

# Post Mortem Estate & Income Tax Planning

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## I. ESTATE TAX RETURNS

Calculation and remittance of federal and NYS estate tax is of primary concern in administering an estate. An estate tax return must be filed within nine months of the decedent's death, and payment must also accompany the Form 706. IRC § 6075. A request for an automatic six-month extension may be made on Form 4768. Such request must include an estimate of the estate tax liabilities, since an extension of time to file does not extend the time in which the tax must be paid. Any tax not paid on or before the due date (without regard to extensions) will attract interest at the underpayment rate established by IRC§6621(a)(2). IRC §6601(a).

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<sup>3</sup> Circular 330 disclosure: Any tax advice herein is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code.

New York imports most of the information contained on the federal 706 onto its own estate tax return, Form ET-706. Since the New York estate tax exemption amount is only \$1 million, an estate must complete and submit a federal Form 706 along with the ET-706 whether or not the federal Form 706 is required to be filed with the IRS.

## **II. NEW YORK STATE ESTATE TAX IMPOSED ON NONRESIDENTS**

New York imposes estate tax on a pro rata basis to nonresident decedents with property subject to New York estate tax. New York imposes no estate tax on nonresidents' intangibles. TSB-M-92 provides that "New York has long maintained a tax policy that encourages nonresidents to keep their money, securities and other intangible property in New York State." TSB-A-85(1) further provides that shares of stock of a New York corporation held by a nonresident are not subject to New York estate tax since shares of stock are considered intangible personal property.

TSB-A-08(1)M, provides that an interest of a nonresident in an S Corporation which owns a condominium in New York is an intangible asset provided the S Corporation has a legitimate business purpose. Presumably, if the S Corporation had only a single shareholder, and its only purpose was to hold real estate, New York could attempt to "pierce the veil" of the S Corporation and subject the condominium to New York estate tax in the estate of the nonresident.

Real property is generally taxed in the state where it is situated. Since LLC or partnership interests are intangibles, they would not be subject to New York estate tax. Therefore, nonresidents who own New York real property might consider converting the real property to personal property by contributing the real property to an LLC and taking back membership interests.

## **III. ELECTIONS TO DEFER PAYMENT OF TAX**

However, a request for an extension of time to pay the estate tax may be made under IRC § 6161 or IRC § 6166. Under IRC § 6161, an extension of up to ten years to pay the estate tax for "reasonable cause" or to prevent "undue hardship." Treasury regulations provide examples of what

may constitute reasonable cause or undue hardship. Under IRC §§6166, an election may be made to pay estate tax in installments over 14 years, provided a “closely held business” interest exceeds 35 percent of the estate.

#### **IV. ALTERNATE VALUATION DATE**

Under IRC § 2032(a), an executor may elect to value estate assets six months after the decedent’s date of death. The election, made on the estate tax return, can be useful if estate assets have depreciated between the date of death and the “alternate valuation date” (AVD). If the election is made to value estate assets on the AVD, it will apply to all estate assets. Any assets sold during the six month period preceding the alternative valuation date are valued as of the date of sale or distribution. The AVD election is made on Form 706. Therefore, if an extension to file the return is made, a decision to make the election can also be deferred until that time. Although the statute advises that “[s]uch election, once made, shall be irrevocable,” the regulations grant some latitude by providing that “in no case may the election be exercised, or a previous election changed, after the expiration of” the due date the return, with extensions. IRC § 2032(d); Treas. Regs., § 1.2032-1(b)(1). IRC § 2032(a)(3) precludes the use of the AVD for changes resulting from the “mere lapse of time.” In *Kohler v. Com’r*, T.C. Memo 2006-152, the Tax Court found that an estate could utilize a lower valuation where a post-death corporate reorganization reduced the value of the decedent’s stock. Following the Kohler decision, the proposed regulations were amended to provide that AVD could not be used for changes resulting from the mere lapse of time or “because of economic conditions.”

#### **V. THE DECEDENT’S FINAL INCOME TAX RETURN**

A decedent’s final income tax return must be filed by April 15 of the year following death. A joint return may be filed by the Executor if the decedent’s spouse did not remarry during the year. If no Executor has been appointed by the filing date, the surviving spouse may file a joint return. A later appointed Executor may revoke the surviving spouse’s election to file a joint return by filing

a separate return within one year from the due date of the return, including extensions. Liability issues may arise if a joint return is filed, since the Executor and spouse become jointly and severally liable for any tax and penalties, unless otherwise agreed. Therefore, as is the case with any joint return, the Executor should exercise caution before doing so, even if tax savings would arise by doing so. Income tax liability arising before death constitutes a bona fide debt of the estate. Accordingly, such tax liability may be deducted on the estate tax return. However, if a joint return is filed, only that portion of the income tax attributable to income for which the decedent was liable may be deducted on the estate return.

## **VI. INCOME IN RESPECT OF A DECEDENT**

IRC §691 provides that income earned by the decedent before death, but collected after death, must be reported as income by the decedent's estate. Such income is termed "income in respect of a decedent" or IRD. IRD items typically include (i) interest; (ii) salary or commissions earned; (iii) dividends whose record date preceded death; or (iv) gain portions of collections on a pre-death installment sale. IRC §2033 provides that a decedent's gross estate equals the value of all property to the extent of the decedent's interest at the time of death. Since IRD is an "interest" of the decedent at his time of death, IRD is also subject to estate tax. To mitigate the harshness of IRD being subject to income as well as estate tax, IRC §691(c) provides an income tax deduction equal to the difference between the actual estate tax payable and the estate tax that would have been payable had the IRD been excluded from the gross estate.

Note that IRD items, in contrast to most other items included in the gross estate, do not receive a basis step up at the decedent's death. IRC §1014(c). This can result in unnecessary income tax if the decedent sells appreciated property before death using the installment method to report gain. In this case, the gross profit ratio would be high, reflecting the appreciation in the property. Had the decedent's estate sold the property instead, there would be no gain because the property would have received a stepped up basis at the decedent's death under IRC § 1014(a).

The mirror image of income in respect of a decedent is "deductions in respect of a decedent" or DRD. IRC § 691(b). These deductions consist of expenses which the decedent accrued before

death but had not paid by the time of his death. DRD includes trade or business expenses, interest, taxes, depletion, and other items which were not deducted on the decedent's final income tax return. Since these items constitute debts, they may also be deducted on the decedent's estate tax return, thus providing the estate with a double benefit.

## VII. FIDUCIARY INCOME TAX

The decedent's estate must file a fiduciary income tax return by April 15th of the year following the year of the decedent's date of death, unless the estate chooses a noncalendar year. The primary reason for selecting a fiscal taxable year would be to achieve a deferral of income. Since all estate distributions to beneficiaries are treated as being made on the last day of the estate's taxable year, choosing a fiscal tax year may enable the executor to achieve this income tax deferral.

Under IRC § 6654(l), an estate must make estimated payments of income tax. However, estates are exempt from this requirement for two years. Since a revocable trust may elect to be taxed as an estate under IRC § 645, an electing revocable trust will also not be required to make estimated income tax payments for two years. To illustrate, assume decedent died on February 15th, 2011, and that the estate elected a taxable year ending on January 31st, 2012. Beneficiary receives a taxable distribution on March 31st, 2011. Since all estate distributions are treated as being made on the last day of the estate's taxable year, the beneficiary would be treated as receiving the distribution on January 31st, 2012, which is the last day of the estate's taxable year. This income would be reported by the beneficiary on his 2012 income tax return, due on April 15th, 2013.

When considering the concept of DNI, one should distinguish IRC § 102, which provides that gross income does not include the value of property acquired by gift or inheritance. To illustrate the distinction, assume decedent died on November 15th, 2011, seized of farmland in Iowa, and left the land to the trustees of a discretionary trust intended to benefit his daughters. There would be no DNI and no income tax with respect to the bequest itself. Income from the farm generated in 2011 until the date of the decedent's death would be reported April 15th, 2012, on the final income tax return of the decedent. The estate would report fiduciary income on its first fiduciary income tax return. Assuming all of the trust's distributable net income was distributed to the daughters in 2011, the trust

would deduct this DNI from trust income. The trust would report net income after the subtraction for DNI, and the daughters would report their respective shares of DNI.

If the terms of the trust required all income to be distributed to the daughters in a given year, and no principal was distributed, the trust would be a “simple” trust for income tax purposes for that taxable year. If the terms of the trust required all income to be distributed in a given year, but principal was distributed in that year, then the trust would be a “complex” trust for fiduciary income tax purposes. Finally, if the does did not require that all income be distributed, then the trust would be a complex trust for all tax years, regardless of whether principal distributions were made in that year.

Some expenses of administering an estate may be deducted on either the estate tax return or on the fiduciary income tax return. Remainder beneficiaries of a trust may be affected by the choice of where the deductions are taken. If an expense of administration is taken on the fiduciary income tax return, this will reduce income tax liability of the income beneficiaries of the trust. However, the burden will be shifted to the remainder beneficiaries, since the gross estate will be larger.

The Uniform Principal and Income Act has been adopted in 26 states, including New York. Five states, also including New York, have enacted statutes enabling trusts to adopt a “unitrust” definition of income. Thus, EPTL 11-2.3(b)(5)(A) provides that where the terms of a trust describe the amount that “may or must be distributed to a beneficiary by referring to the trust’s income, the prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable. . .”

Estates and trusts may also elect to treat distributions made within the first 65 days of the taxable year as being paid on the last day of the preceding taxable year. The election is made on Form 1041. IRC § 663(b). The election may not be made if the if the estate tax return is filed more than one year after the time prescribed by law (including extensions) for filing the return.

## **VIII. ADMINISTRATION EXPENSES**

Certain expenses incurred by the decedent and paid before death may be deducted only on the decedent's final income tax return. Those include (i) medical and other deductible expenses paid prior to death; (ii) capital loss carryovers; (iii) charitable contribution carryovers; and (iv) net operating loss carryovers. Medical expenses incurred before death but paid after death may be deducted either on the decedent's final income tax return (provided they are paid within one year of death) or on the estate tax return. To claim the deduction on the final income tax return, the executor must file a statement certifying that the expense was not claimed as a deduction on the estate tax return.

Expenses of administration actually and necessarily incurred in administering the estate are deductible. IRC § 2053; Treas. Regs. § 1.2053-3. Some estate administration expenses may be deducted either on the estate tax return or on the fiduciary income tax return. Under IRC § 642(g), no income tax deduction for expenses is allowed unless the executor files a statement with the IRS agreeing not to claim those expenses as deductions on the estate tax return. The election may be made on an item-by-item basis. Treas. Regs. § 1.642(g)-2. The election is irrevocable after the statement is filed. The waiver statement must be filed before the statute of limitations for assessment on the income tax return runs. Therefore, if it is unclear on which return it would be preferable to take the expenses, it may be prudent to wait until the statute of limitations is about to expire.

Expenses deductible either on the estate or fiduciary income tax return (or split between them) include (i) appraisal expenses; (ii) court costs; (iii) executor's commissions; (iv) attorney's fees; (v) accountant's fees; (vi) selling expenses; and (vii) costs of preserving, maintaining and distributing estate property. Medical expenses paid within a year of death may be deducted on either the 706 or the 1041, but may not be split.

Some expenses may be deducted only on the estate tax return. These include (i) personal expenses that are not deductible for income tax purposes (e.g., funeral expenses); (ii) income and gift taxes; (iii) or expenses incurred in producing tax-exempt income. Other expenses are deductible only on the decedent's final income tax return. These include (i) net operating losses of the decedent; (ii) capital losses of the decedent; and (iii) unused passive activity losses of the decedent. Deductions in respect of a decedent, which are the mirror-image of income in respect of a decedent, may be deducted on the fiduciary income tax return under IRC § 691(b), as well as the estate tax return



under IRC § 2053. These deductions consist of income tax deductions which accrued prior to the decedent's death, but which were never deducted on an income tax return. These expenses are also deductible under IRC § 2053 as estate administration expenses that reduce the size of the gross estate. Items of DRD include (i) IRC § 162 business expenses; (ii) IRC § 163 interest expenses; (iii) IRC § 212 expenses incurred in the production of income; and (iv) § 164 real estate taxes and state and local income taxes. Any loss carryovers which exist when the estate terminates may be utilized by the beneficiaries under IRC § 642(h).

In most cases, if there is an estate tax liability, it will be preferable to claim the expense on the decedent's estate tax return, since the estate tax rate exceeds the income tax rate. The estate tax is also due nine months after the date of the decedent's death, whereas the income tax may be deferred until a later year. However, the disparity has been reduced of late since the maximum estate tax rate is now 35 percent. If there is no estate tax liability — either because the taxable estate does not exceed the applicable exclusion amount, or the taxable estate has been vanquished by the marital deduction — then taking the deduction on the income tax return will be the only viable option.

Another situation where it would not be preferable to claim administration expenses on the estate tax return is where there has been a formula bequest in the Will to maximize the marital deduction. Taking the deduction on the estate tax return in this case would simply reduce the marital bequest — without any savings in estate taxes. If the marital bequest is designed to eliminate estate taxes, there is no need to produce additional estate tax deductions. Therefore, in this case, it would be preferable to deduct the administration expenses on the fiduciary tax return.

## **IX. ELECTION TO TREAT TRUST AS PART OF ESTATE**

During the 1990's, revocable trusts were in vogue in some states, especially California and Florida. They were promoted as vehicles to avoid probate. Claims were even made that such trusts reduced estate taxes or provided asset protection. The estates of those who depended on those trusts to effectuate the decedent's testamentary wishes were often disappointed. Since New York had enacted little statutory law governing inter vivos trusts as testamentary vehicles, trustees have had difficulty determining whether some assets had been effectively transferred to the trust. While assets such as real estate or brokerage accounts could be retitled into the name of the trust, the adequacy of transfers of personal property was sometimes a significant problem. Some revocable trusts contained mere "schedules" of personal assets which were supposedly transferred to the trust.

The problems created by the use of such trusts as testamentary vehicles greatly exceeded the principal benefit conferred on those using such trusts — the avoidance of probate. Ironically, probate was usually required anyway, since assets often remained which had not been effectively transferred to the inter vivos trust. Thus, a “pour over” Will was typically required in addition to the revocable inter vivos trust.

Fortunately, most estate planners discerned quite early that the touted attributes of inter vivos trusts as Will substitutes were for the most part illusory. Thus, New York never joined the revocable trust bandwagon. For the most part, estate planners in New York never abandoned the Will as the primary testamentary device. Despite their considerable limitations, revocable inter vivos trusts have accomplished one task extremely well: They can avoid the necessity of ancillary probate in another state. Thus, if a New York resident creates an inter vivos trust and deeds into that trust a Florida condominium, ancillary probate of the decedent’s will in Florida will not be required at the decedent’s death.

Recognizing the frequent use of revocable trusts, Congress leveled the playing field somewhat for those who chose to incorporate revocable inter vivos trusts into their estate plan, or chose to use them as their exclusive testamentary vehicle. Thus, IRC § 645 makes available to “qualified” revocable trusts many of the elections available to estates. To constitute a qualified revocable trust, the trust must be one with respect to which the decedent retained the power to revoke the trust until his death. Accordingly, under IRC § 645(a), if both the executor (if there is one) and the trustee make an election, the trust will be treated as part of the estate, rather than as a separate trust. The election applies for two years from the date of the decedent’s death if no estate tax return is filed. If an estate tax return is filed, the election terminates six months after the date of final determination of estate tax liability. IRC § 645(b)(2). Treas. Regs. § 1.645-1(f)(2). Once made, the election is irrevocable.

A decedent’s estate may elect a fiscal tax year, provided the first year does not exceed 12 months, and the fiscal year ends on the last day of the calendar month. IRC § 441(d). Since a revocable trust may elect to be taxed as an estate under IRC § 645, an electing revocable trust may also choose a non-calendar taxable year. The election is made by filing a return by the due date of the return, which would be no more than three and a half months after the month selected.

## **X. DISTRIBUTIONS IN KIND**

Special income tax rules apply to certain distributions made in kind to beneficiaries. The general rule is that an estate recognizes no gain when distributions to beneficiaries are made in kind. The beneficiary takes a substituted basis in the distributed property under IRC § 643(e)(1). However, an exception to this rule applies when funding of a pecuniary bequest with appreciated property. If appreciated (or depreciated) property is distributed in kind to fund a pecuniary bequest, the distribution is treated as a sale or exchange of estate property, and the estate will recognize gain (or loss). There may be times when the executor may wish to recognize gain or loss on the distribution of appreciated property in kind, even when not required to do so. This would be the case if appreciated property were distributed in kind, but was not being distributed in order to satisfy a pecuniary bequest.

IRC § 643(e)(3) provides that an executor may elect to have the estate recognize gain or loss on the date of the distribution to the beneficiary. The amount of gain or loss is determined by calculating the amount of gain or loss that would accrue if the estate had sold the property to the beneficiary on the distribution date. Once made, the election is irrevocable. If the election is made, the basis to the beneficiary of the distributed property equals the estate's basis in the property, adjusted for any gain or loss recognized by the estate in the distribution.

## **XI. PREPARER PENALTIES**

Under revised IRC §6694, a return preparer (or a person who furnishes advice in connection with the preparation of the return) is subject to substantial penalties if the preparer (or advisor) does not have a reasonable basis for concluding that the position taken was more likely than not. If the position taken is not more likely than not, penalties can be avoided by adequate disclosure, provided there is a reasonable basis for the position taken. Under prior law, a reasonable basis for a position taken means that the position has a one-in-three chance of success. P.L. 110-28, §§8246(a)(2), 110th Cong., 1st Sess. (5/25/07). This penalty applies to all tax returns, including gift and estate tax returns. The penalty imposed is \$1,000 or, if greater, one-half of the fee derived (or to be derived) by the tax return preparer with respect to the return. An attorney who gives a legal opinion is deemed to be a non-signing preparer. The fees upon which the penalty is based for a non-signing preparer could reference the larger transaction of which the tax return is only a small part.

## **XII. LATE FILING & PAYMENT PENALTIES**

A failure-to-file penalty of 5 percent per month is imposed for each month the failure causes the return to be filed past the due date (including extensions). The penalty may not exceed 25 percent of the tax, and it may be waived for reasonable cause. New York imposes a similar penalty under Tax Law § 685(a)(1), which may also be abated for reasonable cause. See 20 NYCRR § 2392.1(a)(1); § 2392.1(d)(5), and § 2392.1(h); and Matter of Northern States Contracting Co., Inc., DTA No. 806161, Tax Appeals Tribunal (1992), (“in determining whether reasonable cause and good faith exist, the most important factor to be considered is the extent of the taxpayer’s efforts to ascertain the proper tax liability”); and Matter of AILS Systems, Inc., DTA No. 819303, Tax Appeals Tribunal (2006), (the Tribunal took notice of the “hallmarks of reasonable cause and good faith,” which included “efforts to ascertain the proper tax liability.” A failure-to-pay penalty of 0.5 percent per month is imposed for each month the failure causes payment to be made past the due date (including, if applicable, extensions). The penalty may not exceed 25 percent of the tax, and it may be waived for reasonable cause. New York State imposes a similar penalty, which may also be abated for reasonable cause. Tax Law § 685(a)(2).

## **XIII. APPRAISER PENALTIES**

The Pension Protection Act of 2006 added new appraiser penalties. Under IRC §6695A, a penalty may be imposed on an appraiser if he knew or should have known that the appraisal would be relied upon for tax purposes. The penalty is the greater of 10 percent of the amount of tax attributable to the underpayment of tax attributable to the valuation misstatement, or \$1,000, but in any case not more than 125 percent of the income received by the appraiser in connection with preparing the appraisal. The penalty can be avoided if the appraiser establishes that the appraisal value was “more likely than not” the correct value. IRC §6701 imposes a penalty of \$1,000 against any person who assists in the preparation of a return or other document relating other than a corporation) who knows (or has reason to believe) that such document or portion will be used, and that its use would result in an understatement of tax liability of another person. The IRS may disqualify any appraiser against whom a penalty has been assessed. (Circular 230, §10.51(b)).

If a “valuation understatement” results in an underpayment of \$5,000 or more, a penalty of 20 percent will be assessed with respect to the underpayment attributable to the valuation

understatement. IRC §6662(g). The penalty increases to 40 percent if a “gross valuation understatement” occurs. The penalty will not apply if reasonable cause can be shown for the understatement. IRC §6664(c)(2). A valuation understatement occurs if the value of property reported is 65 percent or less than the actual value of the property. A gross valuation understatement occurs if the reported value is 40 percent or less than the actual value of the property. IRC §6662(h).

#### **XIV. ESTATE TAX LIENS**

Under IRC § 6321, a general tax lien may be imposed on all real and personal property owned by any person liable to pay any tax who neglects or refuses to pay such tax after a demand has been made. The general tax lien applies not only to all property owned by the taxpayer at the time the lien comes into effect, but also to all after-acquired property. Under IRC § 6322, the lien commences when the tax is assessed and continues until it becomes unenforceable by lapse of time. Under IRC § 6502, the period of collection is ten years. Under IRC § 6324, a special estate tax lien attaches to all property which comprises part of the decedent’s estate at death. No formal assessment need be made to create this special lien. The special lien for estate taxes expires 10 years from the date of the decedent’s death.

#### **XV. NEGLIGENCE AND FRAUD PENALTIES**

An accuracy-related penalty is imposed on the portion of an underpayment attributable to negligence, which is defined as “any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code.” The penalty imposed equals 20 percent of the underpayment. IRC §§6662, 6662(c). IRC §7203, which addresses “omissions,” provides that any person who “fails to make a return, keep any records, or supply any information, who willfully fails to pay such. . .tax, make such return, keep such records, or supply such information,” shall be guilty of a misdemeanor, and subject to a fine of not more than \$25,000 and imprisonment of not more than one year. The willful attempt to “evade” any tax (including gift and estate tax) constitutes a felony, punishable by a fine of “not more than \$100,000 (\$500,000 in the case of a corporation)” and imprisonment of not more than 5 years, or both, together with costs of prosecution. IRC §7201.

Generally, the IRS must assess a deficiency within the later of (i) three years of the date when the return is filed or (ii) the due date of the return, with extensions. IRC §6501(a). This period is

tolled for 90 days if a notice of deficiency has been mailed. IRC §6503(a)(1). The period is extended to six years if the taxpayer omits from the return more than 25 percent of gross income (or gross estate). The statute of limitations for assessing a false or fraudulent return never runs. IRC §6501(c)(1). If the taxpayer fails to file an income tax return where one is due, the IRS may assess income (or estate) tax at any time. Tax assessed may be collected for a period of ten years following assessment. IRC §6502(a).

## **XVI. FIDUCIARY AND BENEFICIARY LIABILITY**

An executor is a fiduciary. The IRS also has the power to proceed directly against a fiduciary for the payment of estate tax if any assets of the estate have been distributed before the executor has obtained a release from liability. In correspondence to an executor which it seeks to hold liable for unpaid estate taxes, the IRS may reference 31 U.S.C. § 3713. The statute provides: “A representative of a person or an estate . . . paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment of unpaid claims of the Government.” This statute, which creates fiduciary liability, provides that the government must be paid first out of estate funds. If an estate possesses insufficient assets to pay the deceased’s debts, the government will have first priority in proceedings under Chapter 11.

Although the statute does not create a lien per se, it does set forth a priority of payment. The statute would prevent the executor from paying any debts to others while debts are owing to the United States. The case law, though not uniform, has held that the distribution by an executor of assets would subject the executor to personal liability. On the other hand, if no assets are distributed, the fiduciary does not bear personal responsibility for the payment of estate taxes. If the fiduciary distributes assets or sells assets and distributes the proceeds while estate tax liability exists, the IRS may hold the fiduciary liable for the payment of estate taxes. The same procedures used by the IRS when collecting taxes from an estate are available in enforcing the personal liability of a fiduciary. Under IRC §6901(c)(3), the IRS may assess taxes against a fiduciary until the expiration of the period for collection of the estate tax. Although the Code does not specifically provide for a collection period against a fiduciary, presumably the ten year collection period would be applicable.

Under IRC §6501(d), the executor may request “prompt assessment” of income and gift taxes attributable to prior returns filed by the decedent. This will shorten the statute of limitations for collection and may benefit the executor as well as the beneficiaries. The executor may also file a

written application requesting release from personal liability for the decedent's income and gift taxes. If the IRS fails to notify the executor of any amount due within nine months of such request, the executor will be released from liability. The executor may also incur personal liability for estate taxes. The executor may request a release from liability with respect to any estate tax found to be due within nine months of making the application if the application is made before the return is filed, or within nine months of the due date of the return. An executor so discharged cannot be held personally liable for any deficiency in the estate tax. IRC §2204(a). The executor may remain liable for estate tax in situations where beneficiaries seek early distributions. In these cases, the executor may seek to protect him or herself by funding an escrow agreement or reaching some other satisfactory arrangement with the beneficiaries in the event liability is imposed on the executor in the future.

## **XVII. REVALUATION OF LIFETIME GIFTS**

Taxpayers or decedents may have neglected to file gift tax returns during their lifetime for large gifts. Although no gift tax liability may have arisen by virtue of the earlier gift, the failure to file the Form 709 may give the IRS an inroad to review the value of a gift made many years earlier. This is because the three-year period of limitations for auditing a gift tax return does not commence unless the gift is "adequately disclosed" on a filed gift tax return. It is for this reason that persons making sales to grantor trusts may consider filing a gift tax return even where none is technically required, since it is thought that this may commence the three-year period of limitations on IRS review of the value of the property sold. Beneficiaries of an estate also bear personal liability for unpaid estate taxes with respect to both probate and nonprobate assets. IRC § 6901(a)(1) and 6324(a)(2). Transferee liability cannot exceed the value of the assets on the date of transfer. *Com'r v. Henderson's Estate*, 147 F.2d 619 (5th Cir. 1945). Under IRC § 6901(c), the IRS may impose transferee liability for one year after the expiration of the period of limitations for imposing liability on the transferor.

## **XVIII. VALUING ESTATE ASSETS**

An accurate valuation of estate assets is essential in determining the correct estate tax and defending the estate in the event of an audit. If the IRS or NYS determines on audit that the value

of assets reported is incorrect, not only will the estate tax liability increase, but penalties may apply. Valuation discounts that are successfully challenged by the IRS may result in tax deficiencies of a magnitude sufficient to attract underpayment penalties. The value of stocks traded on an established exchange or over the counter is determined by calculating the mean between the highest and lowest quoted selling price on the date of the gift. Treas. Reg. §25.2512-2(b)(1). Publicly traded stocks reference their market value and should include CUSIP (Committee on Uniform Identification Procedure) information. Valuation services provide historical information for a fee. Historical stock quotes are also available on the internet.

If no sales on the valuation date exist, the instructions state that the mean between the highest and lowest trading prices on a date “reasonably close” to the valuation date may be used. If no actual sales occurred on a date “reasonably close” to the valuation date, bona fide bid and asked prices may be used. Treas. Reg. §20.2031-2(e) provides that a blockage discount may be applied where a large block of stock may depress the sales price. Surprisingly, real estate requires no appraisal or formal valuation. If an appraisal is obtained, it should be attached to the return. Contrary to what some intuitively assume, Treas. Reg. §25.2512-1 provides that local property tax values are not relevant unless they accurately represent the fair market value. Even though not required, a date of death valuation is often obtained in the event an audit is anticipated. Generally, the value of real property is the price paid in an arm’s length transaction before the valuation date. If none exists, comparable sales may be used.

Treas. Reg. §25.6019-4 provides that the real property should contain a legal description such that the real property may be “readily identified.” This would include a metes and bounds description (if available), the area, and street address.) When determining the fair market value of real property, valuation discounts for (i) lack of marketability; (ii) minority interest; (iii) costs of partition; (iv) capital gains; and certain other discounts may be taken into consideration. Lack of marketability and minority discounts may be available for gifts of closely held stock. Rev. Rul. 59-60, an often-cited ruling, sets forth a list of factors to be considered when valuing closely held businesses. Those factors include (i) the nature of the business and the history of the enterprise; (ii) the economic outlook in general and the condition and outlook of the specific industry in particular; (iii) the book value of the stocks and the financial condition of the business; (iv) the earning capacity of the company; (v) the dividend-paying capacity of the company; (vi) goodwill and other intangible value; (vii) sales of stock and the size of the block of stock to be valued; (viii) the market price of stocks of a corporation engaged in the same or a similar line of business having their stocks actively



traded in a free open market, either on an exchange or otherwise. If the decedent was a key person in the closely held business, an additional discount may be applicable. *Furman v. Com'r*, T.C. 1998-157, recognized a key man discount of 10 percent where the services of the decedent were important in the business.

The fair market value of closely held stock is determined by actual selling price. If no such sales exist, fair market value is determined by evaluating the “soundness of the security, the interest yield, the date of maturity and other relevant factors.” Treas. Reg. §25.2512-2(f). The gift tax instructions (by analogy) state that complete financial information, including reports prepared by accountants, engineers and technical experts, should be attached to the return, as well as the balance sheet of the closely held corporation for “each of the preceding five years.” Closely held stocks should be valued by a professional valuation appraiser.

Despite opposition by the IRS, courts have continually held that the cost of an eventual capital gains tax reduces the value of closely held stock. *Jelke v. Com'r*, T.C. Memo 2005-131, rev'd, \_\_\_ F.3d \_\_\_, 2007 WL 3378539 (11th Cir. 11/16/07), allowed a full built-in capital gains discount. Discounts applicable to closely held corporations may exceed those for partnerships or LLCs, since even less of a market may exist for stock in a closely held family business compared to an interest in an LLC or partnership, which typically hold interests real estate. No appraisal is required for tangible personal property such as artwork, but if one is obtained, it should be attached to the return. Rev. Rul. 96-15 delineates appraisal requirements, which include a summary of the appraiser's qualifications, and the assumptions made in the appraisal. If no appraisal is made, the return should indicate how the value of the tangible property was determined. The provenance of artwork will affect its transfer tax value. As is the case with large blocks of stock, if large blocks of artwork are gifted, a blockage discount may apply. *Calder v. Com'r*, 85 TC 713 (1985).

The IRS does not recognize fractional interest discounts in the context of artwork, since the IRS believes that there is “essentially no market for selling partial ownership interests in art objects. . .” Rev. Rul. 57-293; see *Stone v. U.S.*, 2007 WL 1544786, 99 AFTR2d 2007-2292 (N.D. Ca. 5/25/07), (District Court found persuasive testimony of IRS Art Advisory Panel, which found discounts applicable to real estate inapplicable to art; court allowed only 2 percent discount for partition.)

## **XIX. SPECIAL USE VALUATION**

Real estate and farm property is generally valued for estate tax purposes at fair market value based on its highest and best use. The special use valuation election under §2032A can reduce the estate tax value of qualified real property or an existing business based on its actual or “special” use. The greatest decrease in value allowed in 2011 is \$1 million. The qualified real property must be located in the U.S. and have been used by the decedent or a member of his or her family who materially participated in the trade or business for at least five of the eight years preceding the date of death, disability or retirement. To qualify for the election, the adjusted value of the real or personal property must equal 50 percent or more of the adjusted value of the gross estate. In addition, the adjusted value of the real property must equal 25 percent or more of the adjusted value of the gross estate. The property must pass from the decedent to a “qualified heir” with a present interest in the property.

Qualified heirs encompass a large class of persons, including (i) the decedent’s ancestors; (ii) the decedent’s spouse; (iii) lineal descendants of the decedent or the decedent’s spouse; (iv) lineal descendants of the parents of the decedent or the parents of the decedent’s spouse; and (v) spouses of lineal descendants of parents of the decedent or spouses of lineal descendants of the parents of the decedent’s spouse. IRC §§ 2032A(e)(1) and (e)(2). The election is made by the Executor on the estate tax return and once made, is irrevocable. A properly executed “notice of election” and a written agreement signed by each person with an interest in the property must be attached to the estate tax return. IRC § 2032A(c). Any estate can be recaptured if, within ten years after the decedent’s death, the property is disposed of, or if the qualified heir ceases to use the property for the qualified use. The written agreement subjects all qualified heirs to personal liability for payment of the recaptured estate tax. If the Executor is unsure whether the estate qualifies for the election because of uncertainty as to whether the percentage tests can be met, the Executor may file a protective election, pending a final determination of values. Treas. Regs. § 20.2032A-8(b).

## **XX. POST MORTEM EVENTS**

All federal circuits, except the Eighth, have long adhered to the view that post-mortem events must be ignored in valuing claims against an estate. *Ithaca Trust Co. v. U.S.*, 279 U.S. 151 (1929) held that “[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of the

opinion that it cannot be done, but that the value of the wife's life interest must be established by the mortality tables." However, Proposed Regs. §20.2053-1(a)(1) state that post mortem events must be considered in determining amounts deductible as expenses, claims, or debts against the estate. Those proposed regulations limit the deduction for contingent claims against an estate by providing that an estate may deduct a claim or debt, or a funeral or administration expense, only if the amount is actually paid. An expenditure contested by the estate which cannot not be resolved during the period of limitations for claiming a refund will not be deductible.

## **XXI. PREVENTING LOSS OF BASIS**

Many assets today will have a fair market value less than the adjusted basis. Since under IRC §1014 a basis adjustment is made at death to fair market value, a loss of basis could occur in many situations. Various strategies may be considered to reduce the likelihood of this problem arising:

¶ Losses may be recognized on sales to unrelated parties. IRC § 1001(a). Losses on sales to related parties cannot be recognized, but basis is carried over to related party. IRC §267.

¶ No gain or loss is recognized on transfers made between spouses, whether by gift or sale. IRC § 1041(a). The transferee spouse will take a substituted basis in the asset sold or gifted. IRC § 1041(b); Treas. Reg. § 1.1041-1T(d), Q&A 11. Gifts to a spouse qualify for the unlimited marital deduction. IRC §2523. Therefore, no income tax or gift tax consequences arise when property is sold or gifted between spouses.

¶ Gifts of property with a realized loss to related parties who are non-spouses may have some benefit. If the property later increases in value, the basis for determining later gain is the original basis, increased by any gift tax paid. IRC §1015(d)(6). However, the basis for determining later loss is the basis at the time of the gift. IRC § 1015(a).

## **XXII. MARITAL DEDUCTION**

Planning for and preserving the marital deduction is an important objective. It is particularly important when the estate tax is in a state of flux, as is currently the case. By making a "QTIP" election, the Executor will enable the decedent's estate to claim a full marital deduction. A QTIP trust may be asset protected with respect to corpus; the income interest may be subject to claims of creditors.

To qualify, the trust must provide that the surviving spouse be entitled to all income, paid at least annually, and that no person may have the power, exercisable during the surviving spouse's life, to appoint the property to anyone other than the surviving spouse. Since the Executor may request a six month extension for filing the estate tax return, the Executor in effect has fifteen months in which to determine whether to make the QTIP election. Where a QTIP election is made by the executor, the donor's estate takes the marital deduction. Normally, the surviving spouse is considered to be the transferor for GST tax purposes. However, the executor of the donor spouse may make a second election to treat the donor spouse as the transferor for GST tax purposes. IRC § 2652(a)(3). This is known as a "reverse QTIP" election.

Electing QTIP treatment is not always advantageous. Inclusion of trust assets in the estate of the first spouse to die may "equalize" the estates. Prior to 2011, equalization may have been desirable to avoid "wasting" the exemption amount of the first spouse. After 2010, this reason for equalizing estates is somewhat less compelling, since a surviving spouse may now claim the unused part of the predeceasing spouse's exemption amount. However, equalizing the estates may still be important, since remarriage by the surviving spouse will result in the loss predeceasing spouse's unused exemption amount. Equalizing the estate may also have helped to avoid higher estate rate brackets that apply to large estates. Still, the savings in estate taxes occasioned by reason of avoiding the highest tax brackets may itself be diminished by the time value of the money used to pay the estate tax at the first spouse's death. However, with the lower rate of estate tax, this factor is also now less compelling.

Another reason for not electing QTIP treatment would lie where the second spouse dies soon after the first. If no marital deduction is claimed in that case, a credit under IRC §2013 could operate to reduce the estate tax payable at the death of the surviving spouse. An executor may elect QTIP treatment for only a portion of a trust qualifying for the QTIP election. The nonelected portion would be distributed in the same manner as the elected portion (since the trust terms do not change by virtue of the QTIP election). The only difference would be that the decedent's estate would receive no marital deduction, and the estate of the surviving spouse would not be required to include the assets in the estate of the surviving spouse upon that spouse's death.

If a partial QTIP election is anticipated, separating the trusts into one which is totally elected, and second which is totally nonelected, may be desirable. In this way, future spousal distributions could be made entirely from the elected trust, which would reduce the size of the surviving spouse's estate.

Assets within a trust for which QTIP treatment has been elected will receive a step up in basis at death of the first spouse, and will receive a second basis step up at the time they are included in the estate of the surviving spouse. (This assumes that the decedent did not die in 2010 and his estate did not elect the carryover basis provisions.) Assets in a trust which qualifies for a QTIP election but for which no election was made will receive a step up in basis at the death of the first spouse. Since those assets will not be included in the estate of the surviving spouse, no basis step up will occur at the death of the surviving spouse, even if the trust terminates at that time. Therefore, electing QTIP treatment may be desirable if no estate tax is anticipated at the death of the surviving spouse, and the benefit of a basis step up exceeds the cost of any New York estate tax that might be occasioned by reason of the QTIP election.

QTIP property is included in the estate of the surviving spouse at its then fair market value. If estate tax liability arises, the estate of the surviving spouse is entitled to be reimbursed for estate tax paid from recipients of trust property. IRC § 2207A. Reimbursement is calculated using the highest marginal estate tax bracket of the surviving spouse. The failure to seek reimbursement may be treated by the IRS as gift made to those persons who would have been required to furnish reimbursement. However, the failure by the estate of the surviving spouse to seek reimbursement will not be treated as a gift if the Will of the surviving spouse expressly waives the right of reimbursement with respect to QTIP property.

Mistakes made when electing or funding QTIP trusts may sometimes be corrected. Section 9100 relief is available for failure to make a timely QTIP election on an estate tax return, since the deadline for making that election is prescribed by regulation (Treas. Reg. § 20.2056(b)-7(b)(4)(i)). Under Rev. Proc. 2001-38, an unnecessary QTIP election for a credit shelter trust will be disregarded to the extent it is not needed to eliminate estate tax at the death of the first spouse. Similarly, a mistaken overfunding of the QTIP trust will not cause inclusion of the overfunded amount in the estate of the surviving spouse. TAM 200223020.

Since the estate tax is a “tax inclusive,” as opposed to the gift tax, which is “tax exclusive,” there is a distinct tax benefit to making lifetime, as opposed to testamentary, transfers. Distributions from a QTIP trust can assist in accomplishing this objective. A surviving spouse might make gifts of income required to be distributed to the spouse. Even though the spouse is permitted to make gifts of distributed income, the trust may not require the surviving spouse to apply the distributed income to make gifts, as this would as this would constitute an impermissible limitation on the spouse’s unqualified rights to income during his or her lifetime.

A surviving spouse's right to withdraw principal may also be used by the surviving spouse to make gifts. Treas. Reg. §20.2056(b)-7(d)(6) provides: "The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of IRC § 2956(b)(7)(B)(ii)(II)." Estate of Halpern v. Com'r, T.C. Memo. 1995-352 also held that discretionary distributions made to the surviving spouse which were later used to make gifts would not result in inclusion in the estate of the surviving spouse.

The IRS has ruled that granting the surviving spouse a power to withdraw the greater of 5 percent of trust principal or \$5,000 per year (a "five and five" power) will not result in disqualification of QTIP treatment. However, if spouse were given an unlimited right to withdraw principal, the QTIP trust could morph into a general power of appointment trust. A full marital deduction is also allowed for a general power of appointment trust, so in this respect no tax detriment would ensue. However, the decedent's right to choose who would ultimately receive trust property would be defeated if the surviving spouse appointed all of the property during his or her lifetime.

If greater rights of withdrawal are given to the surviving spouse under an intended QTIP, but those rights did not rise to an unrestricted right to demand principal, the trust would be neither fish nor fowl. That is, the trust would constitute neither a general power of appointment trust nor a QTIP trust. This would result in a trust "meltdown" for estate tax purposes. The marital deduction would be lost and the entire trust would be brought back into the estate of the first spouse to die. The decedent's power to determine ultimate trust beneficiaries would be also be severely curtailed if not lose entirely. To illustrate, assume at a time when the applicable exclusion amount is \$5 million, father has an estate of \$8 million, and mother has an estate of \$2 million. Father (who has made no lifetime gifts) wishes to give his four children \$6 million outright. If \$6 million were left to the children, \$1 million would be subject to federal estate tax, and \$5 million would be subject to New York estate tax. The total estate tax liability would be approximately \$1.15 million [(\$1 million x .35) + (\$5 million x .16)].

This would leave the children with \$4.85 million of the \$6 million bequest. If instead of leaving \$6 million to the children outright, father were to leave only \$1 million to them outright, and place \$5 million in a trust qualifying for a QTIP election, federal and New York estate tax would be eliminated at father's death. If mother's estate were not to increase during her lifetime, no federal estate tax would be owed at her death, since her estate would not exceed the (combined) applicable exclusion amount of \$10 million. If the surviving spouse made absolutely no taxable gifts during her lifetime, the New York State estate tax of \$800,000 deferred by the marital deduction (\$5 million

x .16) would be payable upon her death by her estate. However, if the surviving spouse were to make gifts to the children during her lifetime, the eventual New York State estate tax could be diminished or even eliminated.

Consider the effect of the surviving spouse, would now be worth \$7 million, making gifts of \$0.25 million to each child per year for a few years. Each year, the surviving spouse would report a gift of \$1 million for federal gift tax purposes. Since the gift and estate taxes have been reunified, no gift tax liability would arise for federal purposes. Since New York State has no gift tax, no New York gift tax liability could arise by virtue of the gifts. Each year in which the surviving spouse made those gifts, the eventual New York estate tax liability would be reduced by approximately \$160,000. At the death of the surviving spouse, the trustee would distribute all of the remaining trust assets to the children, at a new stepped up basis. Although this strategy appears sound for tax purposes, the surviving spouse must actually make the gifts contemplated. The cost of insuring against the risk of the surviving spouse not making the contemplated gift is the transfer tax savings resulting from the QTIP election. Any attempt to impose a legal obligation on the surviving spouse to make the annual gifts would destroy the QTIP, with potentially disastrous federal and New York state estate tax consequences.

This strategy would in most cases not lend itself well to second marriage situations, or to situations where the surviving spouse cannot be depended upon to make the contemplated annual gifts. Although these considerations do limit the utility of this strategy, the risk of the surviving spouse not making the gifts could conceivably be reduced to an acceptable level by leaving a sum of money to the children outright, and leaving some to the trustee of a QTIP trust.

Even if the spouse were willing to make gifts distributed principal, the ability to make those gifts depends upon the availability of principal. Principal may consist of land, interests in a closely held company, or other property that cannot easily be distributed. Even if principal distributions could otherwise be made, some QTIP trusts are not drafted so as to permit distributions of principal. Other trusts limit the Trustee's ability to make principal distributions. A QTIP trust is only required to provide for annual income distributions to the surviving spouse. If the surviving spouse has no right to withdraw principal and the trustee cannot make discretionary distributions of principal, gifting may still be possible if the surviving spouse releases or gifts all or part of the income interest of the surviving spouse. The gift by a surviving spouse of that spouse's qualifying income interest in the QTIP is a garden variety gift of that income interest under IRC §2511. However, the disposition could also trigger the draconian application of IRC §2519.

The “transfer of all interests” rule found in IRC §2519 applies to the release of the spouse’s lifetime income interest. IRC §2519 provides that “any disposition of all or part of a qualifying income interest for life in any property to which this section applies is treated as a transfer of all interests in the property other than the qualifying income interest.”

Therefore, if surviving spouse were wife to releases or gifts one-half of his or her qualifying income interest, that spouse would be deemed to have disposed of all interests in that property. The gift of a qualifying income interest would result, for gift tax purposes, in the spouse reporting a gift of the entire remainder interest in the trust as well. Fortunately, the “transfer of all interests” rule can be avoided by careful planning. The IRS has ruled that a taxpayer may sever QTIP trusts prior to the surviving spouse disposing of a partial income interest in the QTIP. This avoids the harshness of the “transfer of all interests” rule. See PLRs 200438028, 200328015.

To illustrate, assume the surviving spouse is 85 years old and releases his qualifying income interest in a trust worth \$1 million. Under the prevailing applicable federal rate (AFR) and using actuarial tables, the surviving spouse is deemed to have made a gift of \$180,000. For purposes of IRC §2511, the surviving spouse has made a taxable gift of \$180,000. For purposes of IRC §2519, the surviving spouse is deemed to have made a gift of \$820,000, i.e., all interests in the property other than the qualifying income interest. Under IRC §2207A, the QTIP trust would have a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC §2519.

Under IRC §2207A(a), a surviving spouse who is deemed to have made a gift of the remainder interest under IRC §2519, has a right to recover gift tax attributable to the deemed transfer of the remainder interest under IRC § 2519. Proposed regulations provide for “net gift” treatment of the deemed gift of an interest under IRC §2519. (A net gift occurs if the donee is required, as a condition to receiving the gift, that he pay any gift taxes associated with the gift.) Since the value of what the donees receive is reduced by the gift tax required to be reimbursed to the surviving spouse, the amount of the gift reportable is also reduced by the amount reimbursed. The gift taxes so paid by the donee are deducted from the value of the transferred property to determine the donor’s gift tax.

Assume the value of the income and remainder interest in a QTIP trust is \$500,000. Spouse makes a gift of one-half of the income interest, or \$250,000. Under IRC § 2519, spouse will be deemed to have made a gift of the entire \$500,000. If the gift tax rate were 50 percent, an interrelated calculation yields the result that a gift of \$333,333 would require gift tax of \$166,667. A gift of \$500,000 would therefore result in a “net gift” of \$333,333. The amount of the gift is reduced by the gift tax of \$166,667. This results in a net gift of \$333,333 to the beneficiaries.



Although releasing a qualifying income interest may be effective if the surviving spouse cannot withdraw principal and the trustee cannot make discretionary distributions of principal, spendthrift limitations in the Trust may prohibit the transfer of an income interest. An income beneficiary of a spendthrift trust generally cannot assign or alienate an income interest once accepted. See, e.g., *Hartsfield v. Lescher*, 721 F.Supp. 1052 (E.D. Ark. 1989). If a spendthrift limitation bars the spouse from alienating the income interest, it may still be possible to disclaim the interest under New York's disclaimer statute, EPTL 2-1.11.

Disclaimers may also be effective where after the death of the decedent, the surviving spouse determines that he or she does not require QTIP trust assets. Disclaiming the QTIP would accelerate the remainder beneficiaries' interest in the QTIP trust. However, there are problems associated with utilizing a disclaimer strategy with a QTIP. First, there are strict federal tax requirements that must be met. A "qualified disclaimer" for federal tax purposes must be made within nine months of the vesting of the interest. In addition, though the rule have been construed quite liberally, the disclaimant must not have accepted any of the benefits of the property to be disclaimed. To constitute a qualified disclaimer under the Internal Revenue Code, the disclaimer must meet the requirements of state law, and it must be made within nine months. New York requires that the disclaimer be made within nine months, but the time period may be extended for "reasonable cause."

If a New York Surrogate extended the time for reasonable cause, the renunciation would not constitute a qualified disclaimer under IRC §2519. Rather, the disclaimer would be a "nonqualified disclaimer." While a "nonqualified" disclaimer might still be possible, such a disclaimer will be less attractive from a tax perspective. A nonqualified disclaimer could also trigger IRC §2519, since such a disclaimer would be ineffective for federal transfer tax purposes. Assume the surviving spouse dies not having made any transfer or release of a QTIP interest during his or her lifetime. IRC §2044 requires that remaining QTIP assets be included in the gross estate of the surviving spouse. However, those assets are not aggregated with other assets in the estate of the surviving spouse.

Thus, in *Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996) the surviving spouse at her death owned certain interests outright, and others were included in her estate pursuant to IRC §2044. The estate claimed a fractional interest discount, which the IRS challenged. The Fifth Circuit held that assets included in the decedent spouse's gross estate which were held outright were not aggregated with those included under IRC §2044 by virtue of the QTIP trust. The estate was entitled to take a fractional interest discount. Apparently, even if the surviving spouse were a co-trustee of the QTIP trust, no aggregation would be required. See FSA 200119013.

Under Bonner, the issue arises as to whether the trustee of the QTIP trust may distribute a fractional share of real estate owned by the QTIP trust to generate a fractional interest discount at the death of the surviving spouse. It appears that this is possible. However, in Bonner, the surviving spouse owned an interest in certain property. Subsequently, she became the income beneficiary of a QTIP trust which was funded with interests in the same property. The surviving spouse in Bonner already owned a separate interest in the same property. This situation is distinguishable from one in which the QTIP trust owns all of the interest in a certain piece of property, and then distributes some of that interest to the surviving spouse.

In that case, it is less clear that the estate would succeed in segregating interests in the same property for the purpose of establishing a valuation discount. The case would be weaker if the distribution of the fractional interest to the surviving spouse had, as one of its principal purposes, no purpose other than to support a later assertion of a fractional interest discount.

### **XXIII.           DISCLAIMERS**

Disclaimers can be useful in accomplishing post-mortem estate planning, since a person who disclaims property is treated as never having received the property for gift or estate or tax purposes under IRC § 2516. Although Wills frequently contain express language advising a beneficiary of a right to disclaim, such language is superfluous, since a beneficiary may always disclaim. If the disclaimer meets the requirements of IRC § 2518, it will be a “qualified disclaimer” and the disclaimant will be treated as never having received the property. However, if the disclaimer is not qualified, the disclaimant will be treated as having received the property and then having made a taxable gift. Treas. Regs. §25.2518-1(b). Although the disclaimer statute appears in Chapter 11, the gift tax provisions of the Code, a disclaimer under IRC § 2516 is also effective for federal income tax purposes.

Under the EPTL, as well as under the laws of descent of most states, the disclaimant is treated as having predeceased the donor, or died before the date on which the transfer creating the interest was made. Neither New York nor Florida is among the ten states which have adopted the Uniform Disclaimer of Property Interests Act (UDPIA). To constitute a qualified disclaimer under IRC § 2518, the disclaimer must meet the following requirements:

(i) The disclaimer must be irrevocable and unqualified. PLR 200234017 stated that a surviving spouse who had been granted a general power of appointment had not made a qualified disclaimer

of that power by making a QTIP election on the estate tax return, since the estate tax return did not evidence an irrevocable and unqualified refusal to accept the general power of appointment.

(ii) The disclaimer must be in writing, identify the property disclaimed and be signed by the disclaimant or by his legal representative. Under EPTL § 2-1.11(f) the right to disclaim may be waived if in writing;

(iii) The disclaimer must be delivered to either the transferor or his attorney, the holder of legal title, or the person in possession. Copies of the disclaimer must be filed with the surrogates court having jurisdiction of the estate. If the disclaimer concerns nontestamentary property, the disclaimer must be sent via certified mail to the trustee or other person holding legal title to, or who is in possession of, the disclaimed property;

(iv) The disclaimer must be made within nine months of the date of transfer or, if later, within nine months of the date when the disclaimant attains the age of 21. It is possible that a disclaimer might be effective under the EPTL, but not under the Internal Revenue Code. For example, under EPTL §2-1.11(a)(2) and (b)(2), the time for making a valid disclaimer may be extended until “the date of the event by which the beneficiary is ascertained,” which may be more than 9 months after the date of the transfer. In such a case, the disclaimer would be effective under New York law but would result in a taxable gift for purposes of federal tax law;

(v) The disclaimer must be made at a time when the disclaimant has not accepted the interest disclaimed or enjoyed any of its benefits. Consideration received in exchange for making a disclaimer would constitute a prohibited acceptance of benefits under EPTL §2-1.11(f); and

(vi) The disclaimer must be valid under state law, so that it passes to either the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer. EPTL §2-1.11(g) provides that a beneficiary may accept one disposition and renounce another, and may renounce a disposition in whole or in part. One must be careful to disclaim all interests, since the disclaimant may also have a right to receive the property by reason of being an heir at law, a residuary legatee or by other means. In this case, if the disclaimant does not effectively disclaim all of these rights, the disclaimer will not be a qualified disclaimer with respect to the portion of the disclaimed property which the disclaimant continues to have the right to receive. IRC §2518-2(e)(3). (Note: An important exception to this rule exists where the disclaimant is the surviving spouse. In that case the disclaimed interest may pass to the surviving spouse even if she is the disclaimant. Treas. Reg. §25.2518-2(e); EPTL §2-1.11(e).)

IRC § 2518(c) provides for what is termed a “transfer disclaimer.” The statute provides that

a written transfer that meets requirements similar to IRC § 2518(b)(2) (timing and delivery) and IRC § 2518(b)(3) (no acceptance) and which is to a person who would have received the property had the transferor made a qualified disclaimer, will be treated as a qualified disclaimer for purposes of IRC § 2518. The usefulness of IRC § 2518(c) becomes apparent in cases where federal tax law would permit a disclaimer, yet state law would not. To illustrate, in *Estate of Lee*, 589 N.Y.S.2d 753 (Surr. Ct. 1992), the residuary beneficiary signed a disclaimer within nine months, but the attorney neglected to file it with the Surrogates Court. The beneficiary sought permission to file the late renunciation with the court, but was concerned that the failure to file within nine months would result in a nonqualified disclaimer for federal tax purposes.

The Surrogates Court accepted the late filing and opined (perhaps gratuitously, since the IRS is not bound by the decision of the Surrogates Court) that the transfer met the requirements of IRC § 2518(c). [Note that in the converse situation, eleven states, but not New York or Florida, provide that if a disclaimer is valid under IRC § 2518, then it is valid under state law.]

Treas. Reg. § 20.2055-2(c) provides that a charitable deduction is available for property passing directly to a charity by virtue of a qualified disclaimer. If the disclaimed property passes to a private foundation of which the disclaimant is an officer, he should resign, or at a minimum not have any power to direct the disposition of the disclaimed property. The testator may wish to give family members discretion to disclaim property to a charity, but yet may not wish to name the charity as a residuary legatee. In this case, without specific language, the disclaimed property would not pass to the charity. To solve this problem, the will could provide that if the beneficiary disclaims certain property, the property would pass to the specified charity.

Many existing wills contain “formula” clauses which allocate to the credit shelter trust the maximum amount of money or property that can pass to beneficiaries (other than the surviving spouse) without the imposition of federal estate tax. If the applicable exclusion amount is exceeds the value of the estate, the surviving spouse could be disinherited unless the beneficiaries of the credit shelter trust disclaim part of their interest. To the extent such interest is disclaimed and passes to the surviving spouse (either by the terms of the Will or by operation of law) it will qualify for the marital deduction.

Another use of the disclaimer in a similar situation is where either the surviving spouse renounces a power of appointment so that the trust will qualify as a QTIP trust. A surviving spouse who is granted a general power of appointment over property intended to qualify for the marital deduction under IRC § 2056(b)(5) may disclaim the general power, thereby enabling the executor

to make a partial QTIP election. This ability to alter the amount of the marital deduction allows the executor to finely tune the credit shelter amount. If both spouses die within nine months of one another, a qualifying disclaimer by the estate of the surviving spouse can effect an equalization of estates, thereby reducing or avoiding estate tax.

Consider the effect of a qualified disclaimer executed within nine months by a surviving spouse of his lifetime right to income from a credit shelter trust providing for an outright distribution to the children upon his death. If, within nine months of his spouse's death, the surviving spouse decides that he does not need distributions during his life from the credit shelter trust, and disclaims, he will be treated as if he predeceased his wife. If the will of the predeceasing wife provides for an outright distribution of the estate to the children if husband does not survive, then the disclaimer will have the effect of enabling the children to receive the property that would have funded the credit shelter trust at the death of the first spouse.

Disclaimers can also be utilized to increase basis in inherited assets by causing property that would otherwise pass by operation of law, to pass through a predeceasing spouse's estate. Assume surviving spouse paid no consideration for certain property held jointly with that spouse's predeceasing spouse. If second spouse disclaims within nine months, the property would pass through the predeceasing spouse's probate estate. If the Will provided for a residuary bequest to the surviving spouse, that spouse would inherit the disclaimed property with a full basis step up under the terms of the Will.

A qualifying disclaimer executed by the surviving spouse may also enable the predeceasing spouse to fully utilize the applicable exclusion amount. For example, assume the will of the predeceasing spouse leaves the entire estate of \$10 million to the surviving spouse (and nothing to the children). Although the marital deduction would eliminate any estate tax liability on the estate of the first spouse to die, the eventual estate of the surviving spouse would likely have an estate tax problem. By disclaiming \$5 million, the surviving spouse would create a taxable estate in the predeceasing spouse, which could then utilize the full applicable exclusion amount of \$5 million. The taxable estate of the surviving spouse would be reduced to \$5 million.

To refine this example, the will of the first spouse to die could provide that if the surviving spouse disclaims, the disclaimed amount would pass to a family trust of which the surviving spouse has a lifetime income interest. The Will could further provide that if the spouse were also to disclaim her interest in the family trust, the disclaimed property would pass as if she had predeceased. The grantor may wish to ensure that the named trustee will be liberal in making distributions to his

children. By giving the child beneficiary the unrestricted right to remove the trustee, this objection can be achieved. However, if the child has the ability to remove the trustee, and the trust grants the trustee the power to make distributions to the child that are not subject to an ascertainable standard, the IRS may impute to the child a general power of appointment. If the IRS were successful, the entire trust could be included in the child's taxable estate. To avoid this result, the child could disclaim the power to remove the trustee. This might, of course, not accord with the child's nontax wishes.

If a surviving spouse is given a "five and five" power over a credit shelter or family trust, 5 percent of the value of the trust will be included in her estate under IRC §2041. However, if the surviving spouse disclaims within nine months, nothing will be included in his or her estate. At times, all beneficiaries may agree that it would be better if no trust existed. If all current income trust beneficiaries (which might include the surviving spouse and children) disclaim, the trust may be eliminated. In such a case, the property could pass to the surviving spouse and the children outright. Note that if minor children are income beneficiaries, their disclaimers would require the the appointment (and consent) of guardians ad litem.

Under New York law, if one disclaims, and by reason of such disclaimer that person would cause one to retain Medicaid eligibility, such disclaimer may be treated as an uncompensated transfer of assets equal to the value of any interest disclaimed. This, in turn, could impair Medicaid eligibility. In some states, if a disclaimer defeats the encumbrance or lien of a creditor, it may be alleged that the disclaimer constitutes a fraudulent transfer. Not so in New York and California, where a disclaimer may validly be utilized to defeat the legitimate claims of creditors. In Florida, the result is contra: A disclaimer cannot prevent a creditor from reaching the disclaimed property.

Until 1999, it had been unclear whether a qualified disclaimer could defeat the claim of the IRS. The 2nd Circuit in *United States v. Camparato*, 22 F3d. 455, cert. denied, 115 S.Ct. 481 (1994) held that it did not, finding that a federal tax lien attached to the "right to inherit" property. Therefore, a subsequent disclaimer did not affect the federal tax lien under IRC §6321. Resolving a split among the circuits, the Supreme Court, in *Drye v. United States*, 528 U.S. 49 (1999), adopted the view of the Second Circuit, finding that the federal tax lien attached to the property when created, and that any subsequent attempt to defeat the tax lien by disclaimer would not eliminate the lien.

Bankruptcy courts have generally reached the same result as in *Drye*. The disclaimer of a bequest within 180 days of the filing of a bankruptcy petition has in most bankruptcy courts been held to be a transfer which the trustee in bankruptcy can avoid. Many courts have held that even pre-

petition disclaimers constitute fraudulent transfers which the bankruptcy trustee can avoid. If the Drye rationale were applied to bankruptcy cases, it would appear that pre-petition bankruptcy disclaimers would, in general, constitute transfers which the bankruptcy trustee could seek to avoid. However, at least one bankruptcy court, *Grassmueck, Inc., v. Nistler (In re Nistler)*, 259 B.R. 723 (Bankr. D. Or. 2001) held that Drye relied on language in IRC §6321, and should be limited to tax liens.

The acceptance of benefits will preclude a disclaimer under state law. EPTL §§2-11(b)(2) provides that “a person accepts an interest in property if he voluntarily transfers or encumbers, or contracts to transfer or encumber all or part of such interest, or accepts delivery or payment of, or exercises control as beneficial owner over all or part thereof. . . .” Similarly, a qualified disclaimer for purposes of IRC § 2518(c) will not occur if the disclaimant has accepted the interest or any of its benefits prior to making the disclaimer. Treas. Regs. §25.2518-2(d)(1) elaborates, providing that actions “indicative” of acceptance include (i) using the property or interest in the property; (ii) accepting dividends, interest, or rents from the property; or (iii) directing others to act with respect to the property or interest in the property. However, merely taking title to property without accepting any benefits associated with ownership does not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). Nor will a disclaimant be considered to have accepted benefits merely because under local law title to property vests immediately in the disclaimant upon the death of the decedent. Treas. Regs. §25.2518-2(d)(1).

The acceptance of benefits of one interest in property will not, alone, constitute an acceptance of other separate interests created by the transferor and held by the disclaimant in the same property. Treas. Regs. §25.2518-2(d)(1). Thus, TAM 8619002 advised that a surviving spouse who accepted \$1.75x in benefits from a joint brokerage account effectively disclaimed the remainder since she had not accepted the benefits of the disclaimed portion which did not include the \$1.75x in benefits which she had accepted. The disclaimant’s continued use of property already owned is also not, without more, a bar to a qualifying disclaimer. Thus, a joint tenant who continues to reside in jointly held property will not be considered to have accepted the benefit of the property merely because she continued to reside in the property prior to effecting the disclaimer. Treas. Regs. §25.2518-2(d)(1); PLR 9733008.

The existence of an unexercised general power of appointment in a will before the death of the testator is not an acceptance of benefits. Treas. Regs. §25.2518-2(d)(1). However, if the powerholder dies having exercised the power, acceptance of benefits has occurred. TAM 8142008.

The receipt of consideration in exchange for exercising a disclaimer constitutes an acceptance of benefits. However, the mere possibility that a benefit will accrue to the disclaimant in the future is insufficient to constitute an acceptance. Treas. Regs. §25.2518-2(d)(1); TAM 8701001. Moreover, actions taken in a fiduciary capacity by a disclaimant to preserve the disclaimed property will not constitute an acceptance of benefits. Treas. Regs. §25.2518-2(d)(2). A disclaimant may make a qualified disclaimer with respect to all or an undivided portion of a separate interest in property, even if the disclaimant has another interest in the same property. Thus, one could disclaim an income interest while retaining an interest in principal. PLR 200029048. So too, the right to remove a trustee was an interest separate from the right to receive principal or a lifetime special power of appointment. PLR 9329025. PLR 200127007 ruled that the waiver of the benefit conferred by right of recover under IRC §2207A constituted a qualified disclaimer.

A disclaimant makes a qualified disclaimer with respect to disclaimed property if the disclaimer relates to severable property. Treas. Regs. §25.2518-3(a)(1)(ii). Thus, (i) the disclaimer of a fractional interest in a residuary bequest was a qualified disclaimer (PLR 8326033); (ii) a disclaimer may be made of severable oil, gas and mineral rights (PLR 8326110); and (iii) a disclaimer of the portion of real estate needed to fund the obligation of the residuary estate to pay legacies, debts, funeral and administrative expenses, is a severable interest. PLR 8130127.

For disclaimants (other than a surviving spouse) who are residuary legatees or heirs at law, the disclaimant must be careful not only to disclaim the interest in the property itself, but also to disclaim the residuary interest. If not, the disclaimer will not be effective with respect to that portion of the interest which the disclaimant has the right to receive. §25.2518-2(e)(3). To illustrate, in PLR 8824003, a joint tenant (who was not a surviving spouse) was entitled to one-half of the residuary estate. The joint tenant disclaimed his interest in the joint tenancy, but did not disclaim his residuary interest. The result was that only half of the disclaimed interest qualified under IRC §2518. The half that passed to the disclaimant as a residuary legatee did not qualify.

The disclaimant may not have the power, either alone or in conjunction with another, to determine who will receive the disclaimed property, unless the power is subject to an ascertainable standard. However, with respect to a surviving spouse, the rule is more lenient. Estate of Lassiter, 80 T.C.M. (CCH) 541 (2000) held that Treas. Reg. §25.2518-2(e)(2) does not prohibit a surviving spouse from retaining a power to direct the beneficial enjoyment of the disclaimed property, even if the power is not limited by an ascertainable standard, provided the surviving spouse will ultimately be subject to estate or gift tax with respect to the disclaimed property.



An impermissible power of direction exists if the disclaimant has a power of appointment over a trust receiving the disclaimed property, or if the disclaimant is a fiduciary with respect to the disclaimed property. §25.2518-2(e)(3). However, mere precatory language not binding under state law as to who shall receive the disclaimed property will not constitute a prohibited “direction”. PLR 9509003. Limits on the power of a fiduciary to disclaim may have tax implications. PLR 8409024 stated that trustees could disclaim administrative powers the exercise of which did not “enlarge or shift any of the beneficial interests in the trust.” However, the trustees could not disclaim dispositive fiduciary powers which directly affected the beneficial interest involved. This rule limits the trustee’s power to qualify a trust for a QTIP election.

In some states, representatives of minors, infants, or incompetents may disclaim without court approval. EPTL §2-1.11(c) permits renunciation on behalf of an infant, incompetent or minor. However such renunciation must be “authorized” by the court having jurisdiction of the estate of the minor, infant or incompetent. In *Estate of Azie*, 694 N.Y.S.2d 912 (Sur. Ct. 1999), two minor children were beneficiaries of a \$1 million life insurance policy of their deceased father. The mother, who was the guardian, proposed to disclaim \$50,000 of each child. The proposed disclaimer would fund a marital trust and would save \$40,000 in estate taxes. The Surrogate, disapproving the proposed disclaimer, stated that the disclaimer must be advantageous to the children, and not merely to the parent.

A disclaimer may be valid under the EPTL but not under the Code. EPTL §2-1.11-(b)(2) provides that a renunciation must be filed with the Surrogates court within 9 months after the effective date of the disposition, but that this time may be extended for “reasonable cause.” EPTL §2-1.11(a)(2)(C) provides that the effective date of the disposition of a future interest “shall be the date on which it becomes an estate in possession.” Since under IRC §2518, a renunciation must be made within nine months, the grant of an extension by the Surrogates court of the time in which to file a renunciation might result in a valid disclaimer under the EPTL, but under federal tax law. Similarly, while the time for making a renunciation of a future interest may be extended under EPTL §2-1.11(a)(2)(C), such an extension would likely be ineffective for purposes of IRC §2518.

The rules for disclaiming jointly owned property can generally be divided into two categories. The first category consists of joint bank, brokerage and other investment accounts where the transferor may unilaterally regain his contributions. With respect to these, the surviving co-tenant may disclaim within nine months of the transferor’s death but, under the current EPTL, only to the extent that the survivor did not furnish consideration.

The second category comprises all other jointly held interests. With respect to all other interests held jointly with right of survivorship or as tenants by the entirety, a qualified disclaimer of the interest to which the disclaimant succeeds upon creation must be made no later than nine months after the creation. A qualified disclaimer of an interest to which the disclaimant succeeds upon the death of another (i.e., a survivorship interest) must be made no later than nine months after the death of the first tenant. This is true (i) regardless of the portion of the property contributed by the disclaimant; (ii) regardless of the portion of the property included in the decedent's gross estate under IRC §2040; and (iii) regardless of whether the property is unilaterally severable under local law.

A bill has been introduced in the New York legislature which would conform New York law to federal law. EPTL 2-1.11(b)(1) now provides that a surviving joint tenant or tenant by the entirety may not disclaim the portion of property allocable to amounts contributed by him with respect to such property. Under the proposed legislation, the surviving joint tenant or tenant by the entirety may disclaim to the extent that such interest could be the subject of a qualified disclaimer under IRC § 2518.

#### **XXIV. VALUATION CLAUSES**

Transfer made by gift or by sale are frequently expressed by formula to avoid adverse gift tax consequences that could result if the value of the transferred interest were successfully challenged by the IRS on audit. There are two principal types of formula clauses: "value adjustment" clauses and "value definition" clauses. A value adjustment clause provides for either an increase in the price of an asset or a return of a portion of the transferred asset to the donor if the value of the transferred asset is determined to be greater than anticipated at the time of the transfer. However, this technique, which utilizes a condition subsequent to avoid a transfer in excess of that which is contemplated, is generally ineffective. A number of courts have ruled this would constitute a condition subsequent which would have the effect of undoing a portion of a gift. That would be against public policy and therefore void.

A value definition clause defines the value of the gift or sale at the time of the transfer. The agreement between the parties does not require a price adjustment or an adjustment in the amount of property transferred. The transaction is complete, but the extent of the property sold or given is not fully known at that time. An adjustment on a revaluation by the IRS will simply cause an

adjustment of the interests allocated between the transferor and transferee(s). A value definition clause could allocate the transferred amount among non-taxable transferees, which could include charities, QTIP trusts, or outright transfers to spouses. The Eighth Circuit, in *Estate of Christiansen*, approved the use of formula disclaimers. \_\_\_F.3d\_\_\_, No. 08-3844, (11/13/09); 2009 WL 3789908, aff'g 130 T.C. 1 (2008). Helen Christiansen left her entire estate to her daughter, Christine, with a gift over to a charity to the extent Christine disclaimed her legacy. By reason of the difficulty in valuing limited partnership interests, Christine disclaimed that portion of the estate that exceeded \$6.35 million, as finally determined for estate tax purposes. Following IRS examination, the estate agreed to a higher value for the partnership interests. However, by reason of the disclaimer, this adjustment simply resulted in more property passing to the charity, with no increase in estate tax liability. The IRS objected to the formula disclaimer on public policy grounds, stating that fractional disclaimers provide a disincentive to audit.

In upholding the validity of the disclaimer, the Court of Appeals remarked that “we note that the Commissioner’s role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner’s role is to enforce the tax laws.” Although “savings clauses” had since *Com’r. v. Procter*, 142 F.2d 824 (4th Cir.), cert. denied, 323 U.S. 756 (1944), rev’g and rem’g 2 TCM [CCH] 429 (1943) been held in extreme judicial disfavor on public policy grounds, carefully drawn defined value formula clauses have seen a remarkable rehabilitation. So much so that the Tax Court in *Christiansen* concluded that it “did not find it necessary to consider *Procter*, since the formula in question involved only the parties’ current estimates of value, and not values finally determined for gift or estate tax purposes.”

## **XXV. PROTECTIVE CLAIMS**

The executor may file a “protective claim” for refund, which would preserve the estate’s ultimate right to claim a deduction under IRC §2053(a). A timely filed protective claim would thus preserve the estate’s right to a refund if the amount of the liability is later determined and paid. Although a protective claim would not be required to specify a dollar amount, it would be required to identify the outstanding claim that would be deductible if paid, and describe the contingencies delaying the determination of the liability or its actual payment. Attorney’s fees or executor’s commissions that have not been paid could be identified in a protective claim. Prop. Regs. §20.2053-1(a)(4). A second limitation on deductible expenses also applies: Estate expenses are

deductible by the executor only if approved by the state court whose decision follows state law, or established by a bona fide settlement agreement or a consent decree resulting from an arm's length agreement. This requirement is apparently intended to prevent a deduction where a claim of doubtful merit was paid by the estate.

The proposed regulations suffer from some defects. To illustrate one, assume the will of the decedent dying in 2008 whose estate is worth \$10 million, designates that \$2 million should fund the credit shelter trust, with the remainder funding the marital trust. Assume also the existence of a \$3 million contested claim against the estate. If the executor sets apart \$3 million for the contested claim and files a protective claim for refund, the marital trust would be funded with only \$5 million, instead of \$8 million. If the claim is later defeated, the \$3 million held in reserve could no longer be used to fund the marital trust, and would be subject to estate tax.

Alternatively, the executor could simply fund the marital trust with \$8 million, not set aside the \$3 million, and not file a protective claim. If the claim is later determined to be valid, payment could be made from assets held in the marital trust. However, by proceeding in this manner, the IRS could later assert that the marital deduction was invalid. Some have speculated that the existence of a large protective claim might also tempt the IRS to look more closely at other valuation issues involving other expenses claimed by the estate as a hedge against the possibility of a large future deduction by the estate.

## **XXVI. PARTNERSHIPS & S CORPORATIONS**

Income tax problems may arise if a nongrantor trust becomes the owner of S Corporation stock. In general, only certain trusts, i.e., (i) grantor trusts; (ii) Qualified Subchapter S Trusts; and (iii) Electing Small Business Trusts may own S corporation stock. A grantor trust that becomes a nongrantor trust at the death of the grantor will no longer be an eligible S corporation shareholder. Without some affirmative action, the S corporation election would be lost, with attendant adverse income tax consequences. However, two remedies are available under which address this issue. The first involves the trust making an election to be treated as a "Qualified Subchapter S Trust," or "QSST".

To qualify as a QSST, IRC §1361(d)(3)(B) requires that trust instrument provide that all income be distributed annually to the sole trust beneficiary. An election must be made by the beneficiary to qualify the trust as a QSST. If the trust cannot qualify as a QSST because the trust

instrument does not require all income to be distributed annually (i.e., the trustee is given discretion to distribute income) it cannot qualify as a QSST.

Though less desirable, qualification for a nongrantor trust may still be possible by making an election to be treated as an Electing Small Business Trust, or “ESBT” under IRC §1361(e). In contrast to a QSST, an ESBT does not require that all income be distributed annually. The ESBT election is made by the trustee, rather than by the beneficiary. The ESBT, rather than the income beneficiary, will report his share of income from the S Corporation. Expenses of the trust will be allocated the Subchapter S interest of the Trust and the interest of the Trust consisting of non-S Corporation assets.

Treas. Regs. § 1.1361-1(j)(6)(ii)(A) and IRC § 1.1361-1(m)(2)(iii) provide the time period in which an ESBT election must be made: if S Corporation stock is transferred to a trust, the [ESBT] election must be made within the 16-day-and-2-month period beginning on the day the stock is transferred to the trust. When the Trust distributes income, the Trust will receive a deduction only for the portion of the distribution related to income derived from non-S Corporation trust assets. (This is in sharp contrast to the normal rules applicable to trust distributions to beneficiaries.) Therefore, to the extent a trust will not be entitled to receive any deduction. All income reported by the ESBT is taxed at the highest individual income tax rates. In addition, losses passed through from the S Corporation are not permitted to offset income from non-S Corporation assets held by the trust. See Treas. Regs. § 1.641(c)-1.

IRC § 1361(e)(3) and Treas. Regs. § 1.1361-1(m)(2) provide that the trustee must make the ESBT election. The election is made by signing and filing with the service center where the S Corporation files its returns a statement that meets the trust meets requirements of the regulations. If the trust has more than one trustee, each trustee must sign the election statement. The election statement must include the following information: (i) the name, address, and TIN of the trust; (ii) the potential current beneficiaries, and the S Corporations in which the trust owns stock;

(iii) an identification of the election as an ESBT election made under Internal IRC § 1361(e)(2); (iv) the first date on which the trust owned stock in each S Corporation; (v) the date at which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and (vi) representations signed by the trustee stating that the trust meets the definitional requirements of IRC § 1361(e)(1) and all potential current income beneficiaries of the trust meet the shareholder requirements of IRC § 1361(b)(1).

If a trust which has made an election to be treated as an ESBT or QSST terminates, the S

corporation shares must be transferred to another qualifying shareholder to preserve the S Corporation election. When a partner dies, the basis of any partnership interest passing to heirs is stepped up to fair market value. Until 2001, the partnership's inside basis in partnership assets remained the same following the death of a partner, and the transmission of the partnership interest to the decedent's heirs. However, IRC § 754, enacted in 2001, permits the partnership to increase (or decrease) the inside basis of partnership assets with respect to the interest of the deceased partner. This election will have the favorable result of permitting increasing the adjusted basis of partnership property to fair market value on the date of death of the decedent.

The heir will then be able to use the increased basis to report gain from the sale by the partnership of partnership property. The election will also be beneficial to the remaining partners since it will increase depreciation deductions, and reduce gain when the partnership ultimately disposes of the replacement property. The Section 754 adjustment will have no effect on other partners; therefore, the partnership will be required to keep two sets of books for the basis of partnership property. The election is made by the partnership on the return corresponding to the year in which the partner died. Although not irrevocable, the election may only be revoked with the approval of the IRS.