National Business Institute

Key Issues in Estate Planning and Probate

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Jeff Billings, Godfrey & Kahn, S.C.

I. SELECTED ISSUES IN PROBATE

a. Introduction

i. "Probate": Probate is a court-supervised procedure for transferring ownership of someone's assets after he or she dies. This process validates the person's Will and distributes property as the Will directs. Even if a decedent did not have a Will or other legal arrangement for transferring assets upon death, the Estate still goes through probate.

ii. Goal of Probate: The goal of probate is to protect the rights of heirs or other beneficiaries and others who have an interest in an Estate. Probate determines what the Estate owes in taxes and to creditors. Once probate officially distributes assets to the beneficiaries, those assets are free from any additional tax liabilities or creditors' claims, including claims based on medical assistance recovery laws.

iii. Property Subject to Probate Administration

1. All property "owned" by deceased (includes any interest a decedent may have in marital property) not transferred by reason of title or beneficiary designation.
2. Life insurance and retirement benefits pass outside of probate by reason of beneficiary designation unless Estate is the beneficiary.
3. Jointly held property with right of survivorship passes automatically to the surviving spouse outside of probate
4. Property held in a Living Trust passes as provided in Trust Agreement outside of probate.
5. Pay-on-Death (POD) accounts pass to designee outside of probate.

iv. Marital property (WI Stat Chapter 766)

1. All property of married persons is presumed to be marital property
2. Income earned or received after 12/31/85 or property acquired with such income is classified as marital property
    a. Wages, pensions, etc.
    b. Passive income, e.g., interest,

c. Dividends, rents (unless Unilateral Statement is executed). See §766.59.

3. Title is irrelevant in determining if property is marital property

4. Other classifications under the Marital Property Act:

   a. Individual Property: property acquired after 1/1/86 by gift or inheritance; property owned prior to marriage

   b. Pre-Determination Date Property: property owned prior to January 1, 1986; generally, treated the same as marital property, except on death, when spouse may elect to receive property that would have been marital property if the Act had been in effect throughout marriage (deferred marital property).

v. <u>Intestacy</u>: (WI Stat Chapter 852) governs disposition of probate property when there is no Will.

1. If surviving spouse:

   a. If no children, spouse receives all

   b. If children of marriage survive, spouse receives all

   c. If children from decedent's prior marriage survive, spouse receives one-half of decedent's individual property in addition to the one-half interest in marital property the survivor already owns, and children receive remaining one-half of Estate.

2. If no surviving spouse:

   a. To issue by right of representation (per stirpes)

   b. If no issue, to parents

   c. If no issue or parents, to brothers and sisters with descendants of deceased brother or sister taking his or her parent's share

   d. If no brothers, sisters, nephews, nieces, etc., then to grandparents, or if none, to cousins, etc.

3. If no one, escheat (school fund)

vi. <u>The Advantages of Having A Will:</u>

1. Ability to vary scheme imposed by law of intestate

    a. Succession

        i. Specific bequests

        ii. Memorandum concerning disposition of tangible personal property (WI Stat 853.32(2))

    b. Selection of fiduciaries: Personal Representative

        i. Non-residency - grounds for refusal of Court to appoint

        ii. Name successors

        iii. Multiple fiduciaries

        iv. Corporate fiduciaries

        v. The attorney as fiduciary

        vi. Compensation - statutory rate of 2% (WI Stat 877.05)

    c. Selection of fiduciaries: Guardian

        i. Residency

        ii. Guardian of person

        iii. Guardian of property

        iv. Minor's ability to nominate guardian at age 14

    d. Disposition of creditors' claims:

        i. 90 day claim period following published notice, except for known creditors or creditors who must be known who should be given actual notice (Pope case; §859.02(2).

        ii. Certain claims not barred - tort, tax, etc.

    e. Death Tax savings (when used in conjunction with Trust)

vii. <u>The Limitations of a Will: Other Considerations</u>

1. Burial arrangements - may not be effective if only in Will

2. Specific bequests to minors - use of custodianships under Wisconsin Uniform Transfers to Minors Act (§54.854 et. seq.)

3. Excluding beneficiaries - state intention
4. Bequests to animals - avoid
5. Coordinate disposition of nonprobate assets with plan
6. Burden of administration expenses and death taxes
    a. Tax clauses are extremely important and often are ignored or misused
    b. A "standard" clause that places the burden of paying taxes on the residue when there are substantial non-probate assets that produce tax may skew or disrupt intended disposition
7. Directions to or limitations on fiduciaries
8. Survivorship and lapse
9. An alternative to probate: the Living Trust

b. Types of Probate Administrations

i. Settling the Small Estate. The Probate Code contains three procedures whereby small Estates may be settled quickly and efficiently.

1. *Summary Settlement. WI. Stat. §867.01*
    a. Availability. The court shall summarily settle the Estate of a deceased person without the appointment of a Personal Representative:
        i. Whenever the Estate, less the amount of the debts for which any property in the Estate is security, does not exceed in value any costs, expenses, allowances and claims.
        ii. Whenever the Estate, less the amount of the debts for which any property in the Estate is security, does not exceed $50,000 in value and the decedent is survived by a spouse or one or more minor children or both.
    b. Procedure. A person who has standing to petition for administration of the Estate, which includes a Personal Representative named in the Will or an heir or named

beneficiary in the Will, may petition the Probate Court for Summary Settlement.

i. Petition. The petition shall contain the following:

1. Facts illustrating the Estate's qualification for such procedure;
2. A detailed statement of property in which the decedent had an interest;
3. Names and addresses of all interested persons; and
4. Whether the decedent or decedent's spouse received medical assistance.

c. Order. If the court is satisfied that the Estate may be satisfied under Summary Settlement, the court shall:

i. Assign the property to the persons entitled to the same; any property not otherwise assigned shall be assigned to the surviving spouse or minor children or both;

ii. Order any person indebted to or holding money or other property of the decedent to pay the indebtedness or deliver the property to the persons found to be entitled to receive it; and

iii. Order the transfer of interests in real estate, stocks, bonds, titles of motor vehicles, or any other form of property.

d. Liability. Upon payment in accordance with court order, a person making payment is released from liability to the same extent as if he or she had made delivery to a Personal Representative of the Estate of the decedent.

2. *Summary Assignment. WI. Stat. §867.02*

a. Availability. The court shall summarily assign the Estate of a deceased person without the appointment of a Personal

Representative if the Estate, less the amount of debts for which any property in the Estate is security, does not exceed $50,000 in value and the Estate cannot be summarily settled (i.e., there is no surviving spouse or minor child).

b. Procedure. A Personal Representative, heir or named beneficiary may petition the Probate Court for summary assignment.

c. Petition. The Petition shall contain the following:

   i. A statement that the Estate does not exceed $50,000 in value and the Estate cannot be summarily settled (i.e., the decedent is not survived by a spouse or a minor child);

   ii. A statement as to whether, after the exercise of reasonable diligence, the petitioner has been able to locate the Will of the decedent;

   iii. A detailed statement of property in which decedent had an interest, property over which the decedent had a power of appointment, benefits payable on decedent's death, life insurance, joint and life tenancies and gifts made in contemplation of death;

   iv. Names and addresses of all creditors of the decedent;

   v. Names and addresses of all interested persons; and

   vi. Whether the decedent or decedent's spouse received medical assistance.

d. Order. If the court is satisfied that the Estate may be satisfied under summary assignment, the court shall:

   i. Decide all claims and assign the property to the creditors and persons interested who are entitled to it;

ii. Order any person indebted to or holding money or other property of the decedent to pay the indebtedness or deliver the property to the persons found to be entitled to receive it; and

iii. Order the transfer of interests in real estate, stocks, bonds, title of motor vehicles or any other form of property.

e. Liability. Upon payment in accordance with court order, a person making payment is released from liability to the same extent as if he or she had made delivery to a Personal Representative of the Estate of the decedent. Creditors and persons interested in the Estate who were not assigned the property to which they were entitled from the Estate may recover against those assignees whose assigned shares have been increased by reason of the fact that the creditor or person interested was not assigned the share of the Estate to which the creditor or person interested was entitled.

3. *Transfer by Affidavit. WI Stat. §867.03*

a. Availability. When a decedent leaves solely owned property in Wisconsin and such property does not exceed $50,000, an heir or guardian of the decedent may:

i. Collect any money due the decedent;

ii. Receive the property of the decedent if it is not an interest in or lien on real property; and

iii. Transfer to him or her any evidence of any interest, obligation to or right of the decedent in property upon furnishing the person owing the money, having custody of the property or acting as transfer agent with an affidavit showing:

1. Description and value of property to be transferred;

2. Total value of decedent's solely-owned property in Wisconsin at the date of death;
3. Total value of any property in Wisconsin in which the decedent had any interest at date of death including Trusts, jointly-owned property and life insurance; and
4. Whether decedent or decedent's spouse ever received medical assistance.

b. Liability. Upon the transfer to the heir or person who was the guardian of the decedent, transferor is released to the same extent as if transfer had been made to the Personal Representative of the Estate.

ii. Understanding Formal vs. Informal Administration

1. *Formal Administration.* A formal probate proceeding is a judicial proceeding before the court involving the administration of the Estate of a decedent.
   a. Formal proceedings, either as to a particular issue or as to the entire subsequent administration of the Estate, may be initiated by the Personal Representative or by any interested person at any time by a written demand therefor.
   b. A demand for formal proceeding shall be served on the Personal Representative, if any, and filed with the court.
2. *Informal Administration.* Informal administration of an Estate means the administration of an Estate without continuous court supervision.
   a. Register in Probate oversees the procedure as opposed to court.
   b. Informal administration proceedings are circuit court proceedings and the same records shall be kept as for formal administration.
   c. Informal procedures may be used:

i. Where the decedent died testate and:

   1. Will does not prohibit use of informal administration;
   2. Will names a Personal Representative who accepts such appointment; and
   3. Bond is furnished if required.

ii. Where decedent died intestate or requirements of (2) and (3) are not satisfied and all interested persons request or consent in writing to informal administration and to the appointment of the same person as Personal Representative.

d. Where the Will of the decedent expressly prohibits informal administration it shall not be used.

c. Duties of the Personal Representative; Inventories/Claims

i. <u>How to Interview the Client</u>

   1. *Who is the Client?*
      a. Personal Representative nominated in the Will
      b. Estate of the decedent
      c. Surviving spouse or other family member of the decedent
   2. *Facts Related to Decedent*
      a. Name; residence at time of death and date domicile established; place of death; date of death; date of birth; social security number; occupation; marital status (including information related to previous marriages and any children from previous marriages); name of surviving spouse, if any, and address, date of birth and social security number of surviving spouse; names, addresses, phone numbers, birth dates and social security numbers of decedent's and surviving spouse's children and grandchildren.

b. Firm may have a general probate questionnaire they use to obtain necessary information. However, if your firm does not have such a questionnaire, review the general questions asked on pages 1-3 of the Federal Estate Tax Return Form 706 and the Application and Proof of Heirship.
c. Location of originals of Wills, Codicils and Trust Agreements
d. Location of safe deposit box and names in which box is held
e. Location of Gift Tax Returns filed with the Internal Revenue Service
    i. Transfers of property over $12,000 made within three years of death
f. Bank accounts—type, location, account number, ownership (sole or joint) and amount in account on date of death. Ask the client to provide a copy of the bank statement for the month of the decedent's death.
g. Name of stock broker, if any, and a list of securities owned, their approximate value at time of death and a copy of the broker's statement for the month of death. If the securities are in certificate form, request the original certificates.
h. Approximate value of personal property and real property, and copies of the deeds of conveyance to confirm manner in which title is held and property tax bills for the year prior to death.
i. Approximate amount of indebtedness
j. Information regarding life insurance and annuities including agent's name, company, policy number, face amount of policy, owner of policy and beneficiary
k. Whether deceased ever received public relief, old age assistance or veterans benefits

l. Copy of last income tax return filed with the Internal Revenue Service and name of accountant. It is important to review the income tax return for the period prior to death to make sure the activity shown on the return ties in with the asset information provided to you by your client.

m. Copies of any Trusts either established by the decedent or under which decedent possessed any power, beneficial interest or Trusteeship

ii. Determining Survivor's Immediate Needs

1. Budget of survivor's income and expenses
2. If expenses outweigh income, may need to make distributions or advancements to survivor from the Probate Estate.
    a. Verify they are authorized under Will

iii. Examining the Safe Deposit Box

1. Authority—joint occupancy, permission from bank
2. Contents—original of Will and other estate planning instruments, stock certificates, deeds

iv. Locating the Will

1. Places to check include the safe deposit box, a safe in the house, a vault in the attorney's office or a Trust company if they are named as Personal Representative.
2. People to ask include the surviving spouse or any other family member and the attorney who prepared the Will.

v. Confirmation of a Personal Representative

1. Domiciliary Letters
    a. Letters issued by the court appointing the Personal Representative
    b. Domiciliary Letters are granted to one or more of the persons hereinafter mentioned, who are not disqualified, in the following order:
        i. The personal representative named in the Will

ii. Any person interested in the Estate or the person's nominee within the discretion of the court
iii. Any person whom the court selects

2. Bond of a Personal Representative
    a. The requirement of a bond and the amount of the bond is solely within the discretion of the court, except that no bond shall be required of any Trust company bank which is authorized to exercise Trust powers.
    b. A direction or request in a Will that the Personal Representative serve without bond is <u>not</u> binding on the court.
3. Persons who are disqualified to act as personal representative including personal representative named in Will
    a. Under 18 years of age;
    b. Of unsound mind;
    c. A corporation not authorized to act as a fiduciary in Wisconsin;
    d. A non-resident of this state who has not appointed a resident agent to accept service of process in all actions or proceedings with respect to the Estate and filed the appointment with the court; and
    e. A person who the court deems unsuitable for good cause shown

vi. <u>Probate Process</u>

1. *Delivery of Will to Court.* Every person who has custody of a Will must, within 30 days after he has knowledge of the death of the testator, file the Will in the proper probate court or deliver it to the Personal Representative who in turn must file it.
    a. The proper probate court is in the county in which the decedent was domiciled at the time of his or her death in

Wisconsin, or if none, any county in Wisconsin in which the decedent held property.

2. *Who May Petition for Administration*
    a. Petition for administration of the Estate of a decedent may be made by any personal representative named in the Will or by any interested person.
    b. If no personal representative or interested person has petitioned within 30 days after the death of the decedent, petition for administration may be made by any person who was guardian of the decedent, any creditor of the decedent, anyone who has a cause of action or who has a right of appeal which cannot be maintained without the appointment of a Personal Representative or anyone who has an interest in property which is or may be part of the Estate.
3. *Application*. The application to initiate informal administration shall be verified and shall be directed to the Register in Probate.
    a. To begin the application process, the following mandated forms (available on the Internet at http://www.wicourts.gov/forms1/circuit.htm#probate) are submitted to the Register in Probate along with the original of the Will, if any:
        i. Application for Informal Administration (sets forth various facts regarding the decedent and his or her Will);
        ii. Waiver and Consent (If all interested parties are available and consent to the admission of the decedent's Will and the appointment of the nominated Personal Representative, each interested party may sign a Waiver and Consent which is filed with the Application. If interested parties cannot be

located or Waivers may not easily be obtained, it may be advisable to publish notice under WI. Stat. 865.05(1).);

iii. Proof of Heirship (identifies the parties interested in the probate administration);

iv. Statement of Informal Administration (signed by the Register in Probate to officially commence the probate administration);

v. Acceptance of Duties as Personal Representative (signed by the Personal Representative to indicate his or her willingness to act);

vi. Domiciliary Letters (signed by the Register in Probate to officially appoint the Personal Representative and are routinely asked for as proof of the Personal Representative's authority to transact business on behalf of the Estate); and

vii. Notice to Creditors (completed by the Register in Probate, identifies the deadline for filing claims against the Estate and is submitted to the appropriate publication for publishing notice).

b. Information needed to complete the application includes:

i. Jurisdiction of the court and interest of the party;

ii. Names and addresses of all interested persons;

iii. Name, age, domicile, address and date of death of the decedent;

iv. Whether decedent left a Will and the date of execution of the Will;

v. Name and address of person named as Personal Representative;

vi. Whether Will is already in possession of the court or accompanies the application and applicant believes the Will to have been executed properly or if there is no Will, applicant made diligent inquiry;

vii. Whether the decedent was receiving public assistance; and

viii. Approximate value of property subject to administration.

4. *Determination Made by Register in Probate*. Upon receipt of application for informal administration, Register in Probate shall determine whether:
    a. The application is complete;
    b. Court of the county in which the application is made has jurisdiction;
    c. Consents of all interested persons are complete and notice has been given to such interested persons by the Personal Representative;
    d. Decedent died testate or intestate and if testate, whether court has the Will and if the Will contains an attestation clause and does not expressly prohibit informal administration;
    e. Nominated Personal Representative is qualified to act as such (sound mind, resident of state, over 18 years of age, otherwise suitable); and
    f. Bond is required.
5. *Appointments.* Upon receipt of application and making determinations, Probate Register may:
    a. Enter a statement of informal administration;
    b. Admit Will to informal procedures; and
    c. Appoint nominated Personal Representative by Will or requested by interested persons
        i. By accepting appointment, Personal Representative submits personally to jurisdiction of court in any

proceeding relating to the Estate that may be initiated by any interested person.

6. *Proof of Will and Proof of Heirs Where Uncontested*
    a. The court may grant probate of an uncontested Will on the execution in open court by one of the subscribing witnesses of a sworn statement that the Will was executed as required by the statutes, testator was of sound mind, of full age and not acting under any restraint at the time of the execution thereof.
    b. If the Will contains an attestation clause whereby witnesses attest at the time of execution that the requirements listed above were complied with, the court may grant probate without any testimony or other evidence.
    c. Inclusion in a Will of an affidavit prescribed under WI. Stat. 853.04 is conclusive evidence that the Will was executed in compliance with WI. Stat. 853.03.
7. *Procedure: Informal Administration*
    a. At the commencement of probate, all interested parties in the proceeding must consent to the informal administration of the Estate.
    b. During the informal administration, a party may petition the court to change the administration to formal.
    c. Upon receipt of Will and petition, the court sets the date for hearing the petition. At the hearing, if no party objects, the court (formal) or the Register in Probate (informal) admits the Will and appoints the Personal Representative by the issuance of Domiciliary Letters.
        i. Domiciliary Letters entitle Personal Representative to transact all Estate business and are sent by the court (formal) or the Register in Probate (informal) to the Personal Representative, any person

interested in the Estate, and any person whom the court selects.

8. *Marshalling of Assets.* Upon letters being issued by the court or Register in Probate, the Personal Representative has title to all the property of the decedent and becomes a tenant-in-common with the surviving spouse in any marital property.
    a. Personal Representative must file an inventory of assets within six months after his or her appointment.
    b. Assets subject to probate that do not have a readily ascertainable market value may have to be appraised.
9. *Payment of Claims.* At the hearing to admit the Will, an order entitled "Notice to Creditors" is issued and published in the Daily Reporter for three consecutive weeks.
    a. The notice requires all creditors to file claims on existing obligations within three months.
    b. If the Personal Representative objects to any claim, the court will hold a hearing to determine the validity of that claim.
10. *Tax Returns*
    a. <u>Federal Estate Tax Return</u>. If the total value of the Estate (including probate and non-probate property) exceeds the applicable exclusion amount of the exemption equivalent (currently [$2,00,000] for federal purposes), the Personal Representative must file a Federal Estate Tax Return (Form 706) nine months after the date of death (or if an extension is filed for, 15 months after the date of death).
    b. <u>Federal Income Tax Return</u>. During the period of probate, the Personal Representative must file income tax returns for the Estate.
11. *Final Account.* The Personal Representative is not discharged until his or her final account has been filed with the court in the case of

formal administration or submitted to the beneficiaries in the case of informal administration and receipts have been filed for all distributions.

vii. <u>How to Obtain Information Concerning Assets</u>

1. Prior year income tax returns of the decedent
2. Accountant, attorney, stock broker, investment analyst who dealt with decedent
3. Personal Representative and others interested in the Estate such as the surviving spouse and other family members
4. Decedent’s personal papers, including any information and correspondence decedent receives in the mail after date of death

viii. <u>Dealing With Notice Requirements</u>

1. If notice of any proceeding in any court or informal administration is required by law or deemed necessary and manner of giving notice is not directed by law, notice shall be given either:
    a. By first class mail at least 20 days before the hearing or proceeding, or
    b. By personal service at least 10 days before the hearing or proceeding
2. The first notice given by mail in any administration must be accompanied by publication of notice published in a qualified newspaper (generally, the Daily Reporter in Milwaukee County). Check with the Register in Probate in the county which has jurisdiction over your Estate for the name of the legal publication and the address. Many of the Registers in Probate will forward the Notice to Creditors directly to the legal publication if they are provided with a pre-addressed stamped envelope directed to the newspaper.
3. *Notice Requirement Satisfied by Waiver.* Persons who are not minors or incompetent, on behalf of themselves and appointed guardians ad litem may in writing waive the service of notice upon

them and consent to the hearing of any matter without notice, except that a guardian ad litem cannot waive the notice of a hearing to prove a Will or for administration on behalf of those whom they represent.

4. *Notice Requirements Satisfied by Appearance.* An appearance by a person who is not a minor or incompetent is equivalent to timely service upon the person.

d. Tax Aspects of Probate

i. Probate Expenses.

1. The major probate expenses include court costs and fees paid to the Personal Representative and the attorney. The funds to pay those expenses come out of the Estate. The value of the Estate's assets will determine the court filing fees. Attorney fees vary depending on the complexity of the Estate. Also, fees vary from one attorney to another, depending on experience and other factors. Billing methods also differ. Some attorneys charge by the hour; others charge a fixed fee. But by law, the attorney cannot base charges for probate services on a percentage of the Estate's value.
2. Inventory Filing Fee: 2/10 of 1% (WI Stat 814.16)

ii. Selection of Fiscal Year: until the introduction of the Section 645 election for Trusts, a major advantage of having a probate proceeding was the ability on behalf of the personal representative to elect a fiscal year for income tax periods.

II. FACING TAXES AFTER DEATH – POST-MORTEM PLANNING

a. Alternative Valuation Date – What you Need to Know (Section 2032)

i. Introduction

1. Normally, assets of a decedent's gross estate are valued at date of death. However, if the personal representative makes an election under Section 2032, such assets may be valued as of the date six months after the decedent's date of death or, if sooner, when sold,

exchanged, or otherwise disposed of – referred to as the alternate valuation date.

2. The theory behind allowing an alternate date valuation is to limit the effect of changes in market or economic conditions occurring within a short time period after death and not accommodate changes caused by lapses of time or acts after death that affect the value of specific property.

ii. <u>Availability of 2032</u>

1. Only available if the election will decrease both:
    a. The value of the gross estate; and
    b. The sum (reduced by credits allowable against such tax) of the estate tax and generation-skipping transfer tax owed on the property included in the decedent's gross estate by reason of the decedent's death
2. Exception: if the election is made and property is distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death, the property is instead valued as of the <u>date</u> of such distribution, sale, exchange, or other disposition.
    a. This includes any method by which the property is no longer part of the decedent's gross estate, other than changes that are in form only (i.e. exchanges of property to which no gain or loss would be recognized, tax free stock exchange)

iii. <u>Application of 6 month Rule</u>

1. The six month period is measured in <u>months</u> and not in days, so that the alternate valuation date for an individual dying on February 28 is August 28.
2. When no day in the sixth month corresponds numerically to the date of death, the last date of the sixth month is used. (i.e. alternate valuation date for an individual dying on August 31 is February 28.

iv. <u>Income Producing Assets</u>

1. Interest-bearing obligations consist of two elements: (1) the principal of the obligation and (2) the interest accrued to the date of death. Each element is valued separately under 2032.
2. Interest accruing or earned after the decedent's death is not part of the gross estate and does not affect the alternate valuation.

v. Lapse of Time. An interest whose value is affected only by lapse of time is included at its value as of the time of death, adjusted only for changes in its value as of the alternate valuation date not due to lapse of time (i.e. patents, life estates other than the decedent, remainders, reversions, and other like properties).

vi. Making the Election

1. The election is made by the personal representative on the federal estate tax return (706).
2. If no return is filed, no estate tax is owed and therefore no election may be made.
3. Late elections can be made provided the return is filed no later than one year after the due date (including extensions of time to file actually granted)
4. Extensions for making the election itself can also be made.
5. The personal representative must file supporting evidence for statements made in the return as to any distributions, sales, exchanges, or other dispositions of property during the six-month period.
6. The election is irrevocable once made.

vii. Protective Election

1. Effective for decedents dying on or after January 4, 2005, the regulations specifically provide for a protective election. If, based on the return of tax as filed, use of the alternate valuation method would not result in a decrease in both the value of the gross estate and the sum of the estate tax and the GST tax liability, a protective

election may be made to use the alternate valuation method if it is subsequently determined that such a decrease would occur.

2. A protective election is made on Form 706. The protective election is irrevocable as of the due date of the return. The protective election becomes effective on the date that it is determined that use of the alternate valuation method would result in a decrease in both the value of the gross estate and in the sum of the estate tax and GST tax liability.

viii. Sophisticated Uses of the Election

1. The alternate valuation election will affect the ability to make other elections (i.e. 303 election corporate stock must exceed 35% of gross estate).
2. Even though the alternate valuation election may be available, not making the election and keeping higher gross estate values should result in a higher basis for income tax purposes. A higher basis in assets can reduce potential capital gains and increase depreciation deductions. The personal representative must weigh these potential benefits against the immediate benefit of a reduced estate tax liability.
    i. When the value of the gross estate decreases during the six-month period following the decedent's death, but the alternate valuation election is not available because the use of the marital deduction eliminates the federal estate tax, a qualified disclaimer by the surviving spouse to generate a small estate tax may be beneficial (Favorite mess up [self zeroing marital]: Be careful not to disclaim a pecuniary amount because then there will be no reduction in the estate tax liability!!).
3. *Query:* If the §2032 election is made and the alternate value later turns out to be higher than supposed at the time of the election, can

the election be revoked if the election results in a greater tax? For example, if the alternate value goes down due to a stock market drop but the real estate market goes up (and the personal representative incorrectly values the real estate too low), can the estate revert back to the date of death figures? (Best argument: invalid election).

ix. Miscellaneous Considerations

1. No estate tax deduction may be taken on any item covered by the alternate valuation.
2. Many Code sections refer to property valued as of the decedent's death. All such references refer to the value of such property used in determining the value of the gross estate.
3. *Special rule for insurance* – face amount of policy included (wife owns policy on husband's life, wife predeceases husband who dies within 6 months) (except for with respect to premiums paid by wife's estate).

b. Interpreting the QTIP Elections (2056)

i. Introduction

1. If a client desires a Trust to implement a marital deduction transfer, rather than an outright marital deduction transfer to a surviving spouse, the usual practice is to use a Qualified Terminable Interest Property ("QTIP") Trust. If certain conditions are met, a surviving spouse's income interest QTIP is treated (although terminable) as a deductible interest for purposes of the estate tax marital deduction. The entire property subject to the income interest is treated as passing to the spouse, and no interest in the property is considered to pass to any person other than the spouse, thereby precluding possible treatment as a nondeductible terminable interest.

ii. Requirements for QTIP. QTIP property is property that passes from the donor or decedent:

1. In which the spouse receives a “qualifying income interest” for life; and
    a. A qualifying income interest must meet the following conditions:
        i. The property must "pass" from the decedent to the surviving spouse.
        ii. The surviving spouse must be entitled to all of the income from the entire property interest (or a specific portion thereof) payable at least annually for life.
            1. Either the Trust must contain income-producing property or the surviving spouse must have the <u>right</u> to make the Trust property productive.
        iii. No power may be held by any person (including the surviving spouse) to appoint any part of the property to any person other than the surviving spouse during that spouse's life.
            1. No invasions of principal may be made by the Trustee (or any other person) for anyone other than the spouse.
            2. The surviving spouse cannot make direct lifetime gifts out of the QTIP trust.
        iv. The personal representative must irrevocably elect that the interest be treated as qualified terminable interest property (and, therefore, be deductible and, also, includible in the surviving spouse's estate).
2. For which an irrevocable election is made to treat the property as QTIP property.

iii. <u>The QTIP Election</u>

1. *Statutory Exception:* The personal representative must specifically elect on the estate tax return for the QTIP marital deduction to be available. The election, once made, is irrevocable.
    a. Because there have been so many problems with QTIP elections, the current position is the reverse of the statutory expectation: QTIP treatment is automatic unless the donor or the personal representative elects out of that treatment.
    b. Because there is no box to check on the estate tax return to indicate that the election is being made, listing the property on Schedule M and claiming the deduction constitutes the election.
2. Normally the election should be referenced in estate planning instruments, but an absolute limitation should <u>not</u> be placed on the personal representative concerning this election because the QTIP election permits considerable flexibility in post-mortem planning.
3. Care should be taken to ensure that the QTIP election is made correctly because of the potential negative estate tax consequences and the possible liability to the fiduciary. You may wish to insert a clause into your instruments stating that the personal representative is under no liability for any QTIP election and that no compensating adjustments or reimbursements shall be made with respect to the economic consequences of any election.

iv. <u>Transfer Tax Treatment of QTIP Property</u>

1. The lifetime disposition of the QTIP interest is treated as a transfer of all the property subject to the QTIP election and may be subject to gift tax. The gift transfer will be of (i) the entire value of the remainder interest in the qualified terminable interest property (or a specific portion thereof) and (ii) the income interest. The gift of all or any of the income interest would qualify for the gift tax annual donee exclusion, and may not be taxable if is under the

surviving spouse’s remaining Applicable Exclusion Amount exemption for gift tax purposes.

2. If the property subject to the qualifying income interest is not deemed to be transferred (in a gift tax context) prior to the death of the surviving spouse, the value of the property subject to the qualifying income interest will be included in that spouse's gross estate.

    a. Unless he or she directs otherwise by will, the surviving spouse's estate is granted a right to recover the estate tax paid (including penalties or interest paid) as a result of including the qualified terminable interest property in the spouse's estate. This tax is recoverable from the person or persons receiving such property.

    b. Another approach is to have the decedent donor of qualified terminable interest property direct in his or her will (or the relevant trust agreement) that the taxes (including state death taxes) attributable to the QTIP property will be paid from that property <u>before</u> distribution to the remainder beneficiary. This power should not violate the limitation on the availability of a power of appointment because the power is exercisable only at or after the death of the surviving spouse and such a power is permitted.

v. <u>Advantages/Planning Considerations of QTIP Election</u>

1. Tax Deferral

2. Equalization of Estates

    a. Death of surviving spouse before estate tax return is due

3. Income may not be sprinkled to other beneficiaries to take advantage of lower income tax brackets, however, this disadvantage may be tempered by the Trusts investment strategy (growth versus income producing) in appropriate situations.

4. Spouse may not make gifts directly from Trust – although surviving spouse may, as co-Trustee, distribute principal and then use that principal to make gifts (but the Trust instrument should not mention the power to make gifts).
5. State death tax liability
    a. QTIP property may not qualify for the marital deduction when determining a state death tax liability.
    b. In a state where qualified terminable interest property does not qualify for the federal marital deduction, that portion of the testator's estate necessary to qualify for the maximum allowable state death tax marital deduction might be transferred in another form which does qualify for the deduction.
    c. If not, a state tax liability would otherwise be generated that could reduce the marital gift deductible for federal estate tax purposes (unless under the tax allocation provision in the will this tax liability is allocated to other transfers).

vi. Unnecessary QTIP Elections

1. There may be reasons for not making the QTIP election. For example, the estate may not be taxable even without the QTIP election. Should an election be made under such circumstances, the IRS provides relief for the unnecessary election (i.e., where the estate does not require the QTIP election to reduce the estate tax liability to zero).
    a. When the estate follows the procedures listed in Rev. Proc. 2001-38,168 the IRS disregards the election, treating it as null and void for purposes of §§2044(a), 2056(b)(7), 2519(a), and 2652.
2. On the other hand, not making the election, thus paying some tax, may be beneficial because it may: (1) permit use of §303 or §6166;

(2) permit the credit for property previously taxed under §2013 to be used; (3) permit the use of the §691(c) deduction; (4) permit the use of flower bonds to pay the estate tax; (5) allow the taxable estates of the decedent and the spouse to be equalized; or (6)permit some other advantage.

vii. Partial QTIP Election

1. Partial QTIP elections are anticipated by the Code and regulations and they should be authorized by the estate plan so that postmortem planning may evaluate and adjust the size of the appropriate election.
2. Whenever possible, seek to draft self adjusting formula partial election clauses that adjust to changed values on audit and produce the optimum amount of tax on the death of the surviving spouse.
3. If making a partial election it is a good idea to allow the fiduciary to divide the Trust and or create separate shares for the elected and non-elected portions.

viii. Reverse QTIP Election

1. The personal representative must also bear in mind the potential reverse-QTIP election under Code §2652(a)(3). This election permits the personal representative to treat the QTIP property, which is now treated as if it belonged to the surviving spouse under Code §2044, as if it were still the decedent's for purposes of allocating his generation-skipping transfer tax exclusion amount.

ix. Inter vivos QTIP

1. Addresses the concern of the wealthy spouse dying first.
2. Until the advent of the inter vivos QTIP trust, the only way to address this concern was by outright lifetime gifts to the less wealthy spouse, by an inter vivos general power of appointment marital deduction trust (which gave the donee spouse unfettered power to dispose of the transferred property), or by a §2513 inter

vivos split gift to a third party (which took the property out of the marital coffers entirely).

3. Since its enactment in 1982, §2523(f) allows a spouse to create an irrevocable inter vivos QTIP trust to pay income to the other spouse for life with the remainder passing as the donor spouse originally designated in the Trust, or as the donee may appoint pursuant to a non-general testamentary power of appointment, if granted by the Trust. The donor spouse may make an inter vivos QTIP election under §2523(f)(4), making the initial transfer gift-tax free. On the donee spouse's death, the corpus will be includible in the donee spouse's gross estate, thus sheltering that spouse's unified credit, taking advantage of the donee spouse's GST exemption, or taking advantage of a full bracket run in the donee spouse's estate -- all without giving the donee spouse more control over the trust property than the donor chooses.

x. <u>Contingent QTIP Trust</u>

1. Under §2056(b)(3), a transfer to a surviving spouse will qualify for the marital deduction, even though such a transfer is conditioned on the spouse surviving by more than six months, if the spouse does so survive. Where an individual wishes to provide for a trust that will qualify for the marital deduction under §2056(b)(5), that is, the spouse will be given: (1) a right to withdraw the assets comprising the marital trust during lifetime; or (2) a testamentary general power of appointment, or both, consider providing that such right of withdrawal or power of appointment is contingent on the spouse surviving the decedent by at least six months. If the spouse does survive by at least six months, the trust will qualify as a marital deduction under §2056(b)(5). If the spouse survives but by less than six months, the trust will qualify as a marital deduction under §2056(b)(7) (assuming that the QTIP election is made properly).

2. By providing in this manner for the possibility that the spouses may die close in time to one another, the executor is better able to make a partial QTIP election that minimizes the estate tax liability of both estates because the executor is in a position to take into account the relative values of each gross estate, the credit for property previously taxed, and other factors.

xi. General Power of Appointment to surviving spouse

1. Be wary as the general power may make the Trust a 2056(b)(5) Trust. Although such a Trust would qualify for the Marital Deduction, partial QTIP elections and reverse QTIP elections would not be allowed (if you want a general power of appointment then either add a delay, as discussed above, or make the power subject to the approval of a third party) (but see TAM 8943005 allowing a general power of appointment and not discussing 2056(b)(5)).

xii. QTIP need not be made in Trust

1. Legal Life Estate can qualify as QTIP
2. Annuities, Employee Benefit Payments and IRAs may qualify as QTIP

xiii. Remedies available to deal with defective QTIP election

1. *Closing Agreement* – field offices instructed to allow fiduciary's to fix defects.
2. *Extensions* – automatic and discretionary available
3. *Protective Elections*
    a. A personal representative may make a protective QTIP election if there is a bona fide issue when the federal estate tax return is filed and it concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is to receive.
    b. The protective election, which is irrevocable, must identify either the specific asset, group of assets, or Trust to which

it applies and the specific basis for the protective election (such as because there is an ongoing will contest action that makes the marital bequest uncertain).

xiv. <u>Qualified Disclaimer as alternative to QTIP</u>

1. As an alternative to a QTIP election by the personal representative, or as an additional post-death mechanism to adjust the balance between the probable taxable estates of two spouses, a surviving spouse may be given the right to disclaim all or a portion of the trust assets for which the QTIP election would otherwise apply.
2. This disclaimed property could be deflected into a Trust which is structured to not otherwise qualify for the estate tax marital deduction or for which the QTIP election is not made (even if eligible). Consequently, the specific structure of that disclaimer Trust may be (and often should be) different from the QTIP Trust. The disclaimer Trust may then contain dispositive provisions such as sprinkling powers and remainder beneficiaries who differ from those individuals who take on termination of the QTIP Trust.
3. The Trust receiving the disclaimed property should not specify that the surviving spouse holds a special power of appointment because the IRS states that such a power in the disclaimant to direct the disposition of disclaimed property is not permissible. Furthermore, the disclaiming spouse should not be sole Trustee of a Trust into which the disclaimed property passes if the Trust has sprinkling provisions.

c. Making Redemption a Viable Means of Disposition With Section 303

i. <u>Introduction</u>. Distributions of stock by a corporation are treated as dividends (§301) unless the Code authorizes otherwise. Section 303 requires certain redemptions of stock to be treated as exchanges as opposed to dividends, subject to capital gain or loss.

ii. <u>Availability</u>

1. Not elective, an Estate either qualifies for 303 treatment or does not.
2. To be eligible under §303, the value of stock included in a decedent's gross estate must be greater than 35% of the amount by which the gross estate exceeds all amounts allowable as deductions under §2053 or §2054.
   a. Interests in two or more corporations are treated as one corporation if, with respect to each corporation, 20% or more in value of all outstanding stock (not just voting stock) is included in the decedent's gross estate.
   b. For purposes of this 20% requirement, stock held by the decedent and the decedent's spouse as community property, joint tenants, tenants by the entirety, or tenants in common is treated as having been included in the decedent's gross estate.

iii. <u>Effect</u>. Dividend income is converted to long-term capital gain (or loss). Because stock owned by a decedent at death receives a basis step up (§1014), often there is little or no gain (or loss) resulting from the redemption.

iv. <u>Limitations on 303 Redemptions</u>

1. *Stocks Redeemed*
   a. Stock eligible for 303 treatment must be the stock of the corporation that was included in the decedent's gross estate.
      i. If stock included in the decedent's gross estate is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, for purposes of §303, the new stock will be treated the same as the old stock.
   b. The redeemed shareholder is frequently the decedent's estate, but the section applies to any person who acquired

the stock from the decedent. However, §303 is <u>not</u> applicable to the case where stock is redeemed from a shareholder who has acquired the stock by purchase or in satisfaction of a specific monetary bequest or by gift from a person to whom the stock passed from the decedent.

2. *Amount Redeemed*
    a. The amount that may be redeemed and still qualify for §303 treatment is the sum of:
        i. Estate, inheritance, legacy, and succession taxes, including interest on such taxes, imposed because of the decedent's death; and
        ii. Funeral and administration expenses allowable as deductions under §2053.
    b. For distributions made more than four years after the decedent's death, the amount that is eligible for §303 treatment is limited to the lesser of:
        i. The amounts described above that are unpaid immediately before the redemption; or
        ii. The amounts described above that are paid during the one-year period beginning on the date of the redemption.
    c. The redemption proceeds are accorded §303 treatment only to the extent that the interest of the shareholder is reduced directly by or through a binding obligation to contribute to any payment for death taxes or funeral or administration expenses.

v. <u>Timing of Redemption</u>

1. Redemptions under §303 must be made after death and within one of the following periods:
    a. Within 90 days of the three-year period of limitations for the assessment of estate tax (§6501(a));

b. Within 60 days after a Tax Court decision becomes final with respect to a petition for re-determining a deficiency in such estate tax; or

c. If a §6166 election has been made, within the time determined for the payment of the installments.

vi. <u>Coordination with 6166</u>

1. A §303 redemption will <u>not</u> be considered a distribution of the interest in a closely held business for purposes of §6166 if the proceeds of the redemption are used to reduce the estate tax liability before the due date of the first installment.
2. See Rev. Rule 2003-61.

vii. <u>303 and the GST Tax</u>

1. Where stock is the subject of a generation-skipping transfer occurring at the same time as and as a result of the death of an individual, then, for purposes of §303, the following will apply:
   a. The stock is deemed to be included in such individual's gross estate;
   b. The generation-skipping transfer tax is treated as an estate tax;
   c. Estate, inheritance, legacy, and succession taxes imposed because of the generation-skipping transfer are treated as imposed because of such individual's death;
   d. The period of distribution is measured from the date of the generation-skipping transfer; and
   e. The relationship of stock to the decedent's estate is measured with reference solely to the amount of the generation-skipping transfer.

viii. <u>Other Planning Considerations</u>

1. Giving away non-business assets may enable the estate to satisfy the 35% threshold requirements (But – gifts made within three

years of death will be added back to the gross estate for purposes of satisfying this requirement).

2. The personal representative may consider creating voting and nonvoting interests and redeeming one or the other.
3. When an individual has interests in several corporations, the aggregate value of which exceeds the 35% test, but the individual interests in each fail to satisfy the 20% test, combining corporations to satisfy the 20% test may work.

d. Deferring Estate Tax – Extending Time for Payment (Section 6166)

i. Form 4768

1. Automatic 6 month extension to file 706.
2. A second extension, or any extension beyond 6 months requires a written explanation as to why it is impossible or impracticable to file timely.

ii. Section 6161

1. Section 6161 is broadly drafted to apply to any tax under any provision of the Code including the estate tax, the gift tax, and the generation-skipping transfer tax.
2. IRS may extend the time for the payment of the tax, or any installment of the tax. The extension may be for a reasonable period not to exceed six months for payment of the income or gift tax, and 12 months in the case of the estate tax, from the date fixed for the payment of the tax (9 months for Estate Tax).
3. Examples of Extension in Regulations (§20.6161-1(a)):
    a. An estate with liquid assets spread over several jurisdictions and not readily marshallable;
    b. An estate consisting largely of assets that are rights to receive future payments, such as royalties, against which it is difficult to borrow;

c. An estate consisting largely of assets whose collection will require a lawsuit and whose size is thus not presently ascertainable; and

d. An estate with insufficient funds to support the decedent's survivors and pay claims that are immediately payable.

4. Special rule with respect to the estate tax - an extension may be granted for reasonable cause (including a §6166 installment). The extension under this rule may not exceed a reasonable period and may not be for a period greater than 10 years from the date on which the estate tax return was due (or in the case of a §6166 installment, not greater than 12 months after the due date).

5. A extension may also be granted for payment of the deficiency for "a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency."

   a. Under §6161(b)(3), no extension may be granted for the payment of a deficiency that is due to negligence, intentional disregard of the rules and regulations, or fraud with intent to evade tax.

iii. <u>Section 6163</u>

1. Narrower in scope from 6161 or 6166 – deals with extensions for the payment of estate tax on reversionary or remainder interests.

2. When a reversionary or remainder interest is included in a decedent's gross estate, the personal representative may elect to postpone payment of the part of the estate tax that is attributable to that interest may until six months "after the termination of the precedent interest or interests in the property, under such regulations as the Secretary may prescribe."

3. At the termination of the unilateral extension period under §6163(a), the IRS may upon "reasonable cause" grant a further extension for a period or periods of up to three years.

4. IRS may require a bond for up to twice the value of the retained interest.

iv. <u>Section 6166</u>

1. *Introduction.*
    a. §6166 allows an personal representative to spread the payment of a part of the estate tax (the fraction which is attributable to the inclusion in the gross estate of a substantial interest in a closely held business) over two to ten equal installments, and allows at least a part of the interest on the unpaid balance of the tax to be paid at the rate of 2%.
2. *Estate's Eligibility*
    a. Must be U.S. Citizen or Resident Alien at time of death'
    b. The interest in a closely held business must have an estate tax value which exceeds 35% of the decedent's adjusted gross estate (gross estate less allowable deductions under 2053 and 2054).
3. *Limitations on 6166 Relief*
    a. Section 6166(a)(2) limits the amount of estate tax that may be paid in installments to:
        i. An amount which bears the same ratio to the [estate tax] (reduced by the credits against such tax) as –
        ii. The closely held business amount, bears to the amount of the adjusted gross estate
            1. 2057 opportunity (1997 -2004)
4. *Installments and Interest*
    a. Installments:
        i. Section 6166(a)(3) requires the first installment to be paid "on or before the date selected by the personal representative which is not more than 5 years after the date prescribed in §6151(a) for

payment of the tax." This means that the payment of the estate tax may be spread over a period of as much as 14 years from the date the taxpayer is generally payable.

b. Interest:

   i. Section 6601(j) establishes a 2% rate for interest payable on the deferred tax attributable to the first $1 million (adjusted for inflation) in taxable value of a closely held business.

   ii. Interest on the deferred tax that exceeds the 2% portion is payable at a rate equal to 45% of the annual underpayment rate established under §6621.463.

   iii. Section 6601(j)(4) provides that, if the deferred tax exceeds the 2% amount, any payment of a part of the deferred tax is treated as reducing the 2% portion by an amount bearing the same ratio to the payment as the 2% portion.

   iv. Section 6166(f)(1) provides that during the first five years after the date prescribed by §6151(a), interest is payable annually. Section 6166(f)(2) provides that for periods after the first five years after the date prescribed by §6151(a), interest is paid annually, at the same time as, and as a part of, each installment payment.

   v. In general, if an estate fails to pay principal or interest under §6166 on or before the date fixed for its payment (including any extension of time), the balance of the estate tax payable in installments is required to be paid upon notice and demand from the IRS.

5. *Making the Election*

   a. Section 6166(d) specifies that the election must be made no later than the time prescribed by §6075(a) for filing the estate tax return (nine months from the date of death), or on the last date of the extension of time for filing granted under §6081.

   b. If the election is made at the time the estate tax return is filed, it applies to the estate tax originally determined to be due and to the portion of any future deficiency which may be assessed which is attributable to a closely held business interest.

   c. If no election is made when the estate tax return is filed, the personal representative may elect under §6166(a) to pay the portion of the deficiency attributable to the closely held business interest (but not the tax originally determined to be due) in installments.

   d. An personal representative may make a protective election on a timely filed estate tax return before final determination of the tax or deficiencies to defer payment of so much of the tax as remains unpaid when values are finally determined or agreed to following audit, and of any deficiencies attributable to the closely held interest. This election, however, does not extend the time for the payment of any tax; a final notice of election is required within 60 days after values are finally determined or agreed to following audit, accompanied by payment of the tax and interest due and of tax that is not eligible for deferral.

6. *Special Rules*. A series of special rules apply to the proprietorship, partnership, and shareholder interest requirements in determining if there is an interest in a closely held business. Although review of

these rules is beyond the scope of this outline, the special rule categories are as follows:

   a. Husband and wife (§6166(b)(2)(B));
   b. Indirect ownership (§6166(b)(2)(C));
   c. Decedent's family (§6166(b)(2)(D));
   d. Farmhouses, etc. (§6166(b)(3));
   e. Partnership interests and stock which is not readily tradable (§6166(b)(7));
   f. Certain holding company stock (§6166(b)(8));
   g. Interests in two or more closely held businesses (§6166(c)); and
   h. Qualifying lending and finance business stock (§6166(b)(10)).

7. *Disposition of Interest*
   a. Section 6166(g)(1) provides that if any of the prohibited events listed below takes place and the aggregate of the distributions, sales, exchanges, or other dispositions and withdrawals from an interest in a qualifying closely held business equals or exceeds 50% of the value of that interest, the §6166(a) extension of time for the payment of tax ceases to apply, and the balance of the tax which was payable in installments becomes payable upon notice and demand from the IRS.
   b. The prohibited events are: (1) the distribution, sale, exchange or other disposition of any portion of the qualifying interest; and (2) the withdrawal from the underlying trade or business of money and other property attributable to the interest.
8. *Miscellaneous Issues*
   a. 6166 and 303

i. Section 6166(g)(1)(B)(i) provides that a redemption of stock to which §303 applies, is not treated as a §6166(g)(1)(A) distribution or withdrawal. In addition, for purposes of the subsequent application of §6166(g)(1)(A), the value of the closely held business interest is reduced by the value of the stock so redeemed.

b. Direct Skips

i. Section 6166(i) provides that if an interest in a closely held business is the subject of a direct skip that occurs at the same time as, and as a result of, the decedent's death, any generation-skipping transfer tax imposed by §2601 on the transfer of the interest is treated for purposes of §6166 as if it were additional estate tax, and is therefore eligible for installment payment treatment.

c. Stock Transferred within 3 Years of Death

i. Section 2035(c)(2) coordinates §2035 with §6166, providing: "An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of §6166(a)(1) only if the estate meets such requirement both with and without the application of [the §2035(a) inclusionary rule]."

e. Special Use Valuation Provides Alternatives in Valuing Certain Properties (Section 2032A)

i. <u>Introduction</u>

1. The §2032A election allows an personal representative to value certain farm and business real property at its actual use value instead of the value at its highest and best use. The purpose of §2032A is to help keep family farms and businesses within the family without having to sell these assets to pay the estate tax.

ii. <u>Estate's Eligibility</u>

1. Although 2032A is a relatively complex section of the Code, the following must be present in order to utilize 2032A:
    a. The decedent must be a U.S. resident or citizen;
    b. The real estate must be located in the United States;
    c. The real estate must have been in actual qualified use on the date of death by the decedent or a family member;
    d. The real estate must pass to a qualified heir of the decedent;
    e. The qualified use must have existed for five years or more out of the last eight years; and
    f. 50% or more of the adjusted value of the gross estate must consist of qualified real estate or qualified personal property and 25% or more of the adjusted value of the gross estate must consist of qualified real estate.

iii. <u>Making the Election</u>

1. Two separate appraisals will always be needed if the election is made:
    a. First, the property must be appraised at its highest and best use because that is the value used to determine whether the estate meets the percentage tests.
    b. Second, since the special valuation election cannot reduce valuation by more than $940,000 (for 2007) the preparer must also have its actual use valued to determine the difference between both values.
2. Making the Election itself is complex:
    a. To elect §2032A, the personal representative must first check the "yes" box on line 2, page 2 in Part 3 of Form 706.
    b. Next, Schedule A-1 of Form 706 is completed. On Form 706, the qualified real estate is identified by a notation of "Section 2032A valuation" on the applicable property schedule.

c. The personal representative must answer part 1 of Schedule A-1 by checking the box marked "Regular Election" and then complete all of Part 2 and Part 3 of Schedule A-1.

d. Part 2 includes all items required by Regs. §20.2032A-8(a)(3) and is called the "Notice of Election." Line 11 of Part 2 includes a box for checking the special woodlands election.

e. Part 3 of Schedule A-1 contains the Agreement to Special Valuation which must be signed by all qualified heirs and other interested parties.

3. To ensure that all requirements have been met for the §2032A election, taxpayers should use the checklist published in the instructions for Schedule A-1. The checklist covers the requirements for the notice of election and a fully executed agreement.

4. If the percentage tests are close, the personal representative can make a protective election on Form 706. Later, during the audit, if it is determined that the §2032A requirements are met, the election will be available. A §2032A election is virtually a guarantee of an audit, due to the complexity of the requirements for making an effective election. Absent the protective election, the use of §2032A would be prohibited.

5. The election, once made, is irrevocable.

iv. <u>GST</u>

1. If the estate is subject to the generation-skipping transfer (GST) tax, the §2032A election may also be used to reduce the GST tax. If a skip person is a qualified heir who also receives the qualifying property, that person will be responsible for the payment of the GST tax, as well as the regular estate tax, if there is a disposition of the property within 10 years of the decedent's death. In order to compute this additional GST tax, the preparer must attach

worksheets to Form 706 showing the GST tax savings as to each skip person receiving an interest in the qualifying property. The method for preparing the worksheets is found in the Instructions to Schedule A-1.

f. Avoiding Gift Tax with a Qualified Disclaimer

i. Pre 1976 Gifts

1. *The Test*

   a. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled;

   b. A refusal to accept ownership does not constitute a transfer;

   c. The refusal must be made within a reasonable time after knowledge of the existence of the transfer;

   d. The refusal must be unequivocal and effective under local law. Where the local law does not permit such a refusal, any disposition by the beneficiary, heir or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by that person;

   e. There can be no disclaimer after an acceptance of these rights, expressly or impliedly. Thus, if a beneficiary uses these rights for his own purposes, as by receiving a consideration for his formal disclaimer, he has not refused the right to which he was entitled.

ii. Post 1976 Gifts (Qualified Disclaimers)

1. The effect of a qualified disclaimer is that no transfer is deemed to have been made to or from the person making the disclaimer.
2. A qualified disclaimer is an irrevocable and unqualified refusal to accept an interest, or undivided portion of an interest, in property.
3. The refusal must be in writing, identifying the interest in property disclaimed, signed by the disclaimant or the disclaimant's legal representative, and delivered to the transferor of the interest, the transferor's legal representative, or the holder of the legal title to

the property to which the interest relates, no later than nine months after the date of the transfer creating the interest, or nine months after the disclaimant becomes 21.

4. The disclaimant must not have accepted the interest or any of its benefits. As a result of the disclaimer, the interest must pass, without any direction on the part of the disclaimant, either to the spouse of the decedent (or transferor) or to a person other than the disclaimant.
5. The qualified disclaimer rules apply to post-1976 transfers creating an interest in the disclaimant.

iii. <u>The Five Part Test for Qualified Disclaimers</u>

1. It must be in a writing that adequately describes the disclaimed property (the "writing test").
2. It must be received by the transferor, her legal representative or the holder of legal title to property no later than nine months after the later of:
    a. The date on which the transfer creating the interest in the disclaimant is made; or
    b. The date on which the disclaimant turns twenty-one (the "nine-month test").
3. The disclaimant must not have accepted the property or any benefits from it (the "no-benefit test").
4. The property must pass, without direction from the disclaimant, to either:
    a. The transferor's spouse; or
    b. A person other than the disclaimant (the "passage test").
5. The disclaimer probably has to meet a fifth test, which is the state law test of validity.
    a. In 1981, §2518 was amended to eliminate the possibility that no recognition would be given to a disclaimer that

complied with federal law, but did not comply with state law.

b. Under §2518(c)(3), recognition is given to a disclaimer that satisfies the requirements of federal law even though it does not satisfy the state law.

c. Thus, if the disclaimant gives written notice to the transferor of an interest (the transferor's legal representative, or the holder of legal title in the property to which the interest relates) within the required time period without having accepted the interest or any of its benefits, the disclaimer will be recognized regardless of whether it complies with local law.

iv. Effect of Qualified Disclaimer on Gift Tax Liability

1. Section 2518(a), added by the Tax Reform Act of 1976, provides that "if a person makes a qualified disclaimer with respect to any interest in property, this subtitle [the federal gift tax provisions] shall apply with respect to such interest as if the interest had never been transferred to such person."

2. In other words, a qualified disclaimer allows a beneficiary to pass assets to contingent beneficiaries free of gift tax liability.

v. Uses of Non-qualified Disclaimers

1. The "BAD" property example

2. The "BAD" person example

g. Qualified Plans – Distributions Options Can Save on Income Tax

i. Required Minimum Distributions (RMD)

1. *RMD during Life of Participant*

a. Most retirement plan benefits (Roth IRA's excluded) require RMD's to begin when the participant turns age 70½. The annual amount that must be distributed as RMD is based on IRS actuarially tables.

2. *RMD for Year of Death*

    a. If the participant had not yet taken the entire RMD in that year, the beneficiary must take that amount by the end of the year.

3. *Death before RMD:*
    a. RMD must begin no later then December 31 of the year after the year of the participant's death.
    b. Surviving Spouse (SS) as sole beneficiary – the applicable distribution period (ADP) is the SS's remaining life expectancy unless the 5 year rule applies.
    c. Sole beneficiary who is not SS – ADP of the individual is used unless the fie year rule applies.
    d. Multiple beneficiaries – absent the separate account rule and assuming all beneficiaries are individuals (or qualifying see through Trusts), the ADP is either the life expectancy of the oldest beneficiary or the 5 year, whichever is selected by the beneficiary. This is the only RMD rule that allows the beneficiary to choose.
    e. Non-see through Trust or other nonindividual beneficiary – the participant is deemed to have no designated beneficiary (even if individuals are named) and the 5 year rule applies. Retirement plan benefits must be completely paid out within five years.
    f. See Through Trust – individual beneficiaries of the Trust are treated as the individual beneficiaries.
4. *Death after RMD:*
    a. SS as sole beneficiary – the longer of the life expectancy of the SS or what would have been the life expectancy of the deceased spouse.
    b. Sole beneficiary who is not SS – the life expectancy of the beneficiary is used unless what would have been the life

expectancy of the decedent is greater (15.3 year max for decedent life expectancy based on IRS tables).

c. Multiple beneficiaries – payout is over the life expectancy of the oldest beneficiary unless what would have been the life expectancy of the decedent is greater.

d. Non-see through Trust or other nonindividual beneficiary – payout must be over what would have been the life expectancy of the decedent.

e. See through Trust – use life expectancy of the oldest beneficiary of the Trust unless what would have been the life expectancy of the decedent is greater.

ii. <u>Administrator's Plan</u>

1. Plan may require a faster payout then that dictated by IRS regulations. Many older plans simply allowed for lump sum payout, or for the choice between lump sum payout and payout over 5 years. Consider asking Plan Administrator to amend plan if needed.
2. Problem convincing Plan administrator to payout over specified period.

iii. <u>Special Rules for the Surviving Spouse</u>

1. *Significantly Younger Spouse Rule*

a. If SS is more then ten years younger the deceased spouse, must use joint and last survivor tables rather then uniform lifetime table.

2. *SS Life Expectancy re-calculated Annually*

a. When SS is sole beneficiary and withdraws benefits using her life expectancy that life expectancy is re-calculated annually.

3. *Spousal Rollover*

a. SS can rollover to another retirement plan, tax free, benefits inherited from deceased spouse and can also treat an inherited IRA from the deceased spouse as her own IRA.

4. *Rollover options when assets not left directly to SS*

   a. IRS regulations state that if a Trust is named as the beneficiary of the IRA, the spouse may not roll over the IRA, even if the spouse is the sole beneficiary of the Trust.

   b. However, a number of Private Letter Rulings ("PLR") have provided support that even if the decedent's benefits are left to a Trust, the surviving spouse can roll over the benefits—provided that the spouse has "the right to demand payments of the benefits to herself." Although no statute, regulation, or case law specifically acknowledges this principle, the following PLRs support this Principal

      i. 200549021, 200449040, 200304037, 200242044, 200136031, 199925033, 9811008, 9427035, 9426049, 9302022.

iv. Non-spousal Rollover (Pension Protection Act of 2006)

1. Before the Pension Protection Act of 2006 (the "Act"), a non-spouse beneficiary could not qualify for a direct rollover from a Qualified Plan to an IRA, nor could a direct Trustee to Trustee transfer be made between a Qualified Plan and an IRA. If a transfer was made between a Qualified Plan and an IRA the beneficiary would be required to report the transfer as a taxable event and include the entire transfer as income in the year of the transfer.

2. Under Section 824 of the Act, now codified in Section 402(c)(11) of Internal Revenue Code, however, effective for distributions after December 31, 2006, a Qualified Plan can offer a direct Trustee to Trustee rollover of a distribution to a non-spouse beneficiary. Provided that the distribution amount satisfies all the requirements

to be an eligible rollover distribution, the direct rollover is not treated as a taxable event.

3. In order to qualify as an eligible rollover, the direct rollover must be made to an IRA established in a manner that identifies it as an IRA with respect to the deceased participant and also identifies the deceased individual and the beneficiary. The IRA must also be treated as an inherited IRA pursuant to the provisions of Section 402(c)(11) of the Internal Revenue Code.
4. Although such a rollover is now permissible, a Qualified Plan must specifically permit non-spouse rollovers in order to take advantage of the new rollover option.

v. <u>“Qualifying” a Trust to receive Retirement Benefits</u>

1. *Conduit Trust*
    a. “Conduit Trust” is not an official term used by IRS, rather it is a nickname for a Trust under which the Trustee has no power o accumulate plan distributions made to the Trust.
    b. IRS treats RMD made to the Trust as being made directly to the individual beneficiary allowing the individuals to be considered Designated Beneficiaries. All potential remainder beneficiaries are disregarded because IRS treats them as “mere potential successors.”
    c. The Conduit Trust is a safe harbor for leaving retirement benefit plans into a Trust.
    d. Example Trust language creating conduit Trust:
        i. If any Trust created under Article ___, above, is a beneficiary of any retirement plan subject to the rules of Section 401(a)(9) of the Code, whether directly or by incorporation, including, but not limited to, Section 401(a) qualified plans, Section 403(b) plans, Individual Retirement Accounts and qualified deferred compensation plans under

Section 457 of the Code, and if, under the laws in effect at the time such Trust is created, the life expectancy of the individual for whose benefit such Trust is created cannot be used for purposes of calculating required minimum distributions for such benefits, then the Trustees shall segregate such benefits in a separate account of such Trust under Article ___, above, for the benefit of the individual, and the Trustees shall distribute to (or apply for the benefit of) the individual, not less often than annually, the required minimum distribution calculated under Section 401(a)(9) of the Code. The Grantors hereby authorize and empower the Trustees to take any action necessary to ensure that the individual's life expectancy for whose benefit such Trust is created may be used for purposes of calculating any required minimum distributions under Section 401(a)(9) of the Code.

2. *See Through Trust*
    a. The general rule is that a Trust cannot be a designated beneficiary, however, IRS allows you to disregard the Trust if the following rules are met:
        i. The trust is a valid trust under state law, or would be but for the fact that there is no corpus
        ii. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee
        iii. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A-1 of this section from the trust instrument

1. Identifiable is defined as follows: The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, to identify the class member with the shortest life expectancy.

iv. The documentation described in A-6 of this section has been provided to the plan administrator.

    1. A-6 Documentation is as follows:

        a. Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of September 30 of the calendar year following the calendar year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (b)(1), (2), and (3) of A-5 of this section are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

        b. Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

v. Not an official rule but derived from the other four rules: all beneficiaries under the Trust must be individuals.

b. The advantage of this type of Trust is that retirement plan distributions may be accumulated in the Trust.

h. The Final 1040

i. Introduction

1. Under §6012(b)(1), the personal representative, administrator or other person charged with the decedent's property must file any federal income tax return of the decedent for the period ending with the date of death.

ii. Joint Return

1. *Introduction*

a. Whether or not to file a joint return often depends on whether the estate's liability on a joint return will be lower than its liability under a separate return. This, in turn, depends on how the liability is apportioned between the estate and the surviving spouse.

b. By filing a joint return, the personal representative becomes liable jointly and severally with the surviving spouse for all tax and penalties. The liability may be apportioned between the personal representative and the surviving spouse as they agree. If they do not agree, apportionment is governed by local law.

c. If apportionment is by agreement, the personal representative and the surviving spouse should know the federal estate and gift tax implications of their agreement.

2. *Requirements for a Joint Return*

a. If at the time of his or her death the decedent was married, and if his or her spouse did not remarry during the balance of the year, a joint return can be filed. The joint return will include the decedent's income for the period ending on the date of his or her death and the surviving spouse's income for the entire year. If both spouses die in the same year, a joint return can be filed that includes the income of each for the period covered by his or her last return.

b. If the decedent or his or her personal representative or his or her surviving spouse filed separate returns for a year in which a joint return could have been filed, the personal representative can nevertheless file a joint return, with the consent of the surviving spouse, at any time within three years from the due date, without extensions, of the separate returns. Any election made in the separate returns, however, remains binding in the joint return if the election would have been irrevocable if the joint return had not been filed.

3. *Who may File:*

   a. An personal representative will need to file two income tax returns for a decedent who dies before filing his or her income tax return for the year preceding his or her death, namely: (1) the return for the prior year due by April 15 of the year of death (unless extended); and (2) the return for the year ending with the date of death, due on April 15 of the year following the year of death (unless extended). If all requirements for filing a joint return have been satisfied for both years, the personal representative will have to decide whether or not to file a joint return for the prior year as well as for the year ending with the date of death.

   b. If no personal representative has been appointed, the surviving spouse may file a joint return.

4. *Disaffirmance by Personal Representative*

a. Even if a surviving spouse files a joint return with the decedent, the personal representative who is subsequently appointed may disaffirm the joint return. Such disaffirmance must be made within one year after the last day prescribed for filing the return of the surviving spouse, including extensions. This may give the personal representative a second look at the tax consequences of any filing already made by the surviving spouse.

   i. The disaffirmance is made by filing a separate return for the decedent – upon which point the joint return is converted to the return for the surviving spouse by deleting any items in the return attributable to the decedent.

b. Regs. §1.6013-1(a)(1) provides that if a joint return has been filed by the spouses and the time for filing returns has expired, separate returns may not thereafter be filed. Thus, the filing of a joint return by the decedent, unlike the filing of a separate return, becomes an irrevocable election once the due date has passed and cannot be disaffirmed.

   i. Caveat: If the personal representative is appointed after the decedent has filed a joint return but before the due date for such return has passed, perhaps he or she can disaffirm the joint return by filing a separate return before the due date.

iii. <u>Medical Expenses as an Income Tax Deduction</u>

1. *Introduction*

   a. A medical expense incurred by the decedent but not paid before his or her death: (1) may be deducted under §2053(a) as a debt on the decedent's estate tax return; or (2) may be deducted as a medical expense on the decedent's income tax return for the year in which the medical expense was incurred pursuant to §213(c), if the expense is paid by the estate within one year of death.

b. To elect to take the deduction on the decedent's income tax return, the executor must file in duplicate: (1) a statement that the amount has not been allowed as a deduction under §2053 in computing the decedent's taxable estate; and (2) a waiver of the right to have such amount allowed at any time as a deduction under §2053. The statement and waiver must be filed with, or for association with, the return, amended return, or claim for credit or refund for the decedent covering any taxable year for which a medical expense is claimed as a deduction. The election may be made as to some or all of the qualifying medical expenses.

c. This is an area where the decedent should try to pay all medical expenses before he or she dies. The payment removes such funds from his or her gross estate and also will be deducted for income tax purposes to the extent authorized under §213. Because many individuals are not physically or mentally capable of handling financial affairs shortly before death, a trustee of a revocable trust or an agent acting under a durable power of attorney may make such payment.

2. *The Rate Game*

   a. The general rule is to deduct expenses first on the estate tax return since it will be taxed at 45%, and only then on the decedent’s final 1040 since the highest income tax bracket is 35%.

   b. The decision to make this election to deduct medical expenses on the income tax return does not rest simply on a comparison of the estate tax bracket with the decedent's income tax bracket. Any income tax due with the decedent's income tax return is a debt that will reduce the taxable estate and, correlatively, the estate tax liability.

c. If the decedent's estate will be subject to the federal estate tax and with estate tax rates currently higher than the federal income tax rates, one would expect to deduct the medical expenses on the federal estate tax return. This expectation is further bolstered by two facts:

    i. One is that, for income tax purposes, medical expenses are not deductible until they exceed 7.5% of adjusted gross income. As a result, a portion of such expenses will not be deductible unless the decedent had paid other medical expenses at least equal to 7.5% of his or her adjusted gross income.

    ii. The other fact is that any income tax that otherwise could have been saved by taking medical expenses as an income tax deduction will be deductible for estate tax purposes.

d. If the decedent's estate will not be subject to the federal estate tax, and this will be true for all but the luckiest of estates, then deducting such expenses on the income tax return will result in the most tax savings.

    i. Caveat: Many decedents survived by a spouse and with significant estates will have estate plans that take advantage of the §2010 applicable exclusion amount and the §2056 marital deduction in order to eliminate any estate tax payment. In these situations, it may seem that medical expenses ought to be deducted on the decedent's income tax return. But the executor also must consider who bears the burden of such medical expense payment.

1. Example: A decedent dies in 2007, has an estate of $4,000,000, has medical expenses of $25,000, and is survived by his second wife and his children from his first marriage. His estate plan provides a credit shelter trust for his children and a marital trust for his wife. The marital trust will qualify for the marital deduction and is to receive the smallest amount needed to result in the lowest estate tax liability after accounting for the applicable exclusion amount. Ignoring the medical expenses and assuming that the decedent's applicable exclusion amount is $2,000,000, each trust would receive $2,000,000. If the medical expenses are deducted for income tax purposes, the credit shelter trust will receive only $1,975,000. If the medical expenses are deducted for estate tax purposes, the marital trust will receive only $1,975,000.

iv. <u>Series E Bond Interest</u>

1. A cash-basis taxpayer need not report the increase in redemption value on a series E or EE U.S. savings bond and similar U.S. obligations received in exchange for series E bonds, e.g., series H and HH bonds, until such bond is redeemed or its year of final maturity. For simplicity, all such bonds are referred to as series E bonds.
2. The taxpayer, however, can elect to report all previously unreported E bond interest on his or her current return and thereafter report the E bond interest that accrues annually. The election is for all bonds, must be made on a timely filed income tax

return, and can be made for any taxable year. The IRS has ruled that an executor may make this election for the decedent on the decedent's final income tax return. The election, once made, is binding on the taxpayer.

a. The executor has several choices. The executor may make the election for the decedent or for the estate, or for both. If the executor makes the election for the decedent, such election is not binding on the estate. Similarly, if the executor makes the election for the estate, such election is not binding on the distributees of the bonds.

3. If the executor does not make the election for the decedent, the interest relating to the period before the decedent's death will be an item of income in respect of a decedent (IRD) and will be subject to income tax in the hands of the estate or the person who collects such interest. The recipient is allowed a deduction under §691(c) for any federal estate tax attributed to such income. But no deduction is allowed for state or foreign death taxes on such income. This mismatch is avoided if the executor elects to report the accrued interest on the decedent's final income tax return and obtains an estate tax deduction for the resulting income taxes imposed. This deduction, to the extent available for state and foreign death tax purposes as well as for federal estate tax purposes, avoids double taxation completely and the unfair result just described.

4. The election to accrue series E bond interest on the decedent's final income tax return may help use deductions that otherwise might be wasted. Additionally, the election can be used to help split income between the decedent and the estate if the decedent has little or no other income reportable in his or her final income tax return.

v. Requesting Prompt Assessment and Discharge of Liability

1. *Prompt Assessment*

a. Ordinarily the assessment of a federal income tax deficiency must by made by the IRS within three years after the return is filed. Under §6501(d), however, the executor can request that the assessment of any deficiency be made within 18 months after the request is made. Thus, if the request is made when the return is filed, the statute of limitations is reduced by half. The right to request a prompt assessment has several limitations. For example, it does not shorten the statutory period for assessment of a deficiency if no return was filed or if there was a substantial omission of income.

b. In many cases §6501(d) will be of little value because a request for prompt assessment may force the IRS to ask the executor to withdraw the request. If the request is not withdrawn, the executor must consider whether the IRS will feel compelled to make an arbitrary assessment within the 18-month period to protect the IRS's rights. Once the assessment is made, the government may feel obligated to substantiate it. Furthermore, such a request may trigger an audit where none might have occurred. The request would be useful where an audit is desired or where the executor feels confident that an audit would not lead to a deficiency.

2. *Discharge of Liability*

a. Under §6905 the executor can apply for release from personal liability for the decedent's income taxes. Upon receipt of such application, the IRS may notify the executor of the amount of such taxes. The executor is discharged from liability upon payment of the amount or, if no notice is given, nine months after the IRS's receipt of the application. This provision, like §6501, does not apply unless a return has been filed.

b. The discharge of the executor from personal liability does not discharge the liability or prevent the IRS from seeking payment from estate assets or from asserting transferee liability against the beneficiaries of the estate.

vi. Administration Expenses and Losses: Estate of Income Tax

1. *Introduction*

a. Section 642(g) provides that amounts allowable under §2053 or §2054 as deductions in computing the taxable estate of a decedent will not be allowed as deductions (or as offsets against the sales price of property in determining gain or loss) in computing the taxable income of the estate or other person unless the estate files a waiver of its rights to deduct such items on the estate tax return. From the operation of §642(g), an executor may elect to deduct certain items for income tax purposes or estate tax purposes, but the same expense may not be deducted for both purposes.

b. The IRS has liberally interpreted this election by ruling that: (1) the executor may select expenses to be deducted on the estate tax return and other expenses to be deducted on the income tax return; and (2) a single expense may be split between the two returns as the executor determines. For example, the executor may deduct a portion of his or her commissions on the estate tax return and the balance on the estate's income tax return.

2. *Effect and Availability of Election*

a. Certain expenses, such as funeral expenses, claims against the estate, and federal gift and income taxes cannot be deducted for income tax purposes because they represent nondeductible personal expenses and, thus, are not available for the §642(g) election.

b. Similarly, certain expenses will be deductible only on the estate's income tax return. Examples of such expenses include foreign, state, and city income taxes on income of the estate, property taxes accruing after death, interest accruing on obligations incurred by the estate, and interest accruing after death on obligations incurred by the decedent in those states that do not consider such interest to be an administration expense.

c. To claim an income tax deduction where §642(g) applies requires the executor to file a waiver, in duplicate, of the estate's right to deduct such items on the estate tax return. According to the regulations, the waiver need not be filed with the income tax return, but can be filed at any time before the limitation period applicable to such taxable year expires. By definition, when the estate has violated this regulation, the statute of limitations has expired with respect to the tax year for which the deduction was taken.

d. Even if the estate fails to file a waiver, §642(g) cannot be used to deny the deduction for estate tax purposes. But even though (1) no waiver has been filed, (2) the period of assessing the estate's income tax year in which the deduction was taken has expired, and (3) the deduction is allowed under the estate tax return, the IRS may be able to apply the doctrine of equitable recoupment to recoup part or all of the income tax deficiency.

e. No waiver is required when claiming a deduction on the estate tax return. Allowance of a deduction in computing the estate's taxable income is not precluded by claiming the deduction in the estate tax return as long as the estate tax deduction has not been finally allowed for estate tax purposes.

3. The same considerations with respect to medical expenses, discussed above, apply to whether or not to take expenses and losses on the estate or income tax returns.
4. *Tax Exempt Income*
   a. Where an estate has tax-exempt income, a portion of the estate's expenses not directly attributable to a class of income must be allocated proportionately to such tax-exempt income and not deducted for income tax purposes.
   b. This nondeductible portion may be deducted on the estate tax return and this is so even though a waiver of the estate tax deduction has been filed
5. *Cash Flow Needs*
   a. Cash needs of the estate must be taken into account when determining where administration expenses and losses ought to be deducted. Administration expenses can be deducted on the estate tax return before their actual payment provided that the expenses are ascertainable with reasonable certainty and will be paid. For the estate's income tax returns, however, expenses are deductible only for the tax year in which such expenses are paid.

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