ignored for income tax purposes, lack of business purpose should not prevent an FLP from being given effect for transfer tax purposes. Valuation discounts are thus produced if the FLP is formed in accordance with state law and the entity structure is respected.

Note. The legislative history of Chapter 14 (IRC §§2701–2704) indicates that Congress intended ordinary minority and marketability valuation discounts to be respected, even in a family context.[192]

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189. See, e.g., *Estate of Kelley v. Comm'r,* TC Memo 2005-235 (Oct. 11, 2005) (FLP interest valued under net asset value method with 35% discount).

190. See, e.g., *Kerr v. Comm'r,* 113 TC No. 450 (Dec. 23, 1999).

191. See, e.g., *Estate of Beyer v. Comm'r*, TC Memo 2016-183 (Sep. 29, 2016); *Estate of Powell v. Comm'r*, 148 TC No. 18 (May 18, 2017).

192. See Omnibus Budget Reconciliation Act of 1990, PL 101-580, §11602(a); H.R. Conf. Rept. No. 101-964. However, see *Estate of Bongard v. Comm'r,* 124 TC 95 (Mar. 15, 2005).

IRC §2703 is of particular concern regarding the valuation issue. Under §2703(a), the value of property for transfer tax purposes is determined without regard to any restrictions on the right to use property. However, it exempts a restriction that is a bona fide business arrangement, is not a device to transfer property to family members for less than full consideration, and has terms comparable to those in an arm's-length transaction.[193] Much of the litigation in this area has involved FLPs and various restrictive agreements, but taxpayers have been successful in situations in which a legitimate business purpose can be established and personal assets are kept out of the entity.[194]

Note. Discounts based on restrictive agreements were allowed prior to enactment of the "freeze" rules that went into effect on October 8, 1990.[195] It is now much harder to achieve discounts via a restrictive agreement such as a buy-sell agreement. Currently, to depress the value of transferred interests, a buy-sell agreement must constitute a bona fide business arrangement, not be a device to transfer property to family members for less than full and adequate consideration, and have arm's-lengths terms.[196]

In addition, no valuation discount is allowed when an interest in a corporation or partnership is transferred to a family member and the transferor and family members hold, immediately before the transfer, control of the entity. In such instances, any applicable restrictions (such as a restriction on liquidating the entity that the transferor and family members can collectively remove) are disregarded in valuing the transferred interest.[197] The term "applicable restriction" does not include any restriction imposed by federal or state law.[198]

Observation. It is important to form the entity in a jurisdiction in which state law reinforces liquidation and dissolution provisions of the partnership agreement for §2704(b) purposes.

While the technical aspects of §§2703 and 2704 are important and must be satisfied, the more basic planning aspects that establish the tax benefits of an FLP must not be overlooked. These include the following.

- The parties must follow all requirements set forth in state law and the partnership agreement in all actions taken with respect to the partnership.
- The general partner must retain only those rights and powers normally associated with a general partnership interest under state law (no extraordinary powers).
- The partnership must hold only business or investment assets and not assets for the personal use of the general partner.
- The general partner must report all partnership actions to the limited partners.
- The limited partners must act to ensure that the general partners do not exercise broader authorities over partnership affairs than those granted under state law and the partnership agreement.

193. IRC §2703(b).

194. See, e.g., *Church v. U.S.,* No. 00-50386 (5th Cir. 2001).

195. See *Estate of Novak v. U.S.,* No. CV-84-0-511 (D. Neb. 1987). The "freeze" rules were enacted pursuant to PL 101-508, §§11601, 11602 (1990). The legislation added IRC §2701 *et seq*.

196. See IRC §§2701–2704.

197. The regulations provide that an applicable restriction is a limitation on the ability to liquidate the entity that is more restrictive than the restriction that would apply under state law in the absence of the restriction. Treas. Reg. §25.2704-1(a).

198. IRC §2704(b)(3).

FAMILY LIMITED PARTNERSHIPS AND IRC §2036

Under IRC §2036(a), a gross estate includes the value of all property that a decedent previously transferred for which the decedent retained for life:

- The possession or enjoyment of, or the right to the income from, the property; or
- The right to designate the persons who will possess or enjoy the property or its income.

Thus, the IRS may claim that because a general partner (or majority shareholder) controls partnership distributions, a partnership interest transferred by that partner should be taxed in that partner's estate.

In the typical FLP scenario, parents establish an FLP, then gift the limited partnership interests to their children and the parents (or parent) are the general partners (GP). In this situation, if the GPs have the discretionary right to determine the amount and timing of the distributions of cash or other assets (rather than the distributions being mandatory under the terms of the partnership agreement), the IRS could argue that the GPs have retained the right to designate the persons who will enjoy the income from the property transferred to their children. However, transfers made pursuant to a bona fide sale for an adequate and full consideration in money or money's worth are not included in the gross estate.[199]

> **Observation.** The "purpose clause" in a partnership agreement is critical. The clause can either be drafted as a 1-sentence general statement or it may take up an entire page. The length is not important. The actual reasons for creating the partnership are more important than what the agreement says. If the reasons for creating the partnership are explained in great detail, the stated reasons should be consistent with the actual purposes and not simply be a list of possible partnership purposes.

From a succession-planning perspective, it may be best for one parent to be the transferor of the limited partnership interests and the other to be the GP. For example, both parents could make contributions to the partnership in the necessary amounts so that one parent receives a 1% general partnership interest and the other parent receives the 99% limited partnership interest. The parent holding the limited partnership interest then makes gifts of the limited partnership interests to the children (or their trusts). The other parent retains control of the family assets. Unlike IRC §672(e), which treats the grantor as holding the powers of the grantor's spouse, IRC §2036 does not have a similar provision. Thus, if one spouse retains control of the partnership and the other spouse is the transferor of the limited partnership interests, then §2036 should not be applicable.

USE OF FORMULA CLAUSES FOR GIFTING/TRANSFERRING ASSETS

Formula clauses come in two general types: a definition clause and a savings clause. A **definition clause** defines a transfer by reference to the value of a possibly larger, identified property interest. A **savings clause** retroactively adjusts the value of a transfer due to a subsequent valuation determination.[200]

Taxpayers use formula clauses to avoid unintended gift, estate, and GSTT consequences when transferring property. The estate tax version utilizes the clause in a will or trust and involves the decedent leaving a set dollar amount of the estate to the decedent's children (or specific beneficiaries) with the residuary estate passing to a charitable organization. An alternative technique is for the estate to leave everything to a specific beneficiary, with that beneficiary having the power to disclaim whatever property the beneficiary desires to disclaim, and the disclaimed property is then passed to charity. The portion passing to the charity qualifies for the estate tax charitable deduction and, thus, puts a "lid" on the amount of estate tax owed. The technique can be very beneficial in minimizing tax on the transfer of assets from one generation to the next when family business assets that are difficult to value are involved.[201]

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199. IRC §2036(a).

200. *Formula Clauses: Adjusting Property Transfers to Eliminate Tax.* Skarbnik, John H. and West, Ron. Jan. 31, 2013. The Tax Advisor. [www.thetaxadviser.com/issues/2013/feb/skarbnik-feb2013.html] Accessed on Jul. 25, 2017.

201. Ibid.

The gift tax version works in a similar way by specifying via formula an amount of gifted property to be transferred to family members (or specified nonfamily beneficiaries), with the balance passing to charity.[202]

A benefit of using a formula clause is that it can prevent the IRS from increasing estate or gift tax by denying or diminishing valuation discounts. If the IRS succeeds in reducing a claimed valuation discount, the enhanced value either passes to a charity (estate tax formula clause) or is transferred to a charity (gift tax formula clause). The result is an enhanced charitable deduction on either Form 706 or Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* with no resulting increase in tax. The following cases illustrate this point.

- *McCord v. Comm'r*[203] involved a husband and wife that each held 41.17% of an FLP. They entered into an assignment agreement involving their children, GSTT trusts for the children, and two charities. Under the agreement, the McCords assigned all of their FLP rights to the assignees. A formula clause in the agreement specified that the children and GSTT trusts were to receive portions of the gifted interest having an aggregate FMV of over $6.9 million. If the FMV of the gifted interest exceeded $6.9 million, then a charity was to receive a portion of the gifted interest having an FMV equal to the excess, up to $134,000. If any amount of the gifted interest remained after the allocation to the children, the trust and the two charities received that portion, which was to be allocated by the assignees.

  The FMV of the assignee interest was determined to be $89,505. The agreement essentially changed the dollar value of what each donee received (based on an appraisal of the FLP interests at the date of the gifts) into percentages of FLP interests. Ultimately, the McCords were entitled to a charitable deduction of $324,345. The amount was calculated by subtracting the $6.9 million given to the children and a small amount given to another donee from the FMV of the property, which was approximately $7.37 million. The court upheld the defined value gift clause (e.g., "charitable lid"), stating that the gifts were complete as of the date of the assignment.

- In *Estate of Christiansen v. Comm'r*,[204] the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court in rejecting the IRS's position of refusing to recognize "defined value" types of formula clauses. In the case, a sole beneficiary of a South Dakota family ranching operation disclaimed all of the estate (under a fractional formula) in excess of $6.35 million. The disclaimed assets passed 75% to a charitable lead annuity trust (CLAT) and 25% to a foundation. The IRS and the estate agreed to increase the value of the gross estate by virtue of a reduction in the claimed valuation discount in the deceased mother's estate.[205] For the 25% passing to the charity, the IRS argued that a charitable deduction should not be permitted for the increased value because any increased amount passing to the charity was contingent on future events — the IRS's final determination of the value of the transfer.[206] In addition, the IRS claimed that the transfer violated public policy because it diminished the IRS's incentive to audit estate tax returns. The Tax Court and the Eighth Circuit rejected both arguments.

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202. Ibid.

203. *McCord v. Comm'r,* 461 F.3d 614 (Sep. 15, 2006), *rev'g* 120 TC 358 (2003).

204. *Estate of Christiansen v. Comm'r,* 586 F.3d 1061 (8th Cir. 2009).

205. The Tax Court held that the disclaimer as to the 75% that passed to the CLAT did not satisfy all the technical disclaimer requirements so the estate owed estate tax on that portion of the increased value of the estate. The estate did not appeal that aspect of the case.

206. The IRS position was based on Rev. Rul. 86-41, 1986-1 CB 300.

Observation. The case is a significant taxpayer win validating the use of defined value transfers when the transfer is made and allocated between a taxable and nontaxable portion based on gift or estate tax values or based on agreement. The case is also important for transfers whereby the amount transferred is defined by a formula that refers to gift or estate tax values. A value "enhancement" by the IRS (typically by denying or reducing a claimed valuation discount) works the same way that a standard marital deduction formula clause works in a will or trust. Under such a clause, an increased value allocates a larger value to the surviving spouse but does not generate additional estate tax. Until the *Christiansen* decision, it was not certain whether courts would uphold inter vivos defined-value transfers against a challenge on the grounds of public policy (even though standard marital deduction formula clauses in wills have operated in that same manner for decades).

- In *Petter v. Comm'r*,[207] Ms. Petter inherited several million dollars of UPS stock when UPS was a closely held company. The stock doubled in value at the time it became publicly traded. Utilizing a part-gift, part-sale transaction, Ms. Petter transferred her interests in an LLC to intentionally defective trusts. Pursuant to an agreement, a block of units in the LLC was first allocated to grantor trusts consistent with the gift tax exclusion and the balance was allocated to charities. The LLC interests were allocated based on value as determined by an appraiser, but the IRS claimed that the discount should be less and did not respect the formula allocation provisions for gift tax purposes. The court held that the formula allocation provision did not violate public policy. As a result, the gift tax charitable deduction was allowed for the full value passing to charity based on the value as finally determined by the IRS.

- In *Hendrix v. Comm'r*,[208] the Hendrixes made a small gift to a charitable donee. The gift was a fixed dollar amount of stock that was transferred to family trusts, with the excess passing to the charity. The transfers to trust were structured as part gift/part sale transactions. Only the amount that the aggregate amount of the defined transfers to the trusts exceeded the consideration that the trusts paid was treated as a gift. The IRS objected on the basis that the defined value formula clause was not bona fide because it was not arm's length. The Tax Court, however, disagreed. The court noted that the transfers to the trusts caused the trusts to incur economic and business risk because, if the value of the stock as initially computed was undervalued, more shares would shift from the trusts to the charity.

- In *Wandry v. Comm'r*,[209] the taxpayer prevailed in the utilization of a defined value clause that was used to determine the FMV of gifts for gift tax purposes. The formula referenced a fixed dollar amount rather than a transfer of a fixed quantity of property. The Wandrys, a married couple, transferred interests in their family LLC valued at $261,000 to each of their four children. Interests valued at $11,000 were transferred to each of their five grandchildren. No residual beneficiary was specified if the IRS issued a redetermination of value. However, the transfer document specified that if a subsequent IRS valuation determination (or a court decision) changed the value of the gifted membership units, the number of the gifted LLC units would be adjusted such that the same value as initially specified would be transferred to each child and grandchild. The IRS challenged the use of the defined value clause to transfer fixed dollar amounts of LLC interests to the transferees. However, the Tax Court ruled that there is no public policy against formula clauses that simply define the rights transferred without undoing prior transfers (as opposed to a "savings clause").

207. *Petter v. Comm'r,* TC Memo 2009-280 (Dec. 7, 2009).

208. *Hendrix v. Comm'r,* TC Memo 2011-133 (Jun. 15, 2011).

209. *Wandry v. Comm'r*, TC Memo 2012-88 (Mar. 26, 2011).

Advising Clients

Based on the preceding cases, advice to clients can include the following points.

1. Formula clauses can be used to restrict the value of nonmarketable or difficult to value gifted property or bequests to establish specified amounts.
2. The formula clause utilized in *Wandry* is relatively easy to implement, but the IRS still views formula clauses as improper and will likely challenge them when it can. This is particularly true when a charitable donee is not involved.
3. If the client is inclined to benefit a charity, the type of formula clause used in *Petter* may be desirable.
4. When drafting formula clauses, it is critical to ensure that the gift is complete when the transfer occurs. Attorneys must make sure that the gift is deemed complete at the time of the transfer.
5. The transfer should always be reported on Form 706 or Form 709 (whichever is applicable). An accompanying statement may be required explaining that it may be necessary to adjust the amount of property being transferred due to judicial (or IRS) redetermination of value.
6. The capital accounts of partnerships and LLCs should match the transfer.
7. To avoid a *Procter*-like challenge,[210] transfer documents must not use any language that could be construed as a savings clause that takes property back. There should always be an unambiguous intent to transfer a set value of property rather than a percentage interest or number of membership units.

THE LIFE ESTATE/REMAINDER TRANSFER STRATEGY

The life estate and remainder transfer is a common estate- and succession-planning strategy. This strategy is often integrated as a component of a succession plan, but it is typically not the primary focus of a succession plan. It is also a simple way to own property and move it from one generation to the next. This technique is often employed in relatively smaller-sized estates, sometimes on an informal basis. Thus, an understanding of the basics of life estate/remainder arrangements is critical.

The life estate/remainder arrangement is a form of co-ownership that gives both the life tenant and the person or persons holding the remainder interest certain rights to the property. The life tenant has a current right to possession and the holder of the remainder interest has a right of possession upon the life tenant's death.

CREATION OF AND PROPERTY SUBJECT TO A LIFE ESTATE

A life estate can be created by gift or sale (by virtue of a deed), at death under the terms of a will or trust, by state law, or by a settlement agreement in divorce proceedings (or via court order). Most often, life estates are created with respect to real property, but they can also be utilized with personal property and even intangible personal property.

The life tenant has possession of the property subject to the life estate and is entitled to all of the income generated by the property. Accordingly, the life tenant is subject to the normal tax consequences associated with property ownership. For example, the life tenant is taxed on all of the income received from the property and can deduct items attributable to the property, such as real estate taxes, mortgage interest, depreciation (if the property is depreciable), and depletion (if the life estate is acquired by purchase).

If life estate property is sold, its income tax basis must be apportioned between the life estate interest and the remainder interest in proportion to the respective present values of the interests as determined by the IRS valuation tables. The IRC §7520 rate in effect at the time of valuation is used for this purpose.

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210. *Comm'r v. Procter,* 142 F.2d 824 (4th Cir. 1944), *cert. den. sub. hom.,* 323 U.S. 756 (1944).

The share of uniform basis allocable to each interest is adjusted over time. This occurs in the following ways.

- If the property is not sold during the life tenancy, the holder of the remainder interest receives the entire income tax basis in the property.
- If the life estate interest is sold, the life tenant's portion of uniform basis is disregarded for purposes of determining gain or loss.[211] This means that the gain on sale is equal to the amount realized on sale (i.e., the sale proceeds). The gain would most likely be capital in nature.

Note. If the life estate property is a personal residence, both the holder of the life estate interest and the remainder interest are potentially eligible for the IRC §121 gain exclusion. However, they would have to satisfy the §121(a) requirement to own and use the residence for two years during the 5-year period ending on the date of sale.

- If both the life estate interest and the remainder interest are sold during the life tenancy, the uniform basis of the property and the sale proceeds must be allocated between the life estate interest and remainder interest. This allocation is based on their respective values at the time of sale and determines gain or loss on the sale attributable to each respective interest.[212] Any gain is likely capital gain.
- If the holder of the remainder interest sells the property **after** the life estate terminates, gain or loss on the sale is determined by subtracting the uniform basis in the property from the amount realized on the sale.

Income Tax Basis

It is important to understand the basis rules associated with life estate/remainder arrangements. **Basis depends on how the life estate was created and acquired.**

- For a **granted** life estate/remainder arrangement, those **created by will or trust on the grantor's death,** the property receives a basis in the hands of the recipient of the life estate equal to the FMV at the time of the grantor's death.
- For a **reserved** life estate, those **created by deed when the grantor retains the life estate**, the full value of the property is included in the grantor's gross estate at death. The holder of the remainder interest receives a basis equal to FMV at the time of death.
- A carryover basis applies to a life estate/remainder interest that is created by a gift.
- For purchased interests, the basis is the purchase price.

Note. If the life tenant takes depreciation during the life tenancy, the uniform basis in the property is reduced accordingly.

211. IRC §1001(e).

212. See Rev. Rul. 72-243, 1972-1 CB 233.

Estate and Gift Tax

A transfer of a life estate during life by deed qualifies as a present interest gift (and qualifies for the marital deduction if transferred to the transferor's spouse). However, gifts of successive life estate or remainder interests are future interests that do not qualify for the gift tax present interest annual exclusion. The amount of the gift equals the present value of the interest in the property transferred as determined using the IRS valuation tables. The §7520 rate in effect at the date of the gift applies.

> **Note.** If a grantor retains certain interests in the property and gifts the other interests in the property to members of the grantor's family, the special valuation rules of IRC §2702 apply. This discussion is beyond the scope of this material.

For interests created by will or trust, the entire FMV of the property is included in the decedent's taxable estate for federal estate tax purposes. For granted interests when the grantor retains the life estate, the full value of the property is included in the grantor's taxable estate at death. A life estate to a spouse at death does not qualify for the marital deduction unless it is in the form of a QTIP.

Planning Issues

The life estate/remainder arrangement is a very simple technique that involves minimal cost. It avoids probate because the property passes automatically to the remainder-interest holder. The strategy protects the property from the creditors of the remainder-interest holders during the term of the life estate. However, creditors of remainder holders can reach "vested" remainder interests.[213] This can indirectly cause problems for a life tenant who wants to sell or mortgage the property. Additionally, in some states, the life estate/remainder arrangement can provide a benefit in the event of the need for long-term care when a Medicaid benefit application is filed. For purposes of calculating benefit eligibility, only the value of a retained life estate is considered in determining eligibility and is subject to Medicaid recovery provisions at the recipient's death.

Alternatively, the life estate/remainder strategy can spur conflicts between the life tenant and the holders of the remainder interest. Neither the life tenant nor the remainder holders can independently sell or mortgage the property without the consent of the other party.

Summary Table

The table on the following page addresses a granted life estate/remainder arrangement but does not address retained life estates.

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213. A "vested" remainder is one that is certain to become possessory in the future.

Uniform Basis Rules for "Granted" Life Estate and Remainder [a]

	Transfer (Grant) Made during Life (Carryover Basis Gift Tax Rules)		Testamentary Transfer (Basis FMV DoD of Grantor)	
	Life Tenant	**Remainderman**	**Life Tenant**	**Remainderman**
Original basis at time of transfer	Uniform basis rules using carryover basis — gift tax rules (Treas. Reg. §1.1015-1(b))	Uniform basis rules using carryover basis — gift tax rules (Treas. Reg. §1.1015-1(b))	Uniform basis rules using FMV DoD (Treas. Reg. §1.1014-4)	Uniform basis rules using FMV DoD (Treas. Reg. §1.1014-4)
During life tenant's life	Entitled to depreciation (Treas. Reg. §1.1014-4(b))	No depreciation while life tenant living	Entitled to depreciation (Treas. Reg. §1.1014-4(b))	No depreciation while life tenant living
Complete sale by life tenant and remainderman during life tenant's life	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)	Allocate: sale price, basis (Determined Treas. Reg. §1.1014-5)
Sale by life tenant during life tenant's life	Allocated but disregarded [b] (Treas. Reg. §1.1014-5)	Allocated (Treas. Reg. §1.1014-5)	Allocated but disregarded [b] (Treas. Reg. §1.1014-5)	Allocated (Treas. Reg. §1.1014-5)
Sale by remainderman during life tenant's life	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)	Allocated (Treas. Reg. §1.1014-5 rules)
Death of life tenant before remainderman	Not subject to estate tax. Life estate terminates. No step-up basis.	100% remaining basis (after depreciation taken while life tenant alive). No step-up basis.	Not subject to estate tax. Life estate terminates. No step-up basis.	100% remaining basis (after depreciation taken while life tenant alive). No step-up basis.
Death of remainderman before life tenant	N/A	No adjustment to uniform basis, but heir's basis determined by adding to or subtracting from adjusted uniform basis assigned to remainder interest the difference between DoD value of remainder interest and basis of remainder interest before remainderman's death. [c]	N/A	No adjustment to uniform basis, but heir's basis determined by adding to or subtracting from adjusted uniform basis assigned to remainder interest the difference between DoD value of remainder interest and basis of remainder interest before remainderman's death. [c]
Death of remainderman after life tenant dies	N/A	Basis FMV 100% ownership (IRC §1014)	N/A	Basis FMV 100% ownership (IRC §1014)

[a] This table does not apply to lifetime transfers with retained life estates. It does apply, however, to split interests whether created by deed, trusts, or wills.

[b] IRC §1001(e).

[c] Treas. Reg. §1.1014-8(a)(1).