POST MORTEM PLANNING—IT'S NOT TOO LATE TO PLAN: A REVIEW OF INCOME, GIFT AND ESTATE TAX PLANNING ISSUES

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(This outline is excerpted from a considerably longer outline. Send an email to the author if you would like to receive the longer outline.)

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I. INTRODUCTION; PLANNING FOR 2010 DECEDENTS

This outline is intended as a summary some of the "hot topics" and items of particular current interest. It is not an overall discussion of post mortem planning strategies, but it focuses on selected topics. A more complete (and much lengthier) outline is available from the author (akers@bessemer.com).

A. 2010 Tax Act.

The "short" title of the Act passed by Congress on December 17, 2010 is "Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010." [referred to in this outline as TRA 2010].

B. Temporary Extension of Tax Relief.

TRA 2010 generally provides various tax provisions that apply for just two years. This is accomplished first by extending the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") generally for two years, including the extension of the "Bush tax cuts" and the estate tax provisions. [TRA 2010 § 101(a) amends EGTRAA (effective as if enacted as part of EGTRRA in 2001) by amending section 901 of EGTRRA (the sunset provision) to extend the EGTRRA sunset to specified events occurring after December 31, 2012 (instead of December 31, 2010). Therefore, all of the provisions of EGTRRA generally are extended through 2012.] In addition, TRA 2010 provides that the EGTRRA sunset provisions in section 901 of EGTRRA apply to all of the amendments in the title containing the estate and gift tax provisions. The effect is that the estate, gift and GST amendments made by TRA 2010 also sunset after 2012.

C. Estate, Gift and GST Tax Exemptions and Rates.

TRA 2010 generally sets the estate, gift and GST exemption at $5.0 million, indexed from 2010 beginning in 2012, [TRA 2010 § 302(a)(1)] and sets the maximum rate at 35%. [TRA 2010 § 302(a)(2)]. The $5 million exemptions generally apply in 2010 [TRA § 302(f)], except that the gift exemption remains at $1.0 million for 2010 [TRA § 302(b)(1)(B)].

D. Estate Tax in 2010.

1. Default Rule — Estate Tax Applies in 2010.

The estate tax applies to estates of decedents dying in 2010. As discussed above, the estate tax exemption in 2010 is $5.0 million and the rate is 35%. (For various issues discussed below, it is important to keep in mind that the *default* rule is that the estate tax applies in 2010.) This reenactment of the estate tax for 2010 is in a complicated section of TRA 2010 that sunsets certain provisions of EGTRRA as if they had never been enacted. TRA 2010 § 301(a) provides that "[e]ach provision of subtitle A or E of title V of [EGTRRA] is amended to read as such provision would read if such subtitle had never been enacted." Subtitle A contains I.R.C. § 2210, which says that Chapter 11 [containing the estate tax provisions] does not apply to decedents dying after 2009 (except as to certain distributions from QDOTs) and I.R.C. § 2664 (which says that Chapter 13 does not apply to GST transfers after 2009). Subtitle E contains the carryover basis provisions. The Code would be interpreted as if those provisions of EGTRRA (repealing the estate and GST tax and enacting carryover basis) had never been enacted. [TRA 2010 § 301(a).] The provision retroactively applies to decedents dying after and generation-skipping transfers after December 31, 2009. [TRA 2010 § 301(e).]

2. Carryover Basis Election for 2010 Decedents.

Executors (within the meaning of I.R.C. § 2203) of estates of decedents who die in 2010 may elect to have the modified basis rules of I.R.C. § 1022 apply "with respect to property acquired or passing from the decedent" within the meaning of I.R.C. § 1014(b)) instead of the estate tax. [TRA 2010 § 301(c).]

Statutory Provisions Regarding Carryover Basis Election. The carryover basis election is described in TRA 2010 § 301(c). It is a complicated section, applying double and triple negatives.

> "Notwithstanding subsection (a) [which says that subtitle A or E of title V of EGTRAA are treated as having never been enacted], in the case of a decedent dying after December 31, 2009, and before January 1, 2011, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1986) may elect to apply such Code as though the amendments made by subsection (a) do not apply with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code.)" TRA 2010 § 301(c).

Have a Process*.* The executor should have a checklist and a process for making the decision. Fiduciaries are not guarantors of results, but they must demonstrate that they exercise their discretion. Projections and assumptions in the analysis should be documented and shared with the affected parties. In a Uniform Trust Code state, consent can be obtained from the beneficiaries including by virtual representation. If consents cannot be obtained from the beneficiaries, get court approval. The fiduciary will be in the crosshairs of whoever is disappointed. There is time to accomplish this, but the key is having a process with a checklist approach, documentation in the file of the analysis, and consents or court approval.

In Many Estates The Decision Will Be Easy. The decision will be easy and straightforward for many estates: (1) The taxable estate may clearly be under $5 million (select estate tax regime); (2) The taxable estate may be well over $5 million and the current estate tax will substantially exceed the ultimate income tax that will be paid on appreciation (select carryover basis regime); (3) The estate may have appreciation that can easily be covered by the $1.3 million and $3.0 million (if applicable) basis adjustments (bearing in mind that retirement benefits and other IRD assets cannot receive a basis step-up in any event) (select carryover basis regime); or (4) The estate may be only nominally above $5 million with a great deal of appreciation that cannot be covered by the basis adjustments (select estate tax regime). (However, even in those "easy" situations, the executor must determine whether the election will change the amounts of bequests passing under the will.)

Factors in Decision Making Process*.* The executor will have to consider a variety of factors in making this decision, such as whether the election will change the amounts passing under formula bequests as discussed in section IX.A.1 and IX.B of this outline (including that the election will result in assets passing under the "alternate non-marital deduction manner" if the will contains a "Clayton marital trust"), the amount of estate tax payable currently vs. the gain that would be subject to income tax on a future sale of assets (keeping in mind that income tax rates may *exceed* estate tax rates, 35% estate tax for excess over $5 million vs. 15% rate [but for recapture items the income tax rates could be 25%, 28% or even 35% and the income tax rates may be expected to increase in future years]), anticipated dates of sale, the character of the gain (for example, the Joint Committee on Taxation Technical Explanation (p. 40) says that "real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir"), anticipated state income taxes (including determination of domicile of the beneficiaries and their personal income tax situations), anticipated cash needs of beneficiaries, whether depreciation can be used to derive current income tax benefits even without selling an asset, ability to allocate basis adjustments up to fair market value at the date of death for assets that will likely be sold in the near future, anticipated future capital gains rates (and ordinary income rates for "ordinary income property"), determination of which beneficiaries bear estate taxes and comparison to persons who bear income tax attributable to lack of basis step-up, whether aggressive positions would be taken on the estate tax return or have been taken on prior gift tax returns (and whether there is any question whether disclosures on gift tax returns satisfied the adequate disclosure regulations) that would be highlighted by filing an estate tax return, and weighing the present value of anticipated income tax costs against the current estate tax amount. Some rather subtle effects of making the election include: there will be no benefit of a deduction against federal estate taxes for the payment of state death taxes, there will be no § 691(c) deduction for estate taxes attributable to income in respect of a decedent property, there will be no ability to use a prior transfer credit under § 2013, the election may impact the ability to make a QTIP election for only state purposes, there will be a step-up (or step-down) in basis for *both* halves of community property if the carryover basis election is not made, and the election may impact the expenses and complexity of administering the estate (by making or not making the election).

Consideration of the detailed tax effects of carryover basis is particularly sensitive for real estate or other depreciable property, especially if the property has a "negative basis" due to refinancings or other reasons.

If there is any possibility that the election may impact the amounts of bequests under the will, attempt to get consents of all of the parties or court approval of the election decision. (Equitable adjustments among the parties may be appropriate.) If the election benefits the executor personally, consider whether there are gift tax implications of the election. *See generally* Blattmachr, Heilborn & Gans, *Gifts by Fiduciaries by Tax Options and Elections*, 18 Prob. & Prop. 39 (Nov. Dec. 2004).

Practical Planning Pointer: The executor should carefully document and retain the analysis of the rationale for whatever decision is made regarding the carryover basis election.

<u>Procedural Issues; Time and Manner of Election and Reporting</u>. Section 301(c) says the election is to be made "at such time and in such manner" as prescribed by the Secretary of the Treasury or his delegate (interestingly, not requiring regulations). An IRS Release on February 16, 2011 states that the election to have the carryover basis regime apply "*should not* be made on the decedent's final income tax return." (emphasis in original) An IRS technical advisor has indicated informally that IRS officials are considering the possibility of having the election made simply by filing Form 8939 instead of filing Form 706. (See Section IV.B.3.b of this outline below regarding the carryover basis report.)

In light of the fact that the statute extends the due date of the estate tax return for 2010 decedents who died before December 17, 2010 to no earlier than September 19, 2011, there will presumably be a similar due date for the election for the estate tax not to apply to the estate.

Practical Planning Pointer: Estates of decedents dying in 2010 with gross estates under $5 million would not be required to file an estate tax return under I.R.C. § 6018(a)(1), and there is nothing in TRA 2010 changing that result. Those estates will not make the carryover basis election, so those estates apparently will not have to file either an estate tax return or the carryover basis report that would apply under § 6018 to estates that make the carryover basis election. (There has been no official confirmation of this by the IRS, but it seems the clear answer under the statutory language.) For estates that are over $5 million and that may want to make the carryover basis election so that the estate tax will not apply, planners are quite anxious to find out exactly what must be filed and when in order to make sure that the estate tax does not apply. For estates of decedents who died earlier in 2010, there seems to be no necessity of filing an extension of time to file the estate tax return, because of the extended September 19, 2011 due date. (However some cautious planners may do so anyway.) Query whether a further discretionary six-month extension under I.R.C. § 6081(a) will be allowed?

<u>GST Impact of Election</u>. If the carryover basis election is made, the last sentence of TRA 2010 § 301(c) adds that for purposes of I.R.C. § 2652(a)(1), "the determination of whether any property is subject to the tax imposed by such chapter 11 shall be made without regard to any election made under this subsection." Section 2652(a)(1) defines "transferor" for GST tax purposes as the last person who was subject to a transfer tax. This sentence means that for GST purposes the decedent is deemed to be subject to the estate tax and is therefore the "transferor" even though chapter 11 does not apply to the decedent in that circumstance.

<u>Modified Carryover Basis</u>. For decedents dying after December 31, 2009, the basis of property acquired from a decedent is the <u>lesser</u> of the decedent's adjusted basis or the fair market value of the property on the decedent's death. I.R.C. § 1022(a)(2). There are two exceptions from the carryover basis provisions: (1) The executor can allocate up to $1.3 million (increased by certain unused losses and loss carryovers and built-in losses) to increase the basis of assets, §1022(b); and (2) the executor can also allocate up to $3.0 million to increase the basis of assets passing to a surviving spouse, either outright or in a trust very similar to a QTIP trust, §1022(c). In order for either of the basis adjustments to apply, the assets must be "property acquired from the decedent" and property "owned by the decedent at the time of death." §§1022(d)(1) & 1022(e). There are special definitions of each of those requirements. IRD does not qualify for any basis adjustment. §1022(f). Gifts from the surviving spouse to the decedent spouse qualify for the adjustments, but gifts to the decedent from any one else within three years of the decedent's death do not. 1022(d)(1)(C).The

decedent's one-half interest in the community property and the surviving spouse's interest in the community property are both eligible for the $1.3 and $3.0 million basis adjustments. §1022(d)(1)(B)(iv). A report is due by the due date of the decedent's final income tax return listing, among other things, the fair market value and basis of each asset and the basis adjustments made by the executor. §6018.

Basis Adjustments. If the carryover basis system applies, the estate is entitled to the $1.3 million basis adjustment for assets passing to any beneficiary (§ 1022(b)) and the $3.0 million basis adjustment for assets passing to a surviving spouse or "QTIP-type" trusts (§ 1022(c)).

Holding Period. The automatic long-term capital gains holding period under § 1223(11) will not apply in 2010, because § 1041(a) does not apply. The decedent's holding period may be tacked to the estate or beneficiary's holding period if the basis is determined "in whole or in part" from the decedent's basis. If the decedent's basis is higher than the fair market value at the time of death, the decedent's basis would play no factor in determining the basis, so tacking may not be available. That has been the position of the IRS in the past in other contexts, but we do not know if the IRS will apply that same argument in the context of the carryover basis regime. (That would be a reason for selling loss assets before the decedent's death.) Otherwise, tacking apparently would be available, even if the basis has been adjusted to the date of death value by basis adjustment allocations, because the basis is the decedent's basis plus the amount of allocated basis adjustment.

Adjustments to $1.3 Million Basis Adjustment*.* The $1.3 million amount is increased by net operating losses and capital loss carryovers. I.R.C. § 1022(b)(2)(C). These generally would appear on the decedent's final Form 1040. A complexity is that if there is a joint return, the surviving spouse may have gains that offset some of the losses and there is no guidance on how to determine the decedent's share of the losses.

In addition, the $1.3 million amount is increased by any losses that would have been allowable under §165 if the decedent's property had been sold at fair market value before the decedent's death. Section 165 allows both business losses and investment losses, excluding only personal losses. The adjustment for depreciated business and investment property can be quite significant, probably a much bigger factor than the adjustment for net operating losses and net operating loss carryovers. It is not clear how this rule will apply to passive losses. They would be deductible under § 165 so they would seem to increase the $1.3 million amount. However, § 469(g)(2) describes how unused passive losses at death are treated, and the §1022 and § 469 treatment is inconsistent. Fortunately, both sections grant full regulatory authority to the IRS, so the IRS will need to provide guidance.

An unanswered question is whether the $3,000 per year limitation under § 1211 will apply for this purpose. Under § 165(f), losses from sales or exchanges of capital assets are allowed only to the extent allowed in §§ 1211 and 1212. Under § 1211, the deduction for capital losses that are not offset by capital gains is limited to $3,000 per year. Therefore, apparently there is the possibility that a substantial amount of built-in losses at death will not be added to the $1.3 million amount. The Senate Report to the 2001 Tax Act does not address this apparent limitation. It merely says that "[t]he $1.3 million is increased by the amount of unused capital losses, net operating losses, and *certain* 'built-in' losses of the decedent." (emphasis added).

While there can be a step DOWN in basis at death, the aggregate amount by which estate assets (other than personal use assets) receive a decrease in basis (except as limited by the $3,000 limit if there are not enough gains in the year of death to offset the losses) is added to the $1.3 million amount to result in additional increased basis for *other* assets that are appreciated at the time of death (assuming the estate has appreciation in appreciated estate assets exceeding the $1.3 million [and $3.0 million, if applicable] basis adjustments that would be allowed in any event).

Community Property. Both halves of community property can qualify for receiving basis adjustments and are subject to the modified carryover basis system (i.e., subject to a potential reduction in basis for depreciated assets). If there is substantial appreciation in community property, being able to get both halves of the community property stepped-up may be critically important in the election decision.

Special Carryover Basis Rules; Negative Basis Assets and Gain On Funding Pecuniary Bequests. If an asset has liabilities in excess of the basis, there is no gain at death, but when the estate of beneficiary disposes of the asset there will be gain recognition and the tax liability may exceed the net equity value of the asset. §1022(g).

If a pecuniary bequest is satisfied with appreciated property, gain is realized only with respect to the post-death appreciation amount. The beneficiary's basis is the carryover basis plus the gain recognized on funding (i.e., the post-death appreciation). §1040(c).

3. Extension of Time to File and Pay Estate Tax and GST Tax and to Make Disclaimers.

a. Estate Tax.

The estate tax return and payment date of estate tax is extended to no earlier than nine months after the date of enactment. The extension applies to estates of decedents dying from January 1, 2010 to the day before the date of enactment (i.e., to December 16, 2010). (The extension in the Baucus bill was only for four months rather than nine months.) [TRA 2010 § 301(d).]

Practical Planning Pointer: The date of enactment is December 17, 2010, so the due date is extended to September 17, 2011, which falls on a Saturday, so the due date of estate tax returns for 2010 decedents is no earlier than September 19, 2011.

b. Carryover Basis Report.

Under current law, the carryover basis report under § 6018 is required to be filed with the decedent's final income tax return. I.R.C. § 6075(a). The two types of property that must be reported under § 6018 are: (1) transfers at death of non-cash assets in excess of $1.3 million; and (2) appreciated property received by a decedent within three years of death that does not qualify for the basis adjustments by reason of § 1022(d)(1)(C) and which was required to be reported on a gift tax return. The return is to be filed by the executor. I.R.C. § 6018 (a). In addition to the return required to be filed with the IRS, the person required to file that return must also furnish to each recipient of property described in the return a written statement giving similar information with respect to the property passing from the decedent to such person. I.R.C. § 6018(e).

There is no statute of limitations operating against the IRS with respect to values reported on the § 6018 report. The IRS could question those values years later when beneficiaries sell the assets. (This is probably the same as under current law. Values listed on an estate tax return, even after the period for assessment of additional estate taxes has run, probably are not binding on the IRS or the recipient of the property for income tax purposes [i.e., determining the amount of the basis step-up].)

The penalty for failure to file the report with the IRS under § 6018 in a timely filed return is generally $10,000, but the penalty is increased to 5% of the fair market value of the assets if the failure to report is due to the intentional disregard of the rules. There is no penalty if the failure to file is due to reasonable cause. §6716(b)-(d).

Observe, there is no provision for automatically allocating the $1.3 million basis to the entire estate if the value of non-cash assets does not exceed $1.3 million and no report is required to be filed under §6018.

Under TRA 2010, the due date for filing this report may also be deferred to nine months after the date of enactment. [TRA 2010 § 301(d)(1)(A).] EGTRRA amended § 6018 for decedents dying after 2009 to refer to a carryover basis information return instead of the estate tax return (because the estate tax does not apply under EGTRRA to decedents dying after 2009). That amendment to § 6018 (and the change to § 6075(a) regarding the due date of the carryover basis report) were in subtitle E of title V of EGTRRA, and TRA 2010 § 301(a) interprets the Code as if subtitle E had never been enacted. Therefore, the default rule under TRA 2010 is that § 6018 now refers to the estate tax return, not the carryover basis information report. However, if the carryover basis election is made, the amendment in § 301(a) does not apply as to the estate tax or carryover basis, so § 6018 continues to refer to the carryover basis report and not the estate tax return and § 6075(a) continues to require that the report be filed with the decedent's final income tax return. Section 301(d)(1)(A) extends the filing date of the estate tax return, but *not* the carryover basis report. While it refers to extending the due date for filing any return under § 6018 and while that will mean the carryover basis report if the carryover basis election is made under § 301(c) of TRA 2010,

§ 301(d)(1)(A) specifically says the extension applies to any return under § 6018 "as such section is in effect after the date of this enactment of this Act *without regard to any election under subsection (c)*." Therefore, this provision in § 301(d)(1)(A) of TRA 2010 does not override § 6075 regarding the due date of the carryover basis report.

The IRS issued a draft of Form 8939 for comments on December 16, 2010. The draft form does not include instructions. The draft form does not contain any reference to an election provision (in light of the fact that the draft was prepared before TRA 2010 was enacted providing for the election). The form contemplates that the specific assets passing to each distributee (together with the carryover basis, value, holding period and basis adjustment allocation for each asset) will be listed on the form. (The form does not address what will happen if the executor has not paid all debts and expenses, paid all taxes and made final distributions of the assets to the beneficiaries by the time the form is due. Until all of that has happened, the executor cannot know what specific assets will pass to the respective beneficiaries. Informal indications from IRS officials are that the "estate" would likely be shown as the distributee of undistributed items, and that no further reporting would be necessary after the distributions are made.)

An IRS Release on February 16, 2011, available at http://www.irs.gov/pub/irs-pdf/f8939.pdf, gave the first official preliminary guidance regarding procedures and filing dates for the Form 8939. An announcement on March 2, 2011, available at http://www.irs.gov/formspubs/article/0,,id=236791,00.html, described similar information regarding Publication 4895. The IRS issued an additional news release on March 31, 2011 (saying that a "reasonable period of time" would be allowed after the issuance of further guidance until the deadline for filing Form 8939). These Releases give the following guidance:

- The IRS will issue, in order, (1) Form 8939, and shortly thereafter (2) instructions for Form 8939, followed by (3) Publication 4895, Treatment of Property Acquired From a Decedent Dying in 2010.
- The final Form 8939 will be posted at least 90 days before it is required to be filed.
- The Form 8939 *should not* be filed with the decedent's final income tax return (emphasis in original). ." (OBSERVATION: This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed *with* the return of tax imposed by chapter 1 for the decedent's last taxable year" [(i.e., the decedent's final income tax return] (emphasis added).
- The carryover basis election under § 301(c) of TRA 2010 *should not* be made on the decedent's final income tax return (emphasis in original).
- Instructions on how to make the carryover basis elections under § 301(c) will be described on the Form 8939, in the instructions to Form 8939, and in Publication 4895. The March 2, 2011 Release says that "[t]he election is made by filing Form 8939."
- The March 2, 2011 Release says that Publication 4895 is only relevant for estates that file the Form 8939.
- The latest information on these issues can be found at www.irs.gov/form8939.

A summary of a conversation between Robert Chapman, of the IRS Tax Forms & Publications Desk, and Carol Cantrell on February 3, 2011 (in response to comments filed by the American Bar Association Tax and Real Property, Trust and Estates Law Sections on January 31, 2011) was published by Leimberg Information Services on Feb 8, 2011. Mr. Chapman's comments included the following:

- The Form 8939, Instructions to the Form 8939 and the Publication 4895 are expected to be released by May 2011.
- The IRS will guidance regarding whether appraisals are required and whether group and de minimis rules will be allowed.
- There is no place to report the surviving spouse's one-half of community property on the Form 8939 and the IRS will give guidance; he was asked to clarify that the

surviving spouse's one-half would be eligible for the step-up and as well as a step-down in basis and he hinted that it is, by noting that the question of whether both halves of community property is adjusted is the same for both § 1014 and § 1022.

- The estate would be shown as the recipient of property not yet transferred by the time the Form 8939 is filed.
- An amendment would not be required to report subsequent transfers or distributions by the estate.
- Property that is sold by the estate cannot qualify for the $3.0 million spousal basis adjustment, even if the sale proceeds are distributed to the surviving spouse.
- The IRS may add Schedule R from Form 706 (for reporting generation-skipping transfers and exemption allocations) to the Form 8939 so that executors who need to report generation-skipping transfers or exemption allocations will not have to file both the Form 8939 and Form 706.
- The IRS prefers to make the mere act of filing the Form 8939 as the affirmative election under § 301(c) of the Tax Relief . . . Act of 2011 out of the estate tax regime and into carryover basis, rather than providing a box to check. He agrees that the Form 8939 should contain a statement to the effect that filing the form constitutes the election.
- The IRS is likely disinclined to allow a "protective election" out of the estate tax regime in the event an IRS audit adjustment made the election more advantageous.

On March 1, 2011, the IRS filed another request for comments regarding the Form 8939, stating that comments should be received by May 6, 2011 to be assured of consideration (suggesting that the Form 8939 will not be released before that date).

c. Disclaimers.

The time for making any disclaimer under I.R.C. § 2518(b) for property passing by reason of the death of a decedent (who dies after 2009) is extended to nine months after the date of enactment. [TRA § 301(d)(1)(C).] (The Baucus bill applied the disclaimer extension, as well as the other extensions, only for 2010 decedents who die before the date of enactment and referred to an extension before the time of "receiving" a disclaimer rather than the time for "making" a disclaimer.) This opens up additional planning flexibility, in light of the dramatic change in estate tax treatment under TRA 2010. Concerns with being able to take advantage of this additional time include (1) that beneficiaries may have already accepted benefits, not realizing that the disclaimer period would be extended, and (2) state law requirements for disclaimers often refer to nine months after the transfer, so disclaimers during the extended time period may not satisfy the state law requirements. Query whether states will respond by amending their disclaimer statutes for decedents dying in 2010 before the date of enactment? Section 2518(c)(3) may provide a way for getting around a continuing state law 9-month limitation on disclaimers.

Section 2518(c)(3) provides that a transfer that does not qualify as a disclaimer under local law may still constitute a qualified disclaimer under federal law, as long as the disclaimer operates as a valid transfer under local law to the persons who would have received the property had it been a qualified disclaimer under local law.

The legislative history to § 2518(c)(3), passed in 1981, says that mere acts of receiving property to be able to make a transfer complying with the statute are not treated as acceptance that would preclude a disclaimer. "[T]he individual's direction of the transferor to the individual who would have taken under local law pursuant to an effective disclaimer will not be construed as acceptance of the property." H. Rept. 97-201, 1981-2 C.B. 352, 392. The Tax Court has made clear that §2518(c)(3) applies to a transfer made by the original beneficiary, not by the executor.

> "The transferor (i.e., the beneficiary) referred to in section 2518(c)(3) is not the same transferor of section 2518(b)(i.e., the estate or executor). Section 2518(c)(3) assumes that a transfer to the beneficiary has already occurred under local law because a disqualified disclaimer did not avoid the transfer. That beneficiary can still avoid the effects of the disqualified disclaimer by making a written transfer to the person who would have received

the property (e.g., a surviving spouse) had the beneficiary made an effective disclaimer." *Bennett v. Commissioner*, 100 T.C. 42 (1993).

There must be a "written transfer" for § 2518(c)(3) to apply. Case law has held that a purported "disclaimer" that has no effect under state law does not satisfy the transfer requirement. *Bennett v. Commissioner*, 100 T.C. 42 (1993). In *Bennett*, purported disclaimers did not satisfy state law (among other things, they were not timely). The estate argued that the disclaimers satisfied §2518(c)(3), but the court disagreed because the beneficiaries did not make "actual written transfers of their interests in the Memorial Trust to the person who otherwise would have received those interests had the disclaimers been valid under local law." The court stated that §2518(c)(3) "should not be viewed as a catch-all provision to save defective or disqualified disclaimers" but that it applies when a "would be disclaimant makes an actual written transfer to the person who otherwise would have received the property had the disclaimer been valid under local law." The court quoted some of the legislative history:

> "In order to provide uniform treatment among States, the committee believes that where an individual timely transfers the property to the person who would have received the property had the transfer made an effective disclaimer under local law will be treated as an effective disclaimer for Federal estate and gift tax purposes provided the transferor has not accepted the interest or any of its benefits." H. Rept. 97-201, 1981-2 C.B. at 392.

Section 2518(c)(3) requires a written transfer of the person's "entire" interest in the property disclaimed. There is no law as to what that means (and no regulations have been issued regarding § 2518(c)(3)). The legislative history is scant as to the meaning of this requirement:

> "A transferor will not be considered a transfer of the entire interest in the property if, by reason of the transfer, some or all of the beneficial enjoyment in the property returns to the transferor or the transferor has any period after the transfer to control the beneficial enjoyment from the property." H. Rept. 97-201, 1981-2 C.B. at 392.

It is not clear whether that means that the person's entire interest in a particular "severable" interest (such as the income interest) must be disclaimed or whether literally the entire interest in the property must be disclaimed. Alternatively, is it sufficient for a person to disclaim her entire interest in an undivided one-half interest in Blackacre, or must her entire interest in Blackacre be transferred?

If the disclaimant lives in one of the few states that has a state gift tax, an issue with making transfers that qualify as disclaimers under § 2518(c)(3) is that a state gift tax will apply to the transfer, if it is not a transfer that constitutes a disclaimer under state law.

Practical Planning Pointer: If a transfer is intended as a qualified disclaimer under § 2518(c)(3) even though it does not meet the requirements under state law for a disclaimer, recite in the deed or other transfer document that the transfer is intended as a qualified disclaimer for federal tax purposes and that the assets are passing to the same persons who would have received the property had the transferor made a valid disclaimer.

Extended Due Date*:* The extended disclaimer period runs until September 19, 2011 for 2010 decedents who die before December 17, 2010. Presumably the "holiday" rule under I.R.C. § 7503 will apply because it refers to the day "prescribed under authority of the internal revenue laws for performing any act;" it is not limited just to tax returns. (For decedents who die on or after December 17, the 9-month period will run as usual, which will be sometime on or after September 17, 2011.)

d. GST Tax Returns.

The date for filing any return under § 2662 to report a "generation-skipping transfer" made in 2010 before the date of enactment (i.e., before December 17) is extended to no earlier than 9 months after the date of enactment (or September 17, 2011, which is a Saturday, so the extended due date would be no earlier than September 19, 2011). [TRA § 301(d)(2).]

Practical Impact*:* For generation-skipping transfers (i.e., direct skips, taxable distributions or taxable terminations), the due date for reporting the transaction on an appropriate return is extended to no earlier than September 19, 2011. (The GST transfer would be reported on the form, but the GST tax rate would be zero. Query whether there is any penalty for failing to file the return on time if the penalty is based on the amount of unpaid tax?) The time for filing a timely return to make a timely allocation of GST exemption to a direct skip or to make a timely election out of automatic allocation to a direct skip would be extended to September 19, 2011. (For a lifetime direct skip that would be reported on a gift tax return, if the income tax return is extended, the extended due date (October 17, 2011) would be past the September 19 date in any event.)

Practical Planning Pointer: While the time to file GST returns to report "generation-skipping transfers" (i.e., direct skips, taxable distributions or taxable terminations, § 2611(a)) that occur before December 17, 2010 is extended, there does not appear to be an extension of time for filing a return to make timely allocations of GST exemption (or elect out of automatic allocations) for "indirect skip" transfers to trusts that are not direct skips.

e. Applicability of Extensions.

The extension period for filing returns and paying estate taxes and for making disclaimers applies to estates of decedents dying in 2010 and before the date of enactment (December 17, 2010). Similarly, the extended due dates for GST returns applies for a generation-skipping transfers made in 2010 before the date of enactment. [TRA 2010 § 301(d).]

II. INCOME TAX PLANNING

As a precursor to all of the various income tax issues, the fiduciary (the executor, if any, if not, the testamentary trustee, residuary legatees or distributees) should file Form 56 to advise the IRS of the fiduciary relationship. I.R.C. § 6903; Treas. Reg. §§ 601-503 & 301.6903. Written notice of the termination of the fiduciary relationship should also be filed (on Form 56) with the same office where the initial Form 56 was filed. Treas. Reg. § 301.6903-1(b).

A. Decedent's Final Return.

1. Partnership and S Corporation Income.

For partnership tax years ending after 1997, section 706(c)(2)(A) provides that the taxable year of a partnership closes with respect to a partner whose entire partnership interest terminates by reason of death. Accordingly, the final return of a deceased partner includes the flow through items for the short year ending on the date of death. Under the section 706 regulations, the allocation for the short year is made by an interim closing of the partnership's books or, if all of the partners agree, on a pro rata basis based on the number of days in each period. See Reg. §1.706-1(c)(2)(ii). (It is generally preferable to elect out of the exact method" in order to avoid the expensive accounting costs of preparing a mid-year closing.)

Similarly, an S corporation deceased shareholder must include on his or her final return a pro rata share of S corporation income for the corporation's tax year that ends within or with the decedent's tax year. The decedent's final return must include the decedent's pro rata share of the S corporation's income for the period from the beginning of the year to the date of death, on a number of days allocation basis. §1377(a)(1). If all the shareholders agree, the allocation for the short year is made by an interim closing of the books.§1377(a)(2).

Partnership or C corporations may earn proportionately more income after the date of death than before. In that case, if the income is allocated on a pro rata per day basis (rather than using an interim closing of the books), more income will be allocated to the deceased partner's or shareholder's final income tax return. The additional income tax can be deducted for estate tax purposes as an estate liability. In addition, allocating more income to the decedent's final return may facilitate using any carryovers that terminate with the decedent's final return.

2. Net Operating Losses, Charitable Deduction and Capital Loss Carryovers.

Net operating loss (NOL) carryovers, charitable deduction carryovers and capital loss carryovers from a prior year are deductible only on the decedent's final income tax return. Any unused losses are lost. If an NOL arises from a net business loss appearing on the decedent's final return, the NOL may be carried back to previous years. I.R.C. §172(b)(1)(A)(i); Rev. Rul. 74-175, 1974-1 C.B. 52.

3. Executor's Liability for Decedent's Unpaid Income (as well as Gift or Estate) Taxes.

The executor may have personal liability if the executor makes a distribution which results in insufficient funds to satisfy the decedent's tax obligations. 31 U.S.C.A. §3713. (A major reason for filing the Form 56 is so the executor will receive notice regarding the decedent's tax liabilities to avoid unwittingly distributing assets before the liabilities are paid.) The executor does not have to have actual knowledge of the tax liability before personal liability can be imposed. It is sufficient if the executor has knowledge of facts that would make a reasonably prudent person aware of the existence of the liability. See e.g., Little v. Comm'r, 113 T.C. 474 (1999) (executor received Forms W-2 and Forms 1099 for the decedent and the estate; executor took forms to estate's attorney who advised executor that no taxes would be due because of the size of the estate; held that executor is not personally liable for unpaid income tax deficiencies of the decedent and of the estate, reasoning that receipt of the forms put the executor on "inquiry" notice, but concluding that the executor acted in a prudent and reasonable manner in forwarding the forms to the attorney for advice). Another example that may arise unexpectedly is that the executor may have liability for failing to report foreign accounts that were not reported by the decedent once the executor is put on inquiry notice. See Kapiloff & Brackney, Stuck With the Bill? An Executor's Personal Liability for Unreported Foreign Accounts, 111 J.TAX'N 168 (Sept. 2009).

Determining What Returns Have Been Filed. The executor may file Form 4506-T to make a written request for a "Record of Account" (provided free of charge) with the appropriate IRS region to determine what tax returns have been filed by the decedent. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Call 1-800-829-1040 for details.

Determining Income Items. The executor may file a written request with the appropriate IRS region for "All Information Returns" (provided free of charge) to ascertain information regarding income items reported as being received by the decedent. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Information is available after August 1 for the prior year. Typically, six years of information is maintained by the IRS. Call 1-800-829-1040.

Obtaining Copies of Filed Returns. To obtain copies of returns that have been filed with the IRS by the decedent, the executor may file Form 4506, Request for Copy or Transcript of Tax Form. Income as well as gift tax returns may be requested. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Copies of the returns are provided for a set fee per return. Call 1-800-829-1040 for details.

Estate's Liability for Income and Gift Taxes (§ 6501(d)). The executor can make a request for prompt assessment of income and gift taxes with respect to any prior returns filed by the decedent or the executor by filing Form 4810. Doing so shortens the statute of limitations on a future assessment (or court proceeding without assessment for collection of tax) to 18 months from the date the request is filed. The request must specify the classes of tax and the taxable periods for which prompt assessment is requested. Treas. Reg. §301.6501(d)-1(b). The shorter statute of limitations will not apply to fraudulent returns or unfiled returns (§ 6501(c)), any returns with "substantial omissions" (§6501(e)), or certain other types of assessments described in section 6501(c). Observe that the shorter statute of limitations under this section protects not just the executor from personal liability but also the estate and its beneficiaries.

Executor's Personal Liability for Income or Gift Taxes (§ 6905). For an example of personal liability of an executor for the decedent's gift taxes, see U.S. v. Bartlett, 186 F. Supp.2d 875 (C.D. Ill. 2002) (executrix-surviving spouse was clearly aware of gift tax liability and made distribution to family trust, of which she was trustee and sole current beneficiary, rendering estate insolvent; trust beneficiaries also liable as transferees). The executor may file Form 5495 (filed after the relevant tax return has been filed) requesting release from personal liability for the decedent's income and gift taxes. The IRS then has 9 months to notify the executor of any amount due. After that date, the executor is discharged from personal liability for any deficiency thereafter found to be due. §6905; Reg. §301.6905-1. The request should be filed with the IRS office where the relevant return was filed. After the nine-month period has run, the executor can safely distribute estate assets to beneficiaries without danger of being held personally liable for additional income or gift tax that may be assessed in the future. Filing the request for discharge of personal liability does not shorten the statute of limitations for the IRS to proceed against the estate (or the estate's transferees under transferee liability principles.) If the executor is also the sole beneficiary of the estate, filing this request does no good—the IRS could still proceed against the estate and the beneficiary directly. If the executor is one of various beneficiaries, the request for prompt assessment only protects the executor from the personal liability of an executor (but not in his or her capacity as a beneficiary) and does not protect the other family members at all.

Executor's Personal Liability for Estate Taxes (§ 2204). The executor may have personal liability for the estate taxes of the estate. (Indeed, the personal liability may not be dischargeable in bankruptcy if the executor willfully evades payment of the estate tax debt. Carroll v. U.S. 2009-2 USTC ¶60,577 (N.D. Ala. 2009)(executors failed to make all deferred estate tax installment payments but distributed the estate to themselves).) The executor may request a discharge from personal liability of estate tax after nine months from making the application (or if the application is made before the return is filed, nine months after the due date of the return). §2204(a); Reg. §20.2204-1. The executor is discharged from personal liability with respect to any deficiency in the federal estate tax found to be due after the expiration of such nine-month period. If any estate tax is deferred under sections 6161, 6163, or 6166, the executor can be released from personal liability by providing a bond (or a special lien under §6324A in the case of tax deferred under section 6166.) The request for discharge from personal liability is made by attaching Form 5495 to the estate tax return, or by filing Form 5495 after the Form 706 has been filed. Filing the request for discharge of personal liability does not shorten the statute of limitations for the IRS to proceed against the estate (or the estate's transferees under transferee liability principles.)

Planning Strategies If Executor's Personal Liability Extends Past Termination of Estate. If the executor is ready to distribute the estate while the executor has potential outstanding personal liability for income, gift or estate taxes, one of the following strategies may allow the executor to feel comfortable with distributing the assets (and terminating the estate) before the potential personal liability has been finally resolved: (1) funded escrow agreement with executor holding reserved funds; (2) refunding agreement with appropriate indemnification provisions obligating beneficiaries to deliver funds to pay personal liability obligations of the executor; (3) creation of grantor trusts by beneficiaries with direction to deliver funds to executor to protect against personal liabilities; or (4) creation of limited liability company, with executor as sole manager with authority to distribute assets to executor to pay personal obligations for taxes.

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041.

1. Consider Fiscal Year.

A decedent's estate may elect a non-calendar fiscal year as long as the first year does not exceed 12 months and the year ends on the last day of the calendar month. § 441(e); Reg. § 1.441-1T(b). Considerations in the selection of a non-calendar fiscal year include (1) deferring payment of income tax by the estate, (2) deferring beneficiaries' income tax on distributions, by allowing them to report the income in a taxable year after when the distribution was received in certain circumstances, and (3) using an initial short year to split income into two separate years, (4) if death occurs near the end of a calendar year, to allow additional time to generate deductions (for example, payment of fees) and to minimize the number of estate income tax returns required to be filed.

2. Administrative Expense Deductions; Consider Whether to Deduct Administration Expenses on Income Tax or Estate Tax Return; "Hubert Regulations".

Administration and casualty losses are deductible in computing the taxable income of the estate, even if those expenses are chargeable to principal under state law. §§165, 212, 641. Section 642(g) provides that no income tax deduction can be allowed for such expenses unless a statement is filed before the limitations period runs on the income tax return waiving the right to deduct those items on the estate tax return.

The IRS has issued final regulations in response to the Supreme Court discussion of the prior regulation in Hubert v. Commissioner, 520 U.S. 93(1997).) Treas. Reg. §§20.2013-4(b)(3), 20.2055-3, & 20.2056(b)-4(d). Fortunately, the new regulation recognizes that the payment of certain administration expenses will not require a dollar for dollar reduction of the marital or charitable deduction (as the IRS had argued under the prior regulation). However, the regulation has a variety of restrictions and limitations on when the payment of administration expenses will not require a reduction of the marital or charitable deduction. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. However, administration expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

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

Estate transmission expenses (which must reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity) means all estate administration expenses that are not estate management expenses. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Treas. Reg. §§20.2055-3(b)(1)(ii) & 20.2056(b)-4(d)(1)(ii).

The marital or charitable deduction must be reduced by the amount of any estate management expenses that are "paid from the marital [or charitable] share but attributable to a property interest not included in the marital [or charitable] share." Treas. Reg. §20.2055-3(b)(4) [charitable share] & §20.2056(b)-4(d)(1)(iii)(4) [marital share].

The marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3) & 20.2056(b)-4(d)(3).

In summary, for estates governed by the final regulations, **estate management expenses** should always be deducted on the income tax return if there is a substantial marital or charitable deduction. Taking an estate tax deduction would not result in any estate tax savings, and would forego getting any income tax savings. On the other hand, for **estate transmission expenses** there is no clear answer. Taking a current income tax deduction will usually increase the estate tax (or under a marital deduction formula clause, may operate to decrease the amount of assets passing to the non-marital share.) However, deducting estate transmission expenses on the income tax return may yield more savings if the marginal income tax bracket exceeds the marginal estate tax bracket or if the surviving spouse's estate is not subject to estate tax because of future law changes and increases in the estate tax exemption amount and reductions to the estate tax rates.

Many planners are now starting to take the position that at the first spouse's death, unless the income tax bracket is very low or unless the parties expect huge appreciation, the family is probably better off deducting transmission expenses on the income tax return rather than the estate tax return. That has the effect of reducing the bequest to the bypass trust. However, the idea is to take the "Bird in the hand" income tax savings in light of the uncertainty of the estate tax savings that may be achieved years later with the bypass trust. Another exception might be if the surviving spouse is expected to die in the next several years, and there would not be much appreciation in the bypass trust assets. While many attorneys are tending to take the deduction on the 1041 now and give up on the bypass trust reduction, there is no one answer that fits all.

If the surviving spouse can pay the transmission expenses directly, doing so may give an optimal result. (The spouse would pay expenses under the rationale that much of the advice is to advise the surviving spouse.) That reduces the surviving spouse's taxable estate, but she would not get an immediate income tax deduction—unless it is an expense deductible under §212. (Furthermore, § 212 is not a perfect deduction; for example there is the 2% floor.) Similarly, it should be possible to allocate part of fee to the marital trust.

3. <u>Effect of Two Percent Floor on Miscellaneous Itemized Deductions</u>.

a. <u>Issue</u>. Does the "2% haircut rule" in §67(e) apply to investment advisor fees of trusts—i.e., can investment advisor fees be deducted only to the extent that "miscellaneous itemized deductions" of the trust exceed 2% of the trust's adjusted gross income?

b. <u>Section 67</u>. Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income. Under §67(e) the same rules apply to estates and trusts, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are allowed in full. This exception has been analyzed under a two prong test: (1) costs paid or incurred in connection with the administration of the estate or trust, and (2) which would not have been incurred if the property were not held in such trust or estate.

c. Overview Summary of Tests From Circuit Level Courts of Appeal to Meet the "Second Prong" Requirement. All agree that the statute is clear and unambiguous. However, circuit level courts had reached differing conclusions as to the appropriate test for the second prong requirement. William J. O'Neill Jr. Irrevocable Trust v. Commissioner, 994 F.2d 302 (6th Cir. 1993), nonacq., 1994-2 C.B. 1. (costs are "incurred because of fiduciary duties"); Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. 2001) (costs are "not commonly incurred by individuals"); Scott v. United States, 186 F. Supp.2d 664 (E.D. Va. 2002) , aff'd, 328 F.3d 132 (4th Cir. 2003) (costs are "not commonly incurred by individuals"); Rudkin Testamentary Trust v. Commissioner, 467 F.3d 149 (2nd Cir. 2006) (costs that individuals "are incapable of incurring," giving as examples, trustee fees, judicial accountings, and fiduciary income tax returns). []

The American Bankers Association submitted an amicus brief in Rudkin (and with the Supreme Court in Knight) that focuses on the trustee's specific investment responsibilities under the Prudent Investor Act. That Act causes trustees to incur the cost of having professional investment advice. Many times, the trustee has a duty to delegate. The American Banker Association filed a similar amicus brief with the Supreme Court.

d. Supreme Court Approach. The Supreme Court considered the Rudkin appeal under the name Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. ___, 128 S. Ct. 782 [101 AFTR 2d 2008-544] (2008). The Supreme Court held in favor of the government, but it did not agree with the Second Circuit's test. The Court adopts the "unusual or uncommon" test used by the Fourth and Federal Circuits and concludes generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be *uncommon (or unusual, or unlikely*) for such a hypothetical individual to incur." (emphasis added) In applying this general test to investment advisory fees, the Court observes that a trust's investment advisory fees are often incurred to comply with the prudent investor standard, which is a standard based on "what a prudent investor with the same investment objectives handling his own affairs would do — *i.e.,* a prudent individual investor." In light of that "it is quite difficult to say that investment advisory fees 'would not have been incurred' — that is, that it would be unusual or uncommon for such fees to have been incurred — if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs." [SRA Observation: That seems a real reach. I know that the taxpayer's attorneys were unable to locate statistical data on how many individuals hire investment advisors. I suspect very few, on a percentage basis. For example, I wonder how many of the approximately 2,500 attorneys attending the Heckerling Institute hire investment advisors — as opposed to investing through mutual funds or with a commission based broker (where the expenses are netted against income and are not subject to the §67 limitations in any event.)] In light of the Court's reasoning, it does not seem possible for trusts to argue that individuals in the same financial situation as the trust would not commonly hire an investment advisor.

The Court does acknowledge several exceptions. First, some there may be an exception for some limited special circumstances. The Court recognizes, as the government conceded, that "some trust-related investment advisory fees may be fully deductible '*if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts.*'" (emphasis added). In addition, the court observed that "a trust may have an *unusual investment objective*, or may *require a specialized balancing of the interests of various parties*, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor." (emphasis added). The Court noted that the Trust had not asserted that its investment objective or its requisite balancing of competing interests was distinctive, so held that the Trust's investment advisory fees are subject to the 2% floor.

Second, the Court impliedly recognized that the IRS could provide regulatory guidance in stating "that the inquiry into what is common may not be as easy in other cases, particularly given the absence of regulatory guidance." Regulations could provide more practical guidance as to when investment advisory fees of trusts or estate are not subject to §67.

e. Proposed Regulations. Proposed regulations were issued after the Supreme Court accepted certiorari in Rudkin. They use a standard similar to the very strict test in Rudkin, and add that executor and trustee fees must be "unbundled" to identify the portion of the fee representing services that are unique to estates and trusts. Prop. Reg. §1.67-4. The proposed regulation provides that a cost incurred by an estate or non-grantor trust that is unique to the entity is not subject to the 2-percent floor, but costs that are not unique to estates or trusts are subject to the 2-percent floor. Prop. Reg. §1.67-4(a). The regulation identifies the following non-exclusive list of **unique** services (that are not subject to the 2-percent floor): "fiduciary accountings, judicial or quasi-judicial filings required as part of the administration of the estate or trust; fiduciary income tax and estate tax returns; the division or distribution of income or corpus to or among beneficiaries; trust or will contest or construction; fiduciary bond premiums; and communications with beneficiaries regarding estate or trust matters." The regulation gives the following non-exclusive list of **non-unique** services (the costs of which are subject to the 2-percent rule): "custody or management of property; advice on investing for total return; gift tax returns; the defense of claims by creditors of the decedent or grantor; and the purchase, sale, maintenance, repair, insurance or management of non-trade or business property." Prop. Reg. §1.67-4(b). (Cathy Hughes said that Knight rejected the government's objective test, "that is somewhat reflected in the proposed regs, but not entirely.")

Fiduciary fees must be "unbundled". If an estate or trust pays a single fee for both costs that are and that are not unique to estates and trusts, the estate or trust "must identify the portion (if any) of the legal, accounting, investment advisory, appraisal or other fee, commission or expense that is unique to estate and trusts and is thus not subject to the 2-percent floor. The taxpayer must use any reasonable method to allocate the single fee, commission or expense between the costs unique to estate and trusts and other costs." Prop. Reg. §1.67-4(c). The Second, Fourth and Sixth Circuit level courts provided that trustee fees are deductible, without any suggestion that a portion of them would be nondeductible. But the proposed regulations say the trustee fees must be unbundled. Many times, there is very little difference between trustee fees and investment management fees, so all trustee fees arguably may be nondeductible — which seems contrary to the dictum in circuit level cases. (However, trustees may take the position that a significant portion of their fee represents time spent in communicating with beneficiaries and handling the many administrative duties of trustee — and in effect are undercharging for the investment advice.) There was no discussion of this unbundling requirement in the Supreme Court oral argument (or in the opinion).

Corporate fiduciaries will have difficulty isolating out the portion of the trustee's fee that is unique to estates and trusts. For example, isolating the portion of the fee attributable to "communications with beneficiaries regarding estate or trust matters" is very unclear. Regulations merely provide that the taxpayer "must use any reasonable method" to make the allocation.

No case has ever hinted that legal and accounting fees are not fully deductible, but legal and accounting fees are not on the safe harbor list of expenses considered "unique" to an estate or trust. Form 1041, line 14 invites the trust or estate to deduct "attorney, accountant, and return preparer fees" without any limitation on the deductibility of the fees. Attorneys will now have to allocate their fees between those that all are and are not unique to estates and trusts. For example, attorneys fees on a lawsuit in a contractual matter would be subject to 2% rule, but legal fees incurred by trust in a will contest suit would not.

The Knight case's rejection of the "would means could" position and its interpretation of the exception as referring to uncommon, unusual or unlikely expenses will presumably form the basis for revising the proposed regulations before they are finalized. The Court's reasoning would suggest that the IRS will have to change its proposed regulations, to use some standard other than the "unique" standard (which is just a different way of referring to expenses that only trusts and estates incur and that individuals could not incur.)

The IRS is still in the ;process of finalizing the regulations.

f. Interim Guidance Regarding Unbundling Requirement for 2007-2009 Returns. Notice 2008-32, 2008-11 IRB 593, provides interim guidance on the 2 percent floor limitations for trusts and estates relating to bundled investment management and advisory costs. Importantly, the notice confirms that the forthcoming final regulations will only apply prospectively. Taxpayers may continue to deduct the full amount of the bundled fiduciary fee without regard to the 2 percent floor for 2007 returns (Notice 2008-32), for 2008 returns (Notice 2008-116), and for 2009 returns (Notice 2010-32). (Observe that if a trustee hires an investment advisor, the Knight decision does apply, even for 2007-2009 returns.) Notice 2008-32 requested comments, including comments on possible safe harbors and reasonable allocation methods with respect to costs that are subject to the 2 percent floor, and costs that are not subject to the 2 percent floor. The Notice says that final regulations "will be published without delay after the extended comment period granted in this Notice," but we are still waiting on the final regulations. Apparently, no further proposed regulations will be issued for review of how the regulation is revised in response to the Knight decision or in regard to safe harbors for bundled fees and expenses.

g. Significance. Sometimes, investment management fees are a big number. Also, if the estate or trust has miscellaneous itemized deductions and is in the posture of paying alternative minimum tax, the trust loses all of the deductions (because the portion of "miscellaneous itemized deductions" that are subject to the 2% floor are treated as tax preference items for purposes of the alternative minimum tax.). If a 28% AMT tax applies to the trust, it is a very significant issue.

The practical impact of applying the two percent floor to investment advisory fees may be minimal on the amount of "regular" income tax. Even if a small portion of the expenses of the trust are subject to the 2% rule, they may "soak up" most of the portion that would be subject to the 2% rule. Making additional trust expenses subject to 2% rule would only have a minimal impact on the "regular" income tax of the trust. However, amounts subject to the 2% floor are treated as preference items for alternative minimum tax purposes, and there can be substantial alternative minimum tax effects even if the amount of the "regular" income tax of the trust is not increased.

h. AMT Effect of Being Type of Expense Subject to 2% Floor. Section 63(d) defines "itemized deductions" to mean deductions other than (1) deductions allowed in arriving adjusted gross income and (2) the deduction for personal exemptions. Therefore, if an investment advisory expense "flunks" §67(e), it is an "itemized deduction." Section 67(b) says that "miscellaneous itemized deductions" includes all "itemized deductions" other than 12 specific deductions listed in §67(b), none of which covers investment advisory expenses. In computing alternative minimum taxable income, §56(b)(1)(A) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b)." Therefore, if an investment advisory expense does not come within the §67(e) exception for trusts and estates, all of the expense (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

The AMT effect can be much larger than the effect of not being able to deduct expenses that do not exceed 2% of adjusted gross income. For example, assume a trust has $100,000 of investment advisory expenses, and $100,000 of adjusted gross income. Despite the 2% rule, the trust can still deduct $98,000 for taxable income purposes, resulting in negligible "regular" income tax. However, for AMT purposes, no deduction would be allowed; after reduction for the $22,500 AMT exemption, the 26% tentative AMT tax is roughly $20,000.

The AMT effect is carried through to beneficiaries who receive trust distributions in excess of the trust's taxable income. Although the beneficiary will not have any taxable income if the trust has $100,000 in gross income and $100,000 in deductions, the K-1 to the beneficiary will report the $100,000 as an adjustment that must be added back for AMT purposes on the beneficiary's tax return. Distributions carry out regular taxable income first to the beneficiaries, leaving tax preferences in the trust. If distributions are less than taxable income, the AMT tax preferences stay in the trust. Excess distributions carry out tax preferences to the beneficiaries. Carol Cantrell says that the ideal plan, for AMT purposes, is for the trust to distribute more than its taxable income but less than the AMTI, and to split the preferences between the trust and the beneficiaries (because each taxpayer has its own AMT exemption). "Distributions are a dynamite cure for both the 2% rule and the AMT."

i. Effect on Trust Beneficiaries. If the 2% limitation applies, the effect will be to increase DNI — so there will be a larger hit to beneficiaries of the DNI carryout. A trustee may take the position that the 2% rule does not apply to the payment of certain investment advisory fees because they represent an "incremental cost … beyond what would ordinarily be required for the ordinary taxpayer." If the IRS reverses that position on audit and if that has the effect of disallowing some deductions, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) and who may have to go back tax returns and pay penalties and interest.

j. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income). For example, if the trust distributes enough so that the adjusted gross income, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, then there is only a $200 "hit" even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then trust would lose the benefit of the $10,000 of administration expenses.

k. Not Subject to Overall Limit on Itemized Deductions under §68. Unlike individuals, estates are not also subject to an overall limitation on itemized deductions under section 68, which (for individuals only) generally reduces the overall allowable itemized deductions (even after taking into account the two percent floor on "excess itemized deductions") by the lesser of (1) 3% (2% in 2006-2007 and 1% in 2008-2009) of the excess of adjusted gross income (AGI) over an indexed "applicable amount" ($150,500, or $75,250 if married filing separately, in 2006, Rev. Proc. 2003-70, 2005-47 IRB 979, § 3.11), or (2) 80% of the itemized deductions. §§68(a), 68(f)(2).

l. Planning Suggestion for Documenting Investment Adviser Fees and Trustee Fees. In light of the Knight decision, Carol Cantrell (an attorney and CPA in Houston, Texas) recommends preparing a separate fee agreement for investment advisers, spelling out the special balancing requirements for trustees, the necessity of investing in accordance with the requirements of the Prudent Investor Act, the particular needs of the beneficiaries, etc. There was not any special fee agreement in the facts of the Knight case.

Carol Cantrell also recommends that institutional trustees document the unique things that the trustee does, such as closely reviewing the trust agreement, evaluating situs issues, complying with federal and state filing requirements, evaluating whether to exercise the power to adjust, evaluating requirements for distributions, determining whether to make distributions in cash or in kind, evaluating income tax planning for the trust, evaluating the GST implications of trust distributions, evaluating the tax impact of distributions, etc. (Those things are 98% of the value that the trustee brings; the "stock picking" is the last thing that the trustee does.)

m. Calculation of 2% Floor is Complicated. Calculating the 2% floor is an interrelated calculation if the trust pays the beneficiary more than its DNI. Carol Cantrell says: "The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions (AMID), which depend on its AGI. Thus we have a circular calculation that requires an algebraic formula found only in the IRS instructions to Form 1041, p. 17-18."

n. Legislative Proposals; Revenue Cost. Some Congressmen are considering a bill proposal to delete the delete the second clause of §67(e)(1) ("and would not have been incurred if the property were not held in such trust or estate"). The AICPA Society has prepared an impressive letter supporting the proposal, listing 11 reasons why such repeal makes sense. The Joint Tax Committee released its score on the proposal, estimating a $3.6 billion cost over a 10-year budget window. However, "most everyone who has studied this issue believes that the JTC estimate is grossly overstated based on current IRS statistical data."

4. Election Under §645 to Treat Revocable Trust as Part of Grantor's Estate.

a. Overview. The Taxpayer Relief Act of 1997 permits the executor of an estate and the trustee of a "qualified revocable trust" to treat the trust as part of the estate (and not as a separate trust) for income tax purposes for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date". This change was made as the culmination of a long term planning project generally to treat estates and revocable trusts in a similar manner for income tax purposes.

b. Maximum Election Period; Procedures for Making Election. The election period begins on the date of the decedent's death and terminates on the earlier of (1) the day on which both the electing trust and related estate, if any, have distributed all of their assets, or (2) the day before the "applicable date." Treas. Reg. § 1.645-1(f)(1). The term "applicable date" means (A) if no estate tax return is required to be filed, the date that is 2 years after the date of the decedent's death, and (B) if an estate tax return is required to be filed, the date that is 6 months after the date of the final determination of the estate tax liability. I.R.C. §645(b)(2). The final regulations provide that the date of final determination of liability is the date that is six months after the date the closing letter is issued (or if none, after the final disposition of the case). Therefore, the section 645 election generally will terminate twelve months after issuance of the closing letter. See Treas. Reg. § 1.645-1(f)(2)(ii).

The election must be made not later than the time prescribed for filing the income tax return for the first taxable year of the estate (including extensions) and, once made, is irrevocable. I.R.C. § 645(c); Treas. Reg. § 1.645-1(e)(1).

The mechanical procedures for making the election are revised under the final regulations (which apply for decedents dying on or after December 24, 2002). If there is an executor, the executor and trustee of the QRT make the election by signing and filing Form 8855 (which was issued in March 2004). The election form must be filed by the due date (including extensions) for filing the Form 1041 for the first year of the estate (regardless of whether there is sufficient income to require the filing of that return.) Treas. Reg. § 1.645-1(c)(1)(i). If there is no executor, the trustee of the QRT (or trustees of multiple QRTs) must file the election form by the due date (including extensions) for the first taxable year of the electing trust. Treas. Reg. § 1.645-1(c)(2).

c. Obtaining TINs and Filing Short Year Return. The final regulations revise the approach of the proposed regulations by requiring that the QRT obtain a TIN after the death of the deceased owner (whether or not the election will be made and whether or not there is an executor for the estate). The trustee must furnish that number to payors to the trust after the decedent's death. Treas. Reg. § 1.645-1(d)(1). There is no requirement for the trust to file a short year return from the date of death to December 31 of that year if a section 645 election will be made. However, the final regulations retain the requirement that the Form 1041 be filed for the short taxable year from the date of death to December 31 if the section 645 election will not be made or if the trustee and executor are uncertain whether a section 645 election will be made (whether or not there is an executor). If the election is not made and if the trust has not filed a timely return, the QRT will be subject to penalties and interest. Treas. Reg. § 1.645-1(d)(2).

d. Various Tax Effects of Making Election to Treat Revocable Trust as Part of Grantor's Estate. Some of the income tax benefits that may result from electing to treat a revocable trust as part of the decedent's estate include the following:

- availability of a fiscal year under §644, Treas. Reg. § 1.645-1(e)(3)(i);
- no estimated tax obligation for 2 years after the decedent's death, Treas. Reg. § 1.645-1(e)(4);
- availability of the permanent set-aside charitable deduction under section 642(c)(2), Treas. Reg. § 1.645-1(e)(2)(iv) & (e)(3)(i);
- eligibility to hold S corporation stock without meeting special trust rules (which would permit the trust to hold S corporation stock for a somewhat extended period of time, because if a federal estate tax return is required the § 645 election applies until 6 months after the date of the final determination of the estate tax liability), Treas. Reg. § 1.645-1(e)(3)(i); see Rev. Rul. 76-23, 1976-1 C.B. 264 (estate exception applies for the reasonable period of estate administration and

applies for entire section 6166 deferral period);

• waiver of the § 469 passive loss active participation requirement for rental real estate for 2 years after death, which allows using the estate's exemption under section 469(j)(4) to use up to $25,000 in losses from rental real estate activities, even if the losses exceed the estate's passive income, Treas. Reg. § 1.645-1(e)(3)(i);

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

• allowing losses in funding pecuniary bequests under section 267(b)(13);

• simplifying the number of returns (and K-1s) if the trust meets the requirements to permit filing only an estate Form 1041 and not a separate trust Form 1041; and

• deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven additional months of deferral—which would apply if the grantor were to die in December).

One disadvantage of making the section 645 election is that the revocable trust will have to give up the benefit of an additional personal exemption and use of the lower income tax brackets that would otherwise be available to the trust. In addition, there may be additional administrative costs. For example, an allocation will have to be made of the benefit or cost of various tax effects between the trust and the estate (because they remain separate legal entities even though merged for tax purposes).

C. Funding and Distribution Planning.

1. General Rules Regarding Income Tax Effects of Distributions.

a. General Rules and Capital Gains. Any distribution from an estate, whether of income or principal, will generally carry out the income of the estate to the beneficiary to the extent of the estate's "distributable net income" (DNI). §661 (deduction to estate); §662 (income to beneficiary). DNI is the taxable income of the estate with certain modifications. §643(a). Merely allowing a beneficiary to use trust assets, even if the trust pays property taxes or maintains the asset, is not a distribution that carries out DNI to the beneficiary. duPont Testamentary Trust v. Comm'r, 66 T.C. 761 (1976), aff'd 574 F.2d 1332 (5th Cir. 1978); Comm'r v. Plant, 76 F.2d 8 (2d Cir. 1935), acq. 1976-1 C.B. 1; Ltr. Rul 8341005.

Capital Gains in DNI. One of the main exceptions from the general rule that DNI is the taxable income of the estate is that capital gains and losses are usually excluded from DNI since they are typically allocated to corpus and are not distributed to beneficiaries currently. §643(a)(3). That section provides that gains from the sale or exchange of capital assets are excluded from distributable net income to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. Regulations (published as final regulations on January 2, 2004, effective for trusts and estates with taxable years ending after January 2, 2004) clarify these rules. They provide substantially more flexibility to cause capital gains to be included in DNI; the key is that any allocation in the fiduciary's discretion to treat capital gains as being distributed must be exercised consistently and cannot vary form year to year. Treas. Reg. §1.643(a)-3(e)(Ex.2, 12, 13, 14).

Termination; Distribution of Sales Proceeds. At the termination of the trust, all trust assets including capital gains will actually be distributed, so capital gains are included in DNI. Treas. Reg. §1.643(a)-3(e)(Ex.7). If the only cash in the trust is represented by sales proceeds and they are all distributed, the capital gains are actually distributed and are therefore included in DNI. Treas. Reg. §1.643(a)-3(e)(Ex.9). If the only cash in the trust is represented by sales proceeds and only some of them are distributed, the Trustee may determine to what extent the capital gains are distributed, but in the absence of an exercise of such discretion, the capital gains that are deemed distributed and therefore included in DNI will be determined on a proportional basis. Treas. Reg. §1.643(a)-3(e)(Ex.10).

b. Exceptions: Specific Bequest Exception and Separate Share Rule; Treatment of

Interest on Pecuniary Formula Bequests.

Specific Bequest Exception. Payments of specific bequests are excluded from the general rule that distributions carry out estate income to beneficiaries. This exception applies to a bequest of a specific sum of money or specific property and which is paid or credited all at once or in not more than 3 installments. §663(a)(1). In order to qualify for this exception, the amount of money or the identity of specific property must be ascertainable under the terms of the will as of the date of death. Reg. §1.663(a)-1(b). For example, a marital deduction formula pecuniary bequest is not covered by this exception (because the amount of the bequest depends upon the amount of administration expenses and elections made by the executor.) Observe that tax advantage may be possible by failing to satisfy the specific bequest exception, to facilitate "carrying out" the estate income to the beneficiaries rather than having the income taxed in the estate at high income tax brackets.

Separate Share Rule. The separate share rule is now mandatory for estates. The general purpose is to provide a more equitable result for estate beneficiaries, by limiting the amount of distributable net income (or DNI) that is "carried out" as taxable income for a particular beneficiary to that beneficiary's pro rata share of such income that the beneficiary is entitled to receive from the estate. I.R.C. § 663(c). While this purpose is laudable, the application of the rule can be difficult, especially in estates with difficult-to-value assets.

The general effect of the separate share rule is to limit the amount of DNI that is carried out to each beneficiary (which is taxable to the beneficiary, § 662(a), and deductible to the estate, § 661(a)) to the DNI that is allocable to each beneficiary's separate share. The rule only limits the amount of DNI carried out with distributions that are made. It does not create a "flow-through" system to allocate taxable income to beneficiaries who do not receive distributions. For example, if an estate makes distributions to only one of two equal beneficiaries in year one, the separate share rule would limit the DNI carried out to that one beneficiary to his or her share of the estate's income. The remaining income would be taxed to the estate. State laws (not the separate share rules) would then determine if the income tax paid by the estate would be charged solely against the remaining beneficiary's share of the income, or whether it would be charged against the estate generally—which would be inequitable to the beneficiary who received the distribution and had to pay income tax with respect to his or her share of the income.

Interest on Funding Pecuniary Bequests. The IRS maintains that interest on funding pecuniary bequests is not included in the estate's DNI that is carried out to the beneficiary, and is not deductible by the estate as a distribution deduction under section 661 or other sections. However, it is interest income to the beneficiary. The overall effect is to create taxable income to the family. As a result, there may be an emerging trend for estate planning instruments to allocate estate income to pecuniary bequests, rather than paying interest on pecuniary bequests.

The preamble to the separate share final regulations makes clear that interest on pecuniary bequests is not subject to the 661-662 rules (i.e., it does not carry out DNI to the beneficiary and is not deductible by the estate.) This confirms the analogous position taken in the proposed regulations and retained in the final regulations with respect to elective shares that do not share in estate income but receive interest. Treas. Reg. 1.663(c)-5 Ex. 7.

A district court case has recently held that interest paid on specific bequests was not deductible. Schwan v. United States, 91 AFTR2d 2003-1658 (D. S.D. 2003). The court reasoned that the interest expense was not deductible under section 212 because it was not necessary for the estate to incur the interest charges. An investment interest deduction under section 163 was not allowed because the interest was not tied to debt incurred for an investment:

"Here, there is no investment expenditure and no debt proceeds to trace. The legacies, upon which the interest at issue was incurred, did not arise in connection with the acquisition or maintenance of property held for investment purposes. This is not a situation in which the estate incurred a debt such as a loan to maintain investment property already in the estate. Here, the purported debt at issue was not incurred as an expenditure of the estate but rather was created as an obligation of the estate by the testator in the form of a legacy. As such it has no connection to property held for investment and a deduction under

I.R.C. § 163 is inappropriate. "

Although cases have not allowed an income tax deduction for interest on pecuniary bequests, an estate tax deduction was allowed in Turner v. U.S., 93 AFTR2d 2004-686 (N.D. Tex. 2004). The court reasoned that the delay in funding the bequest was necessary to the administration because the pecuniary bequest was to an entity and the bequest was conditioned on it being a qualified charity under §2055. The entity ("Juliette Fowler Homes, Inc.") was a subordinate organization that claims exempt status by its affiliation with a church, but it had not directly requested a determination letter that it was an exempt entity. The court reasoned that the executor had to take steps to assure that bequest to the entity qualified for an estate tax charitable deduction, and was reasonable in waiting until an estate tax closing letter was received. The case also discusses the wisdom generally of delaying the funding of bequests until after an estate tax closing letter is received. However, in its conclusion, the court says that "a closing letter was particularly important in this case" because the Will required that the bequest be made only to an exempt entity. Whether the court would have allowed the interest deduction without that special situation is unclear.

c. Distribution of Appreciated Property in Satisfaction of Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. A pecuniary bequest or amount is one that has a fixed or definite dollar amount. Reg. §1.661(a)-2(f)(1); Kenan v. Commissioner, 114 F.2d 217 (2nd Cir. 1940). This general concept applies to funding pecuniary marital deduction bequests (Rev. Rul. 60-87, 1960-1 C.B. 286; Rev. Rul. 56-270, 1956-1 C.B. 325), or in satisfaction of a debt (Rev. Rul. 74-178, 1974-1 C.B. 196).

The Taxpayer Relief Act of 1997 extended the loss disallowance rule of §267 (which disallows any deduction for loss on a sale or exchange of property between certain related parties including a trust and a beneficiary of the trust) and the ordinary income rule under §1239 (which treats gain as ordinary income rather than capital gain for sales or exchanges of depreciable property between a trust and a beneficiary of a trust) to sales or exchanges between an executor and a beneficiary of the estate. However, the extension of §§267 and 1239 does not extend to a sale or exchange that is in satisfaction of a pecuniary bequest I.R.C. §267(b) (13). Therefore, a distribution of a depreciated asset to a beneficiary in satisfaction of a pecuniary bequest can still qualify for a loss deduction. In funding pecuniary bequests, keep in mind the possibility of generating a loss deduction to the estate by funding the bequest with assets that have depreciated in value since the date of the decedent's death. This exception from the loss disallowance rule for funding pecuniary bequests is available to estates, but not trusts.

d. Distribution of IRD to Satisfy Pecuniary Bequest Accelerates Recognition of IRD. A distribution of a right to receive IRD in satisfaction of a fixed sum of money bequest will likely cause tax on the IRD accelerated. Treas. Reg. § 1.691(a)-4(b)(2) says that if the right to receive IRD is transferred to a specific or residuary legatee, only the legatee includes the IRD in income. An implied connotation is that transferring IRD in satisfaction of a pecuniary bequest does not carry out the income tax burden to the legatee; if not, the distribution would seem to be treated as a transfer or sale of an IRD item under Reg. § 1.691(a)-4(a), which would trigger the income. See Reg. §1.661(a)-2(f)(1) & 1.1014-4(a)(3).

The acceleration problem does not occur if IRD is distributed in satisfaction of a percentage bequest where the executor had the right to make distributions in cash or in kind and to allocate assets to a particular beneficiary. Letter Rul. 200234019. Furthermore, allocating an item of IRD in satisfaction of a portion of a residuary bequest does not trigger acceleration. E.g., Ltr. Ruls. 201013033 (no listed beneficiary so estate was default beneficiary; IRA transferred to one of charities entitled to residuary estate under revocable trust agreement); 200652028 (trustee's exercise of discretion under non pro rate funding authority to distribute IRA in satisfaction of residuary distribution of trust not a deemed transfer under §691(a)(1)).

e. Distribution of IRA In Satisfaction of Pecuniary Bequest. A different result may apply in the situation of satisfying a pecuniary bequest with an IRA. For example, the IRS has issued several letter rulings that addressed the availability of a spousal rollover when a pecuniary marital deduction bequest was funded with an IRA without also addressing whether funding the pecuniary bequest with the IRA triggered immediate income recognition. Ltr. Ruls. 9808043, 9623056, 9608036, & 9524020. Some commentators believe that the taxation of distributions from qualified plans and IRAs is governed exclusively by sections 672, 402(a), and 408(d)(1), and that no income recognition occurs until there is an actual distribution or some other transaction expressly made taxable under those sections. See Ice, Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Arena From the Sublime to the Ridiculous, Texas Tax Lawyer 37 (Oct. 2000)(describing positions of Marjorie Hoffman and Merv Wilf). The issue is whether section 402(a) and 408(d)(1) are exclusive and, in effect, override section 691. An argument can also be made under §691 itself that satisfying a pecuniary bequest with an IRA would not trigger acceleration. See Choate, Life and Death Planning for Retirement Benefits 103-08 (5th ed. 2003).

In CCM 2006-44020, a trust made a pecuniary bequest of $100,000 to charities. The trustee directed the IRA provider to put $100,000 of the IRA into the names of the charities (hoping to get the $100,000 IRA to the charity without anyone ever having to pay income tax on the $100,000 because of the charity's tax exempt status.) The IRS said that the distribution would trigger ordinary income to the trust, reasoning that a transfer of an IRA to a pecuniary fixed dollar legatee accelerates income recognition under §691(a)(2). There is a split among planners as to whether this is correct. For example, Professor Christopher Hoyt believes that the qualified plan rules should trump §691, and that there should not be gain recognition when an IRA is used to fund a pecuniary bequest. Leimberg Information Services Charitable Planning Newsletter #110 (Nov. 7, 2006). Natalie Choate thinks the IRS may have been right. Leimberg Information Services Employee Benefits and Retirement Planning Newsletters #395 & 396 (Dec. 26 & 28, 2006). Natalie reasons that the trustee had a choice of assets to use to fund the bequest, and because the trustee chose to use the IRA, that could be an assignment of income under §691(a)(2). Section 691(a)(2) says that after death of an owner of an "income in respect of a decedent" asset, a transfer of the IRD to someone else triggers immediate realization of income UNLESS the person is entitled to the asset under the decedent's will or trust. The ruling reasoned that the charity was not entitled to that particular asset. (The CCM went too far, though, in citing a 60 year old case that does not even mention §691(a)(2) as support for its conclusion.)

Planning Pointer: Natalie Choate points out that this ruling should not apply if the trust document says the trustee MUST satisfy the bequest with the IRA—even if it is a pecuniary bequest. Also, the ruling does not apply if the beneficiary designation itself contains the pecuniary gift. Id.

2. Consider Planning Considerations in Distribution of Installment Note.

a. If Decedent Made Sale Before Death, Distribution of Note to Beneficiaries Does Not Trigger Gain. An installment note held by a decedent may be distributed by the estate without causing the immediate recognition of gain (as long as it is not distributed to the obligor on the note and is not distributed in satisfaction of a pecuniary bequest). §453B(c). See generally LeDuc, Avoiding Unintended Dispositions of Installment Obligations, 31 EST. PL. 211 (2004).

b. If Estate Made the Sale, Distribution Triggers Gain. A transfer of an installment obligation would generally cause the transferor immediately to recognize any remaining gain which has been deferred by the installment reporting method. §453B(a). (The exception under §435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing from a decedent, rather than installment notes arising after the decedent's death.) Rev. Rul. 55-159, 1955-1 C.B. 391. Of course, in many situations in which the estate sells an asset for an installment note, there should be little gain to recognize upon a disposition of the installment obligation due to the step-up in basis of the asset at death.

c. Distribute Asset to Beneficiary and Allow Beneficiary to Sell. If an estate asset is to be sold that has substantial appreciation above its stepped-up basis, consider distributing the asset to a beneficiary and allowing the beneficiary to make the installment sale.

d. Distribute Installment Note to Person Other Than Obligor. While §453B(c) contains a general exception for distributing a decedent's installment note to beneficiaries of the estate, that section applies "except as provided in section 691." Section 691(a)(5)(A)(i) provides that a transfer by the estate of a decedent's installment note to the obligor of the note will trigger recognition of gain on the note. If the obligor is related to the decedent, within the meaning of §453(f)(1), the amount of gain triggered by the disposition will be based on the full face amount of the note instead of just the fair market value of the note, if the fair market value is lower. §691(a)(5)(B). In addition, any cancellation of such a note is treated as a transfer that triggers immediate gain on the note. If the decedent's will specifically bequeaths the note to someone other than the obligor of the note, the gain should not be triggered to the estate. If the estate elects to make a non-pro rata distribution of the assets pursuant to authority in the will or state law, and if the executor elects to distribute an installment note to someone other than the obligor, it is not clear whether recognition of the gain to the estate will be avoided. The IRS might conceivably take the position that there has been an indirect distribution of the note to the obligor. See Ltr. Rul. 8806048. See generally Hesch, Dispositions of Installment Obligations by Gift or Bequest, 16 Tax Management-Estates, Gifts and Trusts Journal 137 (1991).

e. Consider Delaying Cancellation of Installment Note Owed by Beneficiary or Distribution of Installment Note Owed by Beneficiary. A cancellation of a note at death, or a bequest of an installment note to the obligor will trigger recognition of inherent gain on the note to the estate. However, the triggering transfer and the related reporting of gain does not occur until the earliest of (1) the executor's assent to the distribution of the note under state law, (2) the actual cancellation of the note by the executor, (3) upon the note becoming unenforceable due to the applicable statute of limitations or other state law, or (4) upon termination of the estate. Ltr. Rul. 8552007. For example, if an installment note passes by the residuary clause to the decedent's child, the accelerated gain is reported by the estate in the year in which the note is actually distributed to the child. Ltr. Rul. 8806048.

3. Consider Whether Making In-Kind Distribution Will be Treated as a Taxable Transaction.

If a will leaves bequests to multiple beneficiaries, and if the beneficiaries agree to take specific assets of equal value rather than receiving pro rata distributions of a fractional interest in every asset, the IRS takes the position that this results in a taxable sale or exchange between the estate beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159.

Rev. Rul. 69-486 indicates, however, that if the executor has the authority to make a non-pro rata distribution, no taxable event occurs when a non-pro rata distribution is made.

4. Basis Issues.

a. General Rule. Property includible in a decedent's gross estate for estate tax purposes generally takes a new basis equal to the fair market value at date of death (unless the alternate valuation date is elected, in which event the value on six months after the date of death or the date of a prior disposition of property by the estate controls.) This rule can either "step up" or "step down" the basis of property. I.R.C. §1014. For community property, both halves receive a changed basis—not just the decedent's half. I.R.C. §1014(c). An important exception to the changed basis rule applies for income in respect of a decedent items (which generally are items earned before death but received after the date of death.)

b. Beneficiary May Rebut Valuation on Estate Tax Return. For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). However, except where the beneficiary is estopped by his previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate), the estate tax value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements. Rev. Rul. 54-97, 1954-1 C.B. 113; see Augustus v. Comm'r, 40 B.T.A. 1201 (1939). In Technical Advice Memorandum 199933001, the IRS ruled that an individual beneficiary who was not the executor of the estate and took no other inconsistent actions or statements was not estopped from trying to establish that the date of death value (and the basis) was higher than the value reported on the estate tax return. In Janis v. Commissioner, T.C. Memo 2004-117, aff'd, 461 F.3d 1080 (9th Cir. 2006) the court applied a duty of consistency where the sole beneficiaries were also the sole co-executors of the estate, The court held that the discounted estate tax value of an art gallery set the basis of individual art works (proportionately), observing that the beneficiaries were not contending that the discounted value was incorrect for estate tax purposes.

The Treasury on May 11, 2009 released the General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (often referred to as the "Greenbook") proposes various "loophole closers" to help fund a reserve for health care reform. One of the deals with consistency of basis. It proposes that gift transferees would be required to use the donor's basis, (except that the basis in the hands of the recipient can be no greater than the value of the property for gift tax purposes). The basis of property received by death of an individual would be the value for estate tax purposes. Regulations would address implementation details, such as rules for situations in which no estate or gift tax return is required, when recipients may have better information than the executor, and when adjustments are made to the reported value after the filing of an estate or gift tax return.

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 provides further insight. As to the estoppel issue, the report states that a beneficiary "should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination." In addition, the report seems to provide that the basis would be the value "*reported* for transfer tax purposes" (i.e., the value placed on the gift or estate tax return) and not the value ultimately determined in an estate or gift tax audit. The report says that would have "the salutary effect of encouraging a more realistic value determination in the first instance." The report adds that the salutary effect would be lost if there were a relief mechanism in case the basis used by transferees differed from the fair market value "ultimately determined for transfer tax purposes." In contrast, the Greenbook says that the basis would be "the value of that property for estate tax purposes" and that regulations would address "the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.") Finally, the report clarifies that under the proposal, the basis of the recipient can be no *greater than* the value determined for estate and gift tax purposes, but the recipient could claim a lower value to avoid accuracy-related penalties under §6662 if the transferor overstated the value for transfer tax purposes.

5. Equitable Recoupment.

An unfair result may occur in a situation in which an estate asset is sold after the decedent's death, the gain is reported using the value date of death value as reported on the estate tax return, the time period for claiming an income tax refund expires, and afterward the estate tax value of the asset is finally determined and is increased. In that situation, equitable recoupment may provide relief for the taxpayer. The equitable recoupment doctrine is a well established equitable remedy when the same transaction, item or taxable event is subject to two inconsistent taxes. United States v. Dalm, 494 U.S. 596, 608 n.5 (1990). The doctrine permits a party to a tax dispute to raise a time barred claim in order to reduce or eliminate the money owed on the timely claim. Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 300 (1946). (The doctrine may also be raised by the IRS as a defense to a claim for refund. E.g., Estates of Buder v. United States, 372 F. Supp.2d 1145 (E.D. Mo. 2005), aff'd, 436 F.3d 935 (8th Cir. 2006).

The required elements of an equitable recoupment offset are as follows. (1) The "same transaction, item or taxable event" must be subject to two taxes; (2) The taxes must be inconsistent; (3) The tax sought to be recouped must be time barred; (4) There must be an "identity of interest" between the parties paying the duplicative tax; and (5) The court in which the recoupment claim is brought must independently have jurisdiction to adjudicate the claim. E.g. Estate of Branson v. Comm'r, 264 F.3d 904 (9th Cir. 2001), cert. denied 535 U.S. 927 (2002); Estate of Jorgensen, T.C. Memo. 2009-66 (equitable recoupment allowed to adjust for prior income tax overpayments in light of increase in basis attributable to increased gross estate value after §2036 applied to include assets contributed to family limited partnership in gross estate).

From a planning perspective filing a protective claim for refund of the initial tax should be filed, if possible, rather than having to rely on an equitable recoupment argument. This is a fairly common situation, where the IRS claims that estate assets are undervalued for estate tax purposes, and typically that allegation would arise before the statute of limitations has run on any post-death sales of assets by the estate or estate beneficiaries, thus leaving time to file a protective claim for refund of the excess income tax paid by the estate or estate beneficiary.

D. Executor's Commissions.

1. Consider Tax Effects of Payment of Executor's Commissions.

If an executor's commission is paid, the executor will receive the fee as ordinary income, and the fees will be deductible by the estate for estate tax or fiduciary income tax purposes. If the executor does not accept a fee, there will be no deduction on the estate tax return or fiduciary income tax return, but the executor will not realize ordinary income. Therefore, the executor should consider the relative marginal brackets of the executor's personal income tax, the estate tax, and the fiduciary income tax. In addition, if younger generation family members are also beneficiaries, the executor may effectively shift value from the older generation to the younger generation without any additional transfer tax costs by waiving commissions.

In comparing the bracket of the individual fiduciary in receiving the income versus the bracket of the estate for deductions, consider whether the executor's commission will be treated as self-employment income subject to the self-employment tax. Rev. Rul. 58-5, 1958-1 C.B. 322 (executor commissions of nonprofessional fiduciaries generally not treated as earnings from self-employment).

2. Comply with Requirements for Valid Waiver of Commissions.

Two issues arise with respect to whether a waiver of executor commissions will be recognized: (1) whether the income will be includible in income even though not received, under the constructive receipt doctrine, and (2) whether the waiver will be treated as a gift to residuary beneficiaries. The primary factor is whether the commissions are waived early in the estate administration. Rev. Rul. 64-225, 1964-2 C.B. 15. A waiver should be formalized within six months of appointment. If commissions are not waived within the first six months, an intention to serve on a gratuitous basis may still be shown if the fiduciary fails to claim fees "and if all of the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve gratuitously." Rev. Rul. 66-167, 1966-1 C.B. 20; Breidert v Commissioner, 50 T.C. 844 (1968), acq., 1969-2 C.B. xxiv.

III. GIFT TAX PLANNING.

Any taxable gifts made by the decedent during life must be reported on timely filed federal gift tax returns. If the executor is aware of taxable gifts by the decedent for which returns have not been filed, the executor should file returns as soon as possible. Reg. §25.6019-1(c) (executor required to file gift tax return for deceased donor). If the donor dies during the calendar year in which a gift is made, the Form 709 must be filed and the gift tax must be paid no later than the earlier of (i) the date (including extensions) the decedent's estate tax return is due or (ii) April 15 of the year following the calendar year in which the gifts were made. I.R.C. §6075(b)(3); Treas. Reg. §25.6075-1(b)(2)(filing); §25.6151-1 (payment). If no estate tax return is required to be filed, the gift tax return is due on April 15 of the following calendar year. Treas. Reg. §25.6075-1(b)(2).

IV. ESTATE TAX PLANNING

A. Alternate Valuation Date.

1. General Rule.

The economy of the last several years has left many situations in which the estate assets decline in value during the first six months following the decedent's death. The alternate valuation election in that situation *may* produce substantial estate tax savings, but careful planning is required. See generally Blattmachr & Lo, Alternative Valuation—Now, Perhaps, More Important Than Ever, 111 J. TAX'N 90 (Aug. 2009).

An executor may elect to have the estate assets valued as of a date six months after the decedent's death. There are two requirements to qualify for the alternate valuation date election; the gross estate must decline as a result of making the election and the combined estate and GST taxes must decline as a result of making the election. If the alternate valuation date is selected, any assets sold or distributed during this six-month period would be valued as of the date of sale or distribution. §2032(a). The actual sales price of a publicly traded security, not the median between the high and low on the date of sale, is used. Rev. Rul 70-512, 1970-2 C.B. 192. For estates of decedents dying after July 18, 1984, the election may be made only if it will decrease the value of the gross estate and the combined amount of federal estate tax (reduced by allowable credits) and federal generation-skipping transfer tax. §2032(c). Treas. Reg. § 20.2032-1(b)(1).

The regulations describe in detail what property is "included" and "excluded" in the alternate valuation date value. For example, income earned or accrued after the date of death is generally excluded. Treas. Reg. §20.2032-1(d).

While income earned or accrued after the date of death are generally treated as "excluded property", Regulation § 20.2032-1(d)(4) states that dividends declared to stockholders of record on or before the date of death are included property. "On the other hand, ordinary dividends out of earnings and profits declared to shareholders of record after the date of decedent's death are 'excluded property' and are not to be valued under the alternate valuation method." Treas. Reg. § 20.2032-1(d)(4). The IRS ruled privately that amounts earned by a decedent's wholly owned corporation during the six-month period after her death that were not distributed to her estate during that period were not excluded property for purposes of determining the value of the stock on the alternate valuation date. Letter Rul. 200343002. (The estate could avoid this result and reduce the alternate value by simply declaring all of the corporation's earnings as dividends during the six-month period after the date of death.)

2. Mechanics for Making Election; Protective Elections

Once made, the election is irrevocable. §2032(d)(1). The election cannot be made if the federal estate tax return is filed more than one year after the expiration of the time for filing the return (including extensions). §2032(d)(2). The election must be made on "the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted)." Reg. § 20.2031-1(b)(1).

The regulation also removes Reg. §301.9100-6T(b), so that estates that fail to make the alternate valuation election on the last estate tax return filed before the due date or the first return filed after the due date could request an extension of time to make the alternate valuation election or a protective election under Reg. § 301.9100-1 and §301.9100-3. There is no limit on the time for making a request for extension of time to make the election or protective election (subject to the requirements under the 9100 regulations), as long as the return was filed no later than 1 year after its due date (including extensions of time actually granted.) Reg. § 20.2032-1(b)(3). E.g.,Ltr. Ruls. 201109014 (revoking Ltr. Rul. 201033023); 200452030. Before the regulation was finalized, the IRS maintained that 9100 relief had to be requested within one year of the due date of the return. E.g., Ltr. Rul. 211419005.

If the election is made, it applies to all property in the gross estate and cannot be applied to only a portion of the property. Reg. §20.2032-1(b)(1).

The regulations provide guidance on making a protective election in cases where, based on the return as filed, alternate valuation would not result in a decrease in transfer tax but it is later determined that such a decrease would occur. Reg. § 20.2032-1(b)(2). While a protective election generally would be irrevocable, it could be revoked on a subsequent return filed by the due date (including extensions actually granted). Absent a revocation, when it is determined that the election would result in a decrease of estate and GST tax payable by reason of the decedent's death, alternate valuation would apply and could not later be changed. Reg. § 20.2032-1(b)(2). Various types of protective elections have been approved. E.g., Estate of Mapes v. Comm'r, 99 T.C. 511 (1992); Tech. Adv. Memo. 9846002; Ltr. Rul. 199942015.

3. Make Alternate Valuation Election if it Produces Lower Estate Tax.

If the aggregate value of assets in the estate has decreased by the time of the alternate valuation date, and if the estate is in the position of having to pay an estate tax, making the alternate valuation election would generally produce a favorable result. The effect is that the estate receives 100% of appreciation during the six-month period, but only bears 55% of depreciation during that period. Some planners suggest using a collar (buying a "put" on the value of the stock on the date of death and selling a "call" to completely offset the price of the put). The effect is that the estate is assured of receiving at least the value of the stock on the date of death, but can also receive some of the appreciation (i.e., up to the "strike price" on the call option) if there is appreciation during the six-month period. The estate would pay estate taxes based on the lower of the date of death or alternate value. Any additional value received by the estate would be subject to capital gains taxes. A potential issue is whether entering into the put obligation constitutes a disposition for purposes of the alternative valuation date election. See Gordon & Hoopingarner, The Estate Collar, TRUSTS & ESTATES 45 (Dec. 2008).

4. Consider Making Sufficient Disclaimers to Cause a Small Amount of Tax to be Payable.

Making the alternate valuation election in an estate that depreciates during the six month period after the date of death may be helpful if the will has a marital deduction formula clause to charge the entire loss against the marital share (for example, if a pecuniary amount marital deduction/credit shelter residuary disposition is used). For decedents dying after July 18, 1984, the election may be made only if it will decrease the value of the gross estate and the amount of the federal estate tax (reduced by allowable credits). If the estate will not pay an estate tax because of the marital deduction, consider having the spouse disclaim a sufficient amount so that a small federal estate tax would be produced. Alternatively, the trustee of a QTIP could make a partial QTIP election to generate a small federal estate tax. However, consider that this may generate a substantial state inheritance or estate tax for decedents dying before 2005. For example, for a decedent dying in 2003, if the state death tax is based on the federal state death tax credit amount, the spouse would need to disclaim $43,458, which would produce a state death tax of $17,817, in order to result in the payment of a federal estate tax—which would be reduced by making the alternate valuation date election. However, if the state has "decoupled," and imposes a state death tax based on the prior level of the state death tax credit and based on lower "applicable exclusion amounts," the added state death tax from the disclaimer may be much lower. For example, a disclaimer of $43,458 for a New Jersey decedent dying in 2003 may result in additional state tax of only $2,434 while producing a federal estate tax of $1. *See* Fox, Pomeroy & Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal State Death Tax Credit: Boom, Bust or Unknown?" 29 ACTEC J*.* 26, 30 (Summer 2003).

For decedents dying after 2004 (but before the sunset in 2011), there is no state death credit, but there is an unlimited federal estate tax deduction for state death taxes under §2058. Under that regime, if the state has an exemption equal to the federal applicable exclusion amount, a disclaimer or "unelected QTIP" of slightly more than the applicable exclusion amount would result in a taxable estate that would produce a small federal estate tax. Because a deduction rather than a credit is allowed for state taxes, a small federal tax would be produced for any amount of taxable estate in excess of the applicable exclusion amount (even after considering the state death tax deduction under §2058) as long as the state tax rate is less than 100%. However, if the state imposes death taxes based on a lower exemption, specific calculations will be needed to determine how much must be disclaimed before a federal estate tax is generated, taking into consideration that a substantial amount of state death taxes may be imposed on the federal applicable exclusion amount.

Some planners prefer using the "unelected QTIP" approach because (1) it is administratively simpler than dealing with the technical disclaimer requirements, (2) there are 15 months (if the return is extended) rather than just 9 months with a disclaimer to make the decision, and (3) the spouse can have a testamentary limited power of appointment with the QTIP approach but not with a disclaimer.

An alternative approach would be to utilize the "decreased GST tax" leg of the decreased tax rule. For example, if a portion of the residue passes to grandchildren, the GST tax may be reduced if using the alternate valuation date values reduce the size of the estate.

The disadvantage of using the alternate valuation date to lower the values in order to be able to fully fund the bypass trust is that the income tax basis of the estate assets in the hands of estate beneficiaries will be lower. The planner must weigh the estate tax savings years later (from a larger bypass trust) vs. the current tax basis decrease.

5. Consider Effects of Sales and Distributions on Alternate Values.

A sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. If assets that have depreciated in value since the date of death will have to be sold in order to generate sufficient liquidity for paying estate taxes, consider selling those assets within the six-month alternate valuation period. If sales are made after the six-month alternate valuation period, any additional subsequent drop in the market value may result in reduced proceeds of sale without any reduction of estate tax values. If the alternate valuation is to be selected, distributions should be made during the six-month period only if the executor anticipates that the value of an asset has reached a low, and that the value may increase prior to the end of the six-month period.

Another possible advantage of sales and distributions would be to prevent the increasing value of a few assets from "cannibalizing" the reduction in value of other estate assets. If the estate assets are generally declining in value but several assets are expected to increase in value, selling or distributing those assets would cap the value used for alternate valuation purposes at the value on the date of such sale or disposition. A very easy way to accomplish that for pourover will estates is to distribute the asset from the estate to the revocable trust. Even if the same person is the executor and trustee, retitling the asset in a book entry is deemed to be a disposition for purposes of the acceleration rule.

In Kohler v. Comm'r, T.C. Memo 2006-152, *nonacq.* AOD 2008-001, the company did a tax-free reorganization during the first six months of the estate administration. Is that a disposition that accelerates the alternate valuation date — so the estate would value the old Kohler stock on the reorg date — or is it a mere change in form so the estate values the new stock on the alternate valuation date? The court said it was a close question, but ruled it was tax free event, a mere change in form, so it was not treated as a disposition and the new stock was valued on the alternate valuation date. The IRS filed a non-acquiescence in the Kohler case. The Treasury's nonacquiescence makes clear that changes in value because of a change in the character of the property should not be permitted on the alternate valuation date.

Proposed regulations provide that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events. "Market conditions" is defined as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued." The regulation goes on to provide that "[c]hanges in value due to mere lapse or time or to other post-death events other than market conditions will be ignored…under the alternate valuation method." Prop. Treas. Reg. §20.2032-1(f)(1). The description of "post-death events" seems to go beyond the general definition of "market conditions," to include "a reorganization of an entity (for example, corporation, partnership, or limited liability company) in which the estate holds *an interest*." Prop. Treas. Reg. §20.2032-1(f)(3). Therefore, a reorganization may occur that is outside the control of the decedent's estate (if the estate merely holds a small interest in the entity), but the example says that is treated as a "post-death event" that would be ignored in determining the value under the alternative valuation date method. In addition, the description of post-death events includes distributions of minority interests or undivided interests between the date of death and the alternate valuation date:

> "The term post-death events includes, but is not limited to, a reorganization of an entity (for example, corporation, partnership, or limited liability company) in which the estate holds an interest, a distribution of cash or other property to the estate from such entity, or one of more distributions by the estate of a fractional interest in such entity." Prop. Treas. Reg. §20.2032-1(f)(3).

An example provides that making 10% distributions of an LLC to each of 6 residuary legatees, leaving the estate owning a 40% interest 6 months following the date of death would not permit valuing each of the distributed and retained interests as minority interests. Prop. Treas. Reg. §20.2032-1(f)(3)(ii)Ex.4. Another example similarly provides that making distributions of undivided interests in real estate pursuant to the will between a trust for the surviving spouse and a trust for the decedent's child would not permit valuing both of those interests as undivided interests for alternate valuation date purposes. Prop. Treas. Reg. §20.2032-1(f)(3)(ii)Ex. 5.

These provisions in the regulation will be effective, when the regulation is finalized, for estates of decedents dying on or after April 25, 2008

B. Special Use Valuation.

1. General Effect of Special Use Valuation.

Certain real estate used in a farm or in a trade or business may be valued at its use in that enterprise rather than at its fair market value measured by its "highest and best use." For persons dying after 1982, the maximum reduction in value is $750,000. §2032A(a)(2). The Revenue Act of 1997 provides that the $750,000 will increased for cost of living increases beginning in 1999, with any increase being rounded down to the next lowest multiple of $10,000. I.R.C. § 2032A(a)(3). The $750,000 amount has increased as follows for persons dying in the respective years: $760,000 in 1999, $770,000 in 2000, $800,000 in 2001, $820,000 in 2002, $840,000 in 2003, $850,000 in 2004, $870,000 in 2005, $900,000 in 2006, $940,000 in 2007, $960,000 in 2008, $1,000,000 in 2009 and 2010, and $1,020,000 in 2011. Rev. Proc. 2010-40, 2010-46 IRB 1.

The special use value applies for generation-skipping transfer tax purposes as well as for estate tax purposes. I.R.C. §§ 2624(b) (direct skips of property in gross estate), 2642(b)(2)(A) (for transfers at death use estate tax values in determining inclusion ratios).

2. Qualification Requirements.

A number of detailed requirements must be satisfied before special use valuation is available. An excellent summary of these requirements is included in the instructions for Schedule A on the Form 706.

3. Special Use Value.

If the special use valuation election is made, the property may be valued based on a capitalization of rents method (if it is farm or ranch land) under §2032A(e)(7) or a five-factor method under §2032A(e)(8). The capitalization of rents method is most commonly used. This method values the property by dividing the average annual gross cash rental (after payment of state and local real estate taxes) for comparable land for the five most recent full calendar years ending prior to death, by the average annual effective interest rate for all new Farm Credit Bank Loans in the district where the property is located for the year of death. The rates for each year are described in a Revenue Ruling. Rev. Ruls. 2009-21, 2009-30 IRB 162 (2009 rates in the 5 different districts range from 6.17% to 7.63%) & 2008-44, 2008-32 IRB 292 (2008 rates range from 6.09% to 7.56%). Therefore, comparable lease information must be obtained in order to determine the special use value. Cash rentals from the decedent's land cannot be used; only cash rentals from the comparable land that are the result of arms' length bargaining may be used. Courts generally have been strict in requiring the identification of comparable land and of five years of actual cash rents from those comparable properties. For an excellent analysis of the alternative valuation methods, see Rogers v. Comm'r, T.C. Memo. 2000-133.

Some attorneys report that they have been successful (on multiple occasions) in getting IRS agents to approve using the "Agricultural Value" on property tax statements as the special use value. This is one of the factors listed under the "five factor method." I.R.C. §2032A(e)(8)(C) ("assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business").

4. Minority Interest Discount With Special Use Valuation.

Various cases and rulings have recognized that a minority interest discount could not be applied to the special use value. Maddox v. Comm'r, 93 T.C. 228 (1989), Technical Advice Memorandum 9119008 and Field Service Advice 1999-1081 (April 2, 1993). A recent case, however, has held that for purposes of determining the limit based on the $750,000 (indexed) maximum reduction in value attributable to §2032A valuation, the estate could determine the highest and best use value taking into consideration a minority interest discount. (The §2032A value could be as low as such discounted highest best use value minus $750,000 indexed amount.) Estate of Hoover v. Comm'r., 69 F.3d 1044 (10th Cir. 1995), rev'g, 102 T.C. 777 (1994). The IRS has announced its acquiescence in part in the Hoover case. 1999-1 I.R.B.5, and has followed that approach in private rulings. Ltr. Rul. 200448006. The IRS has confirmed that the same approach of applying minority interest discounts to special use values also applies for GST purposes. Ltr. Rul. 200448006.

C. General Valuation Considerations.

1. Penalty Considerations.

a. Substantial and Gross Valuation Penalty Tests. The Pension Protection Act of 2006 toughened the valuation penalty rules. These tougher rules apply to any returns filed after August 17, 2006. Income tax: Substantial valuation misstatement--If there is an underpayment of income tax by more than $5,000 and if the value claimed on the return is from 150% to 200% (down from 200% to 400%) of the "correct" value, there is a penalty of 20% of the underpayment of income tax attributable to the overvaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 200% (down from 400%) of the "correct" value. I.R.C. § 6662(a & e).

Estate and gift tax: Substantial valuation misstatement--If there is an underpayment of estate or gift tax by more than $5,000 and if the value claimed on the return is from 65% to 40% (up from 50% to 25%), there is a penalty of 20% of the underpayment of estate or gift tax attributable to the undervaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 40% (up from 25%) or less of the "correct" value. I.R.C. §6662 (g-h). For example, the 20% substantial valuation misstatement penalty could apply if an estate or gift tax return claims a 35% discount that is disallowed totally.

b. Reasonable Cause Exception. A "reasonable cause" exception applies if the underpayment was due to "reasonable cause" and the taxpayer "acted in good faith". §6664(c).However, reasonable cause is no longer a defense to a gross valuation misstatement penalty for income, estate, or gift tax purposes for returns filed after August 17, 2006. As an example, this exception might apply if the valuation is supported by an appraisal by an independent qualified appraiser. See Estate of Berg v. Commissioner, 976 F.2d 1163 (8th Cir. 1992) (reliance on experienced and respected CPA constituted reasonable cause); Litman/Diener v. United States and Hotels.com v. United States, 78 Fed. Cl. 90 (2007); Estate of Jung, 101 T.C. 412 (1993) (reasonable basis for valuation used on return even though court criticized appraiser's report); Bernard Mandelbaum, 69 T.C.M. 2852 (1995) (reliance on advice of company's outside counsel and outside accountant).

One case did not suggest that merely having an independent appraisal satisfied the good faith exception, but found that the exception applied based on various factors including that the valuation was particularly difficult and unique and involved a number of difficult judgment calls. The Tax Court specifically observed that while the appraisers for both the estate and the IRS were aggressive, the court's determination of value was closer to the estate's valuation than the IRS's valuation. Estate of Josephine Thompson v. Comm'r, T.C. Memo 2004-174. The Second Circuit determined that the Tax Court did not apply the correct legal test, and remanded to the Tax Court to make factual findings based on the legal test announced by the Second Circuit. 499 F.3d 129 (2nd Cir. 2007). The court said that "reliance on … an appraiser does not necessarily demonstrate reasonable cause and good faith,", but reliance on an appraiser does satisfy the reasonable cause exception if "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." The court noted that reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law."

c. Penalty Imposed On Appraisers. Rather than the aiding and abetting penalty under §6701 (generally limited to $1,000), appraisers are now subject to a penalty equal to the greater of $1,000 or 10% of the underpayment attributable to the valuation misstatement, up to a maximum of 125% of the gross income received for preparing the appraisal, in certain circumstances. The appraiser penalty applies if the appraiser knew or should have known that the appraisal would be used in connection with a return or refund and if the appraised value results in a substantial valuation misstatement or a gross valuation misstatement. No penalty is imposed on the appraiser if the appraiser establishes that the appraised value was "more likely than not" the correct value. The appraiser penalty applies for appraisals prepared for returns or submissions filed after August 17, 2006. Query whether this provision will have a "chilling" effect on appraisers and significantly affect appraisals for tax purposes. Appraisers may be more conservative in giving tax appraisals than when giving appraisals for "real life" transactions.

d. Tax Return Preparer Penalties Broadened. While not limited to valuation issues, penalties apply to a practitioner who signs a return (I.R.C. §6694) or to a practitioner who does not sign a return but gives advice about a position on a tax return (Circular 230, §10.34(a)). Small Business and Work Opportunity Act of 2007.

(1) Overview of Standard. Section 6694 was amended in the Small Business and Work Opportunity Act of 2007 to strengthen the return preparer penalties. Section 6694 was amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50%) likelihood of success to avoid penalties. I.R.C. §6694(a)(2)(B). The Emergency Economic Stabilization Act of 2008 (often referred to as the bailout act) changed the "more likely than not" standard to "substantial authority." If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard (which may be as low as a 10% likelihood of success). I.R.C. §6694(a)(2)(C).

(2) Overview of Comparison to Taxpayer Penalty Standards. Very briefly, the major taxpayer penalty provision is for the substantial understatement of income tax, if the understatement is the greater of (1) 10% of the tax shown on the return, or (2) $5,000. The standard for avoiding taxpayer penalty is substantial authority. Therefore, for this taxpayer penalty, the standard to avoid penalties is the same for taxpayers and for preparers.

The other taxpayer penalties (including penalties related to estate and gift taxes) can be avoided if there is "reasonable cause and good faith" or a "realistic possibility of success" (which has been referred to as a 1 in 3 likelihood of success). If the taxpayer discloses a problematic issue, the standard drops to "reasonable basis" (which a recent IRS Fact Sheet says means a 10% likelihood of success, see discussion of reasonable basis standard below.)

Accordingly, for estate and gift taxes, there is still a higher standard for preparers than taxpayers to avoid penalties. Therefore, the disclosure rules (to drop the standard to a "reasonable basis" standard) is still important following the 2008 change of the basis standard to a "substantial authority" standard (rather than the higher "more likely than not" standard).

(3) Definition of Return Preparer. Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b)(2). In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return. I.R.C. §7701(a)(36)(A); Reg. §301-7701-15(a). This approach is continued in the proposed regulations.

Position by Position Approach; Primary Responsibility. A very important change in the proposed regulations is to adopt a "position by position" approach, recognizing that different preparers can be responsible for different positions on a return. (The AICPA recommended this approach. See Gans, Blattmachr & Madden, supra at 78.) If an advisor is responsible for a particular position on a return, that person is the preparer with respect to that position, not the person who signs the return.

Only One Preparer For a Position In Same Firm. "There is only one individual with a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement." Prop. Reg. §1.6694-1(b)(1).

Substantial Portion. "Whether a schedule, entry or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund." Prop. Reg. §301.7705-15(b)(3)(i). A single tax entry may constitute a substantial portion of the tax required. Factors to consider include but are not limited to: "(A) the size and complexity of the item relative to the taxpayer's gross income; and (B) the size of the understatement attributable to the item compared to the to the taxpayer's reported tax liability." Id. There is a de minimis safe harbor for certain nonsigning income tax return preparers.

(4) Reasonable Basis. The reasonable basis standard will be interpreted in accordance with the current regulations (§1.6662-3(b)(3)). Reg. §1.6694-2(d)(2).

33%? A proposed amendment to Circular 230 removed the statement that a reasonable basis means a one in three chance of success, but gives a more subjective description.

20%? An analogous provision in the taxpayer penalty provisions suggests a 20%

likelihood of success standard. (Taxpayers are only subject to a "substantial authority" standard (which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits) for undisclosed positions and a "reasonable basis" standard (which the Joint Committee on Taxation says is approximately a 20% likelihood of success on the merits) for disclosed positions in order to avoid penalties under §6662.)

10%? A recent IRS "Fact Sheet" indicates that "[a] reasonable basis is one that has approximately 10 percent or greater chance of success if challenged." Avoiding Penalties and the Tax Gap, FS-2008-19 (March 2008).

(5) Disclosure Methods to Reduce Standard to Reasonable Basis Standard — Signing Preparers. Notice 2008-13, the proposed regulations, and the final regulations include significant lenient alternatives for satisfying the disclosure requirement. Three permissible disclosure methods are described for signing preparers. One method is to file a Form 8275 or Form 8275 R with the return, Reg. §1.6694-2(d)(3)(i)(A). The second method is to deliver the return to the taxpayer with a disclosure attached. Reg. §1.6694-2(d)(3)(i)(B). The third method applies for returns other than income tax returns. (The regulation refers to returns subject to penalties pursuant to §6662 "other than the substantial understatement penalty under §6662(b)(2) and (d)." Section 6662(b)(2) and (d) refer to income tax returns.) Under this method that applies to estate and gift tax returns, the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under §6662, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(i)(C). Therefore, the preparer can always reduce the reporting standard from a substantial authority standard to a mere reasonable basis standard (for returns other than income tax returns) by merely advising the taxpayer of the taxpayer penalty standards under section §6662.

The regulations give detailed guidance as to the requirements for giving sufficient advice about penalties in order to use the more lenient disclosure standards. Reg. §1.6694-2(d)(3)(iii).

- Each Position That May Not Meet Substantial Authority Standard. The preparer must address each position for which there is a reasonable basis but not a substantial authority basis for the position.
- Tailored to Taxpayer. "The advice to the taxpayer with respect to each position… must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances." Id. The preparer must contemporaneously document the advice.
- Boilerplate Not Sufficient. "There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement …" Id.
- May Use Form or Template. "Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code." Id. The Preamble to the final regulations says that "Tax return preparers, and their firms, may use standard language to describe applicable law and may adopt a standard approach to disclosure issues."
- Single or Separate Documents. The advice may be given in a single document covering all positions, or in separate documents for each position. Id.

Practical Planning Pointer. While a boilerplate notice is not sufficient, observe that the notice required is of the penalty standards that apply to the taxpayer under §6662 (or for a nonsigning preparer, advice to the taxpayer of the opportunity to avoid penalties under §6662 or advice to another return preparer of his or her disclosure requirements). That would seem to be a very similar notice for all situations, as long as there is listing of each position for which the substantial authority standard may not be satisfied. Preparers may be able to develop a format that will generally be used for giving the requisite advice, and list the particular positions on the return that may have inherent uncertainty as to satisfying the substantial authority standard.

(6) Disclosure Methods — Nonsigning Preparers. For advice to a taxpayer, the disclosure requirement (to reduce the standard from substantial authority to reasonable basis) is met if the preparer advises the taxpayer of any opportunity to avoid penalties under section 6662 that

could apply to the position and of the standards for disclosure to the extent applicable. The preparer must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(A). For advice to another return preparer, the preparer must advise the other return preparer that disclosure under section 6694(a) may be required, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(B).

(7) Exception for Advice Given Before Transaction. In describing who constitutes non-signing return preparers, the regulations provide that if an advisor gives advice both before and after the transaction, if the amount of time afterward is less than 5% of total time both before and after, then the person is not a preparer. Planners suggested that advisors in planning transactions who anticipated having to advise another signing return preparer about reporting the transaction could avoid being treated as a preparer by giving all advice before the transaction and preparing a lengthy memo of how to report the transaction —so the planner would not have to spend any time afterward. However, the final regulations add an anti-abuse rule saying that time spent on advice before the transaction will be taken into account if the facts and circumstances show that the advice was given before the transaction primarily to avoid being treated as a return preparer. Reg. §301.7701-15(b)(2)(i). Many attorneys believe that in typical planning situations, for example such as a sale to a grantor trust, preparing a memo describing the tax effects of the transaction would be satisfactory to satisfy this exception.

(8) Reliance on Information From Others and Legal Conclusions. For purposes of determining if there is a reasonable belief to satisfy the substantial authority or reasonable basis standards or for purposes of meeting the reasonable cause and good faith exception, the regulations address when the preparer can rely on information provided by the taxpayer or another party. Reg. §1.6694-1(e)(1). The preparer may rely on such information without auditing, examining or reviewing "books and records, business operations, or documents or other evidence to verify independently" the information. However, the preparer cannot ignore the implications of information furnished to or actually known by the preparer. For purposes of the reasonable cause and good faith exception, there are further conditions described in the regulations. Reg. §1.6694-2(e)(5).

The proposed regulations stated that the preparer cannot rely on legal conclusions offered by the taxpayer. However, many issues involve both fact and legal issues. For example, if the taxpayer says "I'm married to my wife," isn't that a mixed fact and law conclusion? Also corporations have in-house counsel who offer conclusions that the preparer should reasonably be able to rely on. The final regulations dropped the statement that the preparer cannot rely on legal conclusions offered by the taxpayer.

(9) Reasonable Cause Exception. Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith. I.R.C. §6694(a)(3). (That same exception applied under prior law as well, although the formatting of the section has been revised.)

2. Make Appropriate Valuation Adjustments.

a. Undivided Interests in Real Estate. The IRS scrutinizes valuation adjustments for undivided real estate interests, in large part based on the state law right of co-tenants to partition real property interests. Tech. Adv. Memo. 9336002 (only discount is for cost of partition action). Cases have allowed substantial discounts and generally reject the IRS position limiting the discount to partition costs. Samuel J. LeFrak v. Commissioner, T.C. Memo. 1993-526 (20% minority discount and a 10% marketability discount for gifts to children of interests [under 10% to each child] in a number of apartment and office buildings); Estate of Barge v. Comm'r, T.C. Memo 1997-188 (26% discount in valuing a 25% undivided interest in timberland); Estate of Ellie Williams, T.C. Memo 1998-59 (44% discount for an undivided interest in timberland); Estate of Brocato v. Comm'r, T.C. Memo. 1999-424 (20% discount for decedent's 50 percent interest in various multiple dwelling properties; consider factors other than just cost of partition, such as the historical difficulty in selling fractional interests and lack of control); Wineman v. Comm'r, TCM 2000-193 (15%); Stevens v. Comm'r, TCM 2000-53 (25%); Estate of Busch v. Comm'r, T.C. Memo 2000-3 (10% discount); Estate of Forbes, 81 T.C.M. 1399 (2001) (allowed 30% discount suggested by the estate's appraiser); Estate of Baird, T.C. Memo. 2001-258 (60% undivided interest discount for timberland).

The Baird case is most interesting in light of the Fifth Circuit's recent determination that the estate was entitled to an award of administrative and litigation costs because the IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property. Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005), rev'g, T.C. Memo 2002-299.

A recent case continued the approach of considering illiquidity and marketability issues in addition to the cost of partition in determining that a 17.2% discount was allowed for 50% interests in a Hawaiian vacation home that were contributed to QPRTs. Ludwick v. Comm'r, T.C. Memo. 2010-104. Judge Halpern determined the value assuming a two-year partition action would be required (resulting in a 26.5% discount) and assuming that the property could be sold in one year without a partition action (resulting in a 16.2% discount). The judge weighted those outcomes, concluding that there was a 90% likelihood that no partition action would be needed (based partly on the taxpayer having the burden of proof). The resulting weighted discount was about 17.2%.

Many practitioners indicate that they often claim fractional interest discounts on the estate tax return without the benefit of an appraisal specifically addressing the fractional discount. Some practitioners indicate that the IRS audit groups in their locales are "comfortable" with a 20-25% discount, but an unsubstantiated claim for more than 25% will draw an objection on audit. One appraiser (Jeffrey Wolpin in California) who appraises about 10-20 undivided interests each year maintains a proprietary database of over a hundred undivided interest sales comparables that indicate discounts in the 30% range, which he believes has a relatively low margin for error. He indicates that their appraisals of undivided interests have not been audited to date, despite the large number of such appraisals that they have done.

The case law is not as clear regarding undivided interest discounts for tangible personal property. A mere 5% discount for owning 50% of an art collection was allowed in Stone v. U.S., 103 AFTR 2d 2009-1379 (9th Cir. 2009). The court's decision is largely based on the taxpayer not carrying the burden of proof beyond a 5% discount.

b. Interests in Closely Held Businesses.

Generally; Actual Sales. In the typical situation, there are no actual sale prices or bona fide bid and asked prices for closely held businesses. In that case, the regulations provide that shares of stock are to be valued taking into account the company's net worth, prospective earning power, dividend-paying capacity, and "other relevant factors". Reg. §20.2031-2(f).

An example of a case giving primary importance to earnings and the dividend paying capacity of the company is Kohler v. Comm'r, T.C. Memo. 2006-152,*nonacq*., AOD 2008-001. The IRS and the taxpayer were about $100 million apart on valuation issues involving both estate and gift tax deficiencies. One of errors cited was that the IRS appraiser did not use a dividend method of determining value. Because this was minority block of stock, and because there were historically payments of dividends, and because there was no other prospect of realizing value as a practical matter, the company should be valued using a dividend based methodology. Failure to use that was error—and part of the reason the IRS expert was rejected.

Actual sales within a reasonable period before and after the valuation date are given substantial weight in determining the value. In Huber v. Comm'r, T.C. Memo 2006-96, the court approved valuing gifts of closely held stock on an appraisal based on publicly traded company comparables with a 50% discount, where over 90 sale transactions had occurred with family and non-family members using that same appraisal approach. For example, in Estate of Branson v. Comm'r, T.C. Memo 1999-231, the court rejected valuing stock on the basis of "market method" appraisals by two nationally reputed appraisers. Instead, the court based the valuation primarily on sales that were made sporadically but in significant ratios just prior to and soon after death. In Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001), the Court found "no good reason" for disregarding the prior sales because the sales occurred close to the valuation date, the sellers sold the stock under their free will, and the sellers were not really closely related to the buyer.

Nonmarketability Adjustment. Some of the factors examined by courts and in IRS rulings to determine the amount of an appropriate lack of marketability discount are: (1) The cost of a similar corporation's public and private stock; (2) an analysis on the corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued. See Rev. Rul. 77-287, 1977-2 C.B. 319, 320-21; Estate of Gilford v. Comm'r, 88 T.C. 38, 60; Estate of Desmond v. Comm'r, T.C. Memo. 1999-76; Mandelbaum v. Comm'r, T.C. Memo. 1995-255 (30% marketability discount; detailed analysis of 10 factors for determining amount of marketability discount). For an analysis taking the position that the courts have generally underestimated the "magnitude of discounts for lack of marketability in the real world," see Pratt, Defending Discounts for Lack of Marketability, 29 ACTEC J. 276 (2004).

A wide variety of cases have allowed substantial marketability discounts in valuing interests in non-publicly traded corporations that own investment assets or that constitute operating entities. E.g. Estate of Josephine Thompson v. Comm'r, T.C. Memo 2004-174, rev'd on other grounds, 499 F.3d 129 (2nd Cir. 2007) (30% marketability discount and 15% minority interest discount [seriatim discount of 32%] for valuing 27% stock ownership of publishing company [compared to 45% and 40% discounts for marketability and minority claimed by the estate]; Second Circuit reversed as to reasonable cause exception to accuracy related penalty); Estate of Jelke, T.C. Memo 2005-131 (15% nonmarketability discount and 10% lack of control discount for corporation that owned mostly marketable securities, observing that the facts suggest a lower-than-average nonmarketability discount based on the factors outlined in the Mandelbaum case), rev'd and remanded on other grounds, 507 F.3d 1317 (11th Cir. 2007), cert. denied; Anderson et al v. U.S., 97 AFTR2d 2006-649 (W.D. La. 2005) (estate owned minority interests in LLCs that owned mineral interests; 40% marketability discount applied for both market and net asset value approaches and 10% liquidation discount and 10% minority discount applied for the net asset approach); Huber v. Comm'r, T.C. Memo 2006-96 (valued gifts of closely held stock on the basis of an appraisal that was based on publicly traded company comparables with a 50% discount, where over 90 transactions had occurred with family and non-family members using that same appraisal approach); Dallas v. Comm'r, T.C. Memo 2006-212 (closely held stock valued for gift tax purposes with a 20% nonmarketability discount based on restricted stock studies [the court pointed out that the taxpayer's expert should have used studies in the time frame of when the gifts were made], and minority interest discounts of 15% for the portion attributable to nonoperating assets and 20% for the portion attributable to operating assets, with no additional discount for lack of voting rights); Langer v. Commissioner, T.C. Memo 2006-232 (parties stipulated a 47.5% discount "for all applicable discounts" in valuing decedent's 29.19% interest in an LLC holding various commercial real estate development properties); Robertson, Trustee v. U.S., 97 AFTR2d 2006-371 (N.D. Tex. 2006)(magistrate's finding of fact of value of 19.6686% limited partnership interests held by four charitable lead trusts at their termination; 19% discount for lack of control interests [8% based on world equity closed-end fund data and 11% for the fact such funds were significantly different than a partnership interest] and 12.5% marketability discount [accepting IRS's appraisal and rejecting taxpayer's appraiser's 25% discount because IRS appraisal reflected actual data and academic research and taxpayer's appraisal was based solely on the appraiser's judgment and was not supported by empirical evidence], for a combined seriatim discount of 29.125%); Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F.3d 763 (8th Cir. 2010) (limited partnership holding Dell stock; lack of marketability discount of 12.5%, in part based on reasoning that partnership would have incentive to purchase gifted interests if donee wished to sell; lack of control discounts for 1999, 2000 and 2001 of 11.32%, 14.34% and 4.63%, respectively); Estate of Litchfield, T.C. Memo 2009-21 (25% marketability discount for 43% interest in corporation that owned farmland, marketable securities and a closely held subsidiary; 20% marketability discount for 23% interest in corporation that owned marketable securities and other equities; case also addressed lack of control and built-in gains discount).

Minority, Non-Controlling Interest Adjustment. Cases have also consistently allowed discounts for interests in closely held businesses that are nonvoting or that do not represent control of the business. There has been a trend in recent cases to apply a blended minority discount, with different discounts for different classes of assets in a partnership. E.g., McCord v. Comm'r, 120 T.C. 358 (2003)(minority discounts of 10% for equities and bonds, 23.3% for real estate partnerships, 40% for directly owned real estate, 33.5% for oil and gas; blended overall weighted minority discount of 15%; marketability discount of 20% [not weighted for different classes]);Lappo v. Comm'r, T.C. Memo 2003-258 (minority discounts of 8.5% for securities and 19% for real estate; overall weighted minority discount of 15%; marketability discount of 24% [not weighted for different classes of assets]); Perracchio v. Comm'r, T.C. Memo 2003-820 (minority discount factors for five different classes of assets ranging from a low of 2.0% for cash/money market funds to a high of 13.8% for foreign equities; overall weighted minority discount of 6% and 25% marketability discount [not weighted for different classes of assets]); Dallas v. Comm'r, T.C. Memo 2006-212 (closely held stock valued for gift tax purposes with a 20% nonmarketability discount based on restricted stock studies [the court pointed out that the taxpayer's expert should have used studies in the time frame of when the gifts were made], and minority interest discounts of 15% for the portion attributable to nonoperating assets and 20% for the portion attributable to operating assets, with no additional discount for lack of voting rights); Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F.3d 763 (8th Cir. 2010) (limited partnership holding Dell stock; lack of marketability discount of 12.5%, in part based on reasoning that partnership would have incentive to purchase gifted interests if donee wished to sell; lack of control discounts for 1999, 2000 and 2001 of 11.32%, 14.34% and 4.63%, respectively); Estate of Litchfield, T.C. Memo 2009-21 (14.8% lack of control discount for 43% interest in corporation that owned farmland, marketable securities and a closely held subsidiary; 11.9% lack of control discount for 23% interest in corporation that owned marketable securities and other equities; case also addressed marketability and built-in gains discount).

Family Limited Partnerships. John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in these cases as follows:

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%
Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%

Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	Undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)

Porter, Hot Topics in Estate Planning (Feb. 18, 2010).

Discount of Corporate Stock for Built-In Gains Tax. The Tax Reform Act of 1986 repealed the General Utilities doctrine, so that a liquidation of a corporation will generally generate gain at the corporate level on the corporate assets. Taxpayers have argued that such tax, which will be incurred whenever the corporation is liquidated, should be taken into account in valuing the stock.

The Fifth and Eleventh Circuits allow dollar-for-dollar discounts in cases where an interest in a corporation is being determined on a net asset value approach. Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke, 507 F.3d 1317 (11th Cir. 2007), cert. denied. The Second and Sixth Circuits instructed the Tax Court to consider the built-in gains tax liability in valuing a corporation, but suggested that it would not be appropriate to use a dollar-for-dollar discount. Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir.1998) acq. 1999-4 IRB 4; Estate of Welch v. Comm'r, T.C. Memo. 1998-167, 208 F.3d 213 (2000) (unpublished opinion).

The latest of these Circuit level cases is Estate of Jelke, 507 F.3d 1317 (11th Cir. 2007), cert. denied. The court gave a detailed history of the prior case law. The case concluded this review with a determination that the assumed liquidation and 100% offset approach avoided having to prophesy as when assets would be sold, observing that the IRS's approach "requires us to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other." The court found support in the underlying nature of the estate tax as being based "upon a 'snap shot of valuation' frozen on the date of Jelke's death." Using a liquidation assumption "eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation." In addition, the approach "bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions." The court pointed to the Fifth Circuit's reasoning, observing that while some say that this approach is an oversimplification, the other end of that spectrum is over-engineering. The court also thought this approach better reflects economic reality because a hypothetical buyer "will not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a close-held corporation, with significant, built-in tax consequences." The Eleventh Circuit remanded the case to the Tax Court, for it to recalculate the net asset value of the corporation "using a dollar-for-dollar reduction of the entire $51 million in built-in gains tax liability, under the assumption that CCC is liquidated on the date of death and all assets sold." (The Eleventh Circuit did not change the Tax Court's finding of a 10% lack of control discount and a 15% lack of marketability discount.) The Supreme Court denied the government's petition for certiorari.

The latest Tax Court case to consider the built-in gains discount is Estate of Litchfield, T.C. Memo. 2009-21. The case involved the valuation of a decedent's stock in a C corporation and in an S corporation that had converted from a C corporation about 22 months before the valuation date, and the corporate-level capital gains tax would be imposed on the sale of assets within 10 years of the S election. The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates (after discussions with the officers and board of directors of the corporation), estimated appreciation of the assets up to the anticipated sale dates, calculated the estimated capital gains taxes on those sales dates (taking into account appreciation before the date of death as well as anticipated appreciation after the date of death up to the sale date for anticipated sale dates that were within ten years of the S conversion), and discounted the tax amounts to present values. The court agreed with the estate's appraiser as to the built-in gains discount. The court specifically criticized the IRS's expert for not taking into account appreciation after the valuation date to the anticipated sale dates "that also likely will occur and that will be subject to taxes at the corporate level—what one expert has described as the tax-inefficient entity drag." (If the asset were not in the corporation, future appreciation would not be subject to the double tax, so the analysis assumes that a hypothetical buyer would take this extra corporate level tax burden into account in negotiating a sales price. The court specifically observed in footnote 10 that the expert did not apply a dollar-for-dollar discount and that the court did not need to decide if that approach would have been appropriate in this case.)

3. No Necessity of Aggregating With QTIP Assets for Valuation Purposes.

If fractional interests in an asset are included in a decedent's estate under §2033 and §2044, the IRS previously took the position that the interests must be aggregated for purposes of determining whether a minority discount is available.
Various courts rejected the IRS approach and the IRS has acquiesced. Estate of Mellinger v. Comm'r, 112 T.C 26 (1999), acq.1999-2 C.B. 763, the IRS stated that it acquiesced, in result only, in the Mellinger case. 1999-2 C.B. 763.

An important consideration in structuring estate plans prior to the first spouse's death is whether to use a bequest to a QTIP trust rather than outright to a surviving spouse in order to take advantage of the possibility of discounting values in the surviving spouse's estate for estate tax purposes if a QTIP trust is utilized. Apparently, the advantages can be achieved even if the spouse is named as a co-trustee (perhaps even as sole trustee) and is given a testamentary limited power of appointment.

These developments may cause the IRS to be even more sensitive to the values placed on assets at the first spouse's death, making sure that the estate reports based on the values of fractional interests passing at the first spouse's death, to eliminate any excess step up in basis due to overvaluation. Alternatively, some commentators have hinted that the IRS might choose to raise no objections about inclusion of assets at the first spouse's death without any fractional ownership discounts, and claim at the surviving spouse's death that a "duty of consistency" would require that the same valuation approach (i.e., no discounts) be used. (The IRS has prevailed in its duty of consistency argument in a different context in various cases. See Section IV.E.1.b of this outline.)

4. Effect of Post-Transfer Events.

The effect that should be given to post-transfer events was summarized in Polack v. Comm'r, 366 F.3d 608 (8th Cir. 2004).

> Whether evidence relating to subsequent events is admissible in determining the fair market value of property on an earlier date is an issue of relevance. Most subsequent events are not relevant because "the measure of the tax must be determined according to the situation as it existed on the date [in question], and not according to subsequent events." Morris v. Commissioner, 761 F.2d 1195, 1201 [56 AFTR 2d 85- 6485] (6th Cir. 1985), quoting Walter v. United States, 341 F.2d 182, 185 [15 AFTR 2d 1306] (6th Cir. 1965). "Information that the hypothetical willing buyer could not have known is obviously irrelevant to this calculation." First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 894 [56 AFTR 2d 85-6492] (7th Cir. 1985); accord Saltzman v. Commissioner, 131 F.3d 87, 93 [80 AFTR 2d 97-8365] (2d Cir. 1997). But subsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as "evidence of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time ... and no intervening events drastically changed the value of the property." First Nat'l Bank of Kenosha, 763 F.2d at 894; see Schnorbach v. Kavanagh, 102 F. Supp. 828, 834 [41 AFTR 808] (W.D. Mich. 1951).

In Polack, the court refused to allow an appraiser to consider unaudited financial statements in the two years after the date of death, or to consider post-transaction earnings, because those items of information would not have been known to prospective purchasers on the valuation date.

Okerlund v. United States, 365 F. 3d 1044 (Fed. Cir. 2004) was a gift tax case where post-gift sales prices were lower than the values asserted by the IRS on the date of the gift.

The Federal Circuit affirmed the Federal Claims Court decision to approve the IRS's position to exclude post-gift sales where there were changed circumstances. The changed circumstances in that case included specific instances of food contamination, which resulted in the death of a customer, and which resulted in a decline of sales and income.

In Estate of Noble v. Comm'r, TC Memo 2005-2, the decedent owned 11.6 % of a private bank. The estate reported the shares at $8,000/share (with a 45% minority interest discount) on the estate tax return. There was a prior sale of 1% of the stock 15 months before the date of death for $1,000 per share, and a sale of 0.7% of the stock 2 months before the date of death for $1,500 per share. The owner of the balance of the shares (a bank holding company that was owned by the family of an individual who was unrelated to the decedent) offered to buy the estate's shares for $7,569 per share (based on a book value appraisal, with a 29% minority discount and a 35% marketability discount). The estate declined that offer. The estate later sold all of its shares to the remaining shareholder for $9,483 per share about 13 months after the date of death. The court examined whether the buyer was a "strategic buyer" that would pay more than a hypothetical purchaser. The court held that the buyer was not a strategic buyer. The court also addressed whether the post-death event of the actual sale of the stock would be considered in determining the date of death value. The court held that it would because there was no evidence of changed circumstances that would affect the value of the property. The court discounted the actual purchase price (assuming a 3% inflation factor) to discount back to the date of death value.

In U.S. v. Davenport, 97 AFTR2d 2006-825 (S.D. Tex 2006) the issue involved the value of stock that was given on July 2, 1980. The IRS offered, as evidence of value, various settlements in other cases, and a subsequent sale of the stock about a year later. The court said the subsequent sale "is a post-event transaction which is inadmissible under existing Fifth Circuit authority. *See Estate of Smith v. Commissioner,* 198 F.2d 515 (5th Cir. 1999)."

In Estate of Gimbel v. Comm'r, T.C. Memo. 2006-270, the court determined the effect of a redemption agreement and actual purchases of stock under the agreement after the decedent's death. The actual redemption of 63% of the shares at a lower discount did not control as to the valuation of that 63% block. The court gave the standard reasoning: "Post death events are generally disregarded…However, subsequent events which are reasonably foreseeable as of the valuation date may be considered." The appraisal attached to the Form 706 did not consider the redemption agreement and the company's history of prior repurchases at all—in spite of the fact that the Company in fact purchased 63% of the estate's stock at a price that reflected only a 7.0% discount. Perhaps that was the primary red flag that triggered the audit and the lawsuit.

In Levy v. U.S.,106 AFTR2d 2010-7205 (5th Cir. 2010)(*per curiam*), the Fifth Circuit affirmed a jury finding at the district court setting the value of a partnership interest at $25 million without allowing any discount for lack of control and marketability due to partnership ownership. The facts are not well developed in the appellate opinion. The estate owned an interest in a limited partnership that owned undeveloped land, and apparently, the partnership sold the land about two years after the estate valuation date, resulting in the estate receiving $25 million. The jury determined that the value of the estate's interest was $25 million, without a discount for lack of control and marketability due to partnership ownership. The court rejected the estate's various arguments for setting aside the jury verdict. The trial court did not abuse its discretion in admitting evidence of the sale two years after the valuation date. ("The estate's expert testified that the Plano real estate market was relatively flat-- increasing approximately 3%-- so the sales price would be an accurate comparator.") As to the jury verdict allowing no discounts, the court concluded that "[t]he jury could have rationally found that no discounts for lack of control or marketability were merited because the estate controlled the general partnership interest, which has nearly unfettered control over the Partnership's assets." A confusing final footnote stated that while the appellate court "declined to set aside the jury's verdict of zero discount, we note that the actual discount applied in taxing the Estate was thirty percent. Given the valuation found by the jury, it would have had to find a discount of larger than thirty percent for the verdict to have made a difference to the judgment in this case."

Practical Lesson: Actual subsequent sales are highly persuasive absent changed economic conditions. That may be particularly true for jury trials. In this case, the jury refused to allow any discount and set the value at the amount of the actual sale proceeds received by the estate.

Section 2036: The court ruled against the IRS with respect to §2036, finding that there was a legitimate non-tax purpose of the partnership. The court did not allow the §2036 issue to go to the jury, but the jury heard all of the evidence related to §2036 (presumably including testimony suggesting that the partnership was created primarily to generate discounts).

For an excellent review of the authorities regarding the effect of post-death events, see Soskin, Estate Tax Valuation of Property Sold After Death, 30 ACTEC J. 198 (2004). The estate must always balance selling estate assets before the estate tax audit is completed. The IRS will scrutinize sales at prices higher than the value reported on the estate tax return. That factor must be balanced against the possibility of losing a sale at an outstanding price that might not be offered after the estate tax audit is completed.

D. Administration Expense and Debt Deductions.

See generally Berall, Limitations on Deductibility of Legal Fees and Fiduciary Commissions, 33 EST. PL. No. 9, 19 and No. 10, 20 (Sept & Oct. 2006).

1. Allocating Between Income Tax Return and Estate Tax Return; "Hubert Regulations". See Section II.B.2 of this outline.

2. Deductibility of Post-Death Interest Expenses.

Section 2053 does not refer to the deduction of interest as such. To be deductible, interest must qualify as an administration expense. For an outstanding article addressing the deductibility of interest, see Lindquist, Making Lemonade from Lemons—Deducting Interest on the From 706, 14 Probate & Property 21-26 (May/June 2000). See generally Harmon, & Kulsrud, When is Interest Deductible as an Estate Administration Expense?, 77 PRACTICAL TAX STRATEGIES 166 (Sept. 2006). Deducting interest as an estate tax deduction is not as attractive as at one time, because the interest would be recognized as income when received and the decrease in the estate tax rates reduces the amount of arbitrage on the rate differential between the estate tax savings and the income tax cost. Even so, substantial savings may be achieved. The estate tax rates are still higher than the income tax rates, and the estate tax reduction occurs nine months after date of death whereas the interest income may not be recognized until later years.

a. Pre-Death Indebtedness.

Interest Accrued Before Date of Death. Interest accrued before the date of the decedent's death is deductible as a claim against the estate. I.R.C. §2053(a)(3).

Interest Accrued After Date of Death. Interest that accrues after the date of death is not deductible as a claim, even if the debt is payable in installments which mature after death. Rev. Rul. 77-461, 1977-2 C.B. 324. Some courts have held that interest accruing after the date of death on pre-death debts is deductible where the executor does not pay the decedent's debt immediately in order to avoid selling estate assets at sacrifice prices, and where the interest is treated as an allowable expense of administration under local law. Ballance v. United States, 347 F.2d 419 (7th Cir. 1965); Estate of Wheless v. Comm'r, 72 T.C. 470 (1979), *nonacq.* 1982-2 C.B. 3. The Tax Court has permitted a deduction of post-death interest on a loan used to purchase "flower bonds". Estate of Webster v. Comm'r, 65 T.C. 968 (1976), *acq. in result in part,* 1977-2 C.B. 2, *nonacq. in part* ,1977-2 C.B. 3.

Interest Accrued After Date of Death on Pre-Death Debt Extended By Executor. A distinction in treatment may apply after the executor has renewed the pre-death loan. In Rev. Rul. 77-461, 1977-2 C.B. 324, the ruling stated that if the executor had obtained an extension of the decedent's obligations, in order to avoid a sacrifice sale of assets, "any *additional* interest could be deductible as an administration expense." 1977-2 C.B. at 325 (emphasis in ruling).

b. Post-Death Interest on Income and Gift Tax, State and Foreign Tax, and Funds Borrowed for General Estate Purposes.

Post-death interest on income tax is a deductible administration expense. Maehlling v. United States, 1967-2 U.S.T.C. ¶12,486 (S.D. Ind. 1967); Rev. Rul. 69-402, 1969-2 C.B. 176 (post-death interest on federal and state income tax is deductible). Similarly post-death interest expenses on gift tax deficiencies are recognized as deductible administration expenses for estate tax purposes. Estate of Webster v. Comm'r, 65 T.C. 968 (1976). The IRS acquiesced in the Webster case with respect to this issue.

Interest paid to a state in connection with state death taxes is deductible. Rev. Rul. 81-256, 1981-2 C.B. 183; Ltr. Rul. 9106005. Similarly, interest paid to a foreign tax authority for death taxes is deductible if it is an allowable expense under local law. Rev. Rul. 83-24, 1983-1 C.B. 229.

Various cases have permitted the deduction of post-death interest with respect to loans obtained by an executor, where the loans were necessary for the administration of the estate. E.g., Estate of Huntington v. Comm'r., 36 B.T.A. 698 (1937); Estate of Todd v. Comm'r, 57 T.C. 288 (1971); Hipp v. U.S., 72-1 U.S.T.C. ¶ 12,824 (D. S.C. 1971); Hibernia Bank v. U.S., 75-2 U.S.T.C. ¶13,102 (N.D. Calif. 1975), *aff'd*, 581 F.2d 741 (9th Cir. 1978).

c. Post-Death Interest on Federal Estate Tax.

(1) Interest on Deferred Payment of Estate Tax to IRS. It is now clear that interest payable to the IRS on a federal estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law; Estate of O'Neal v. Comm'r, 258 F.3d 1265 (11th Cir. 2001).

The Taxpayer Relief Act of 1997 provides that interest paid on estate taxes deferred under Section 6166 is not deductible for estate or income tax purposes. I.R.C. §§2053(c)(1)(D), 163(k). (Instead a lower rate is used for Section 6166 deferrals.) However, that imitation does not apply to estate tax deferrals under sections 6161 (discretionary extensions) or 6163 (extensions for estate taxes on reversionary or remainder interests).

Estate of Buchholtz v. Comm'r, 70 T.C. 814 (1978); Rev. Rul. 79-252, 1979-2 C.B. 333 (interest on estate tax deficiency); Rev. Rul. 78-125, 1978-1 C.B. 292 (interest on section 6166 extension).

The interest expense is deductible even if the interest accrues as a result of the estate's willful delay in filing the estate tax return and in paying the estate tax. Rev. Rul. 81-154, 1981-1 C.B. 470.

(2) Timing of Deduction for Interest on Deferred Payment of Estate Tax to IRS. In Rev. Rul. 80-250, the IRS gave two reasons for refusing to allow an "up-front deduction" for the interest accrued on a section 6166 pay out. First, an estate can accelerate payment of the deferred tax. Second, the interest rate of the deferred amount fluctuates, which makes it impossible to accurately estimate the projected interest expense.

Various courts agreed with the IRS's concerns, and refused to allow an upfront deduction of the estimated interest because of the fluctuating interest rate and the possibility of prepayment (or forced acceleration) of the deferred payments. Estate of Bailly v. Comm'r, 81 T.C. 246, modified, 81 T.C. 949 (1983); Estate of Spillar v. Comm'r, 50 T.C.M. 1285 (1985); Estate of Harrison, 52 T.C.M. 1306 (1987).

(3) Interest on Amounts Borrowed By Executor to Pay Federal Estate Tax--Generally. Unlike interest payable to the IRS on deferred estate tax payments, interest on private loans used to pay estate taxes is not automatically deductible. The IRS recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets. Rev. Rul. 84-75, 1984-1 C.B. 193 (interest on private loan obtained to pay federal estate taxes deductible because loan was obtained to avoid a forced sale of assets).

Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets. Estate of Todd v. Comm'r, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; Estate of Sturgis v. Comm'r, T.C. Memo 1987-415; Hipp v. United States, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971); Estate of Webster v. Comm'r, 65 T.C. 968 (1976); Estate of Graegin v. Comm'r, T.C. Memo 1988-477; Estate of Huntington v. Comm'r, 36 B.T.A. 698, 726 (1937).

A 1999 case refused to allow the estate to deduct interest on borrowing to pay estate tax where the beneficiaries rather than the estate borrowed the funds after an extended period of time. Estate of Lasarzig v. Comm'r, T.C. Memo. 1999-307. The court was troubled by the estate's effort to keep the case open for up to 20 years after the parties had resolved all controversies. The court observed that the IRS allowed deferral of payment of the estate tax for 5 years, "which seems to be a sufficient time to raise the funds to pay an agreed tax obligation."

An unpublished district court case addressed the evidence required to establish the necessity of borrowing to pay estate taxes in a request for summary judgment by the estate. Dorothy Rupert, Executor of Estate of Knepp v. U.S., CV-03-0421 (M.D. Pa. 2004). The total gross estate was $6.97 million, of which $5.56 was the present value of lottery payments. The estate had to borrow $1.715 million to pay the estate taxes. The IRS argued that the estate did not prove a necessity for the borrowing, because it could have sold the right to receive the lottery payments. The estate had the burden of showing that the interest expense was necessary, which required the estate to show that the loan avoided some harm to the estate. There was no such evidence in the record, so summary judgment could not be granted. However, the court observed that "such evidence could be supplied by showing that the sale of the lottery payments would be the equivalent of a forced sale of stock" [in light of the "forced sale of assets" standard described in Revenue Ruling 84-754, 1984-1 C.B. 193].

(4) Interest on Amounts Borrowed by Executor From Family-Owned Entity to Pay Federal Estate Tax. Several cases have permitted an interest deduction where the funds were borrowed from a family-owned entity rather than being borrowed from a bank. Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. October 2, 2009); Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009)($114 million borrowed after death from FLP on a 9-year note); Estate of Thompson v. Comm'r, T.C. Memo 1998-325 (estate borrowed $2 million from irrevocable life insurance trust; court observed that regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary"); McKee v. Comm'r, T.C. Memo. 1996-362 (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors"); Estate of Graegin, T.C. Memo. 1988-477.

In Estate of Murphy, the estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The IRS argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred "because it was the result of an unnecessary estate-tax avoidance transfer" that drained decedent's estate of liquid assets. The court rejects this reasoning, because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes. (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejects this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. *McKee*, 72 T.C.M. at 333."

In Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009), the decedent signed a partnership agreement and expressed the intent to fund the partnership with a specifically identified bond portfolio and cash, but the funding did not formally occur before her death. The decedent died unexpectedly, so the planner put the formal funding on hold for about a year until one of the planners heard about the Church case, which had recognized a partnership that similarly had not been formally funded at the decedent's death. In the meantime, the estate had paid the estate tax, not realizing that the assets legally already belonged to the partnership. The estate then documented the payment as an advance from the partnership to the estate, and deducted the interest on the loan from the partnership. The initial case allowed the interest deduction because the "estate lacked sufficient liquid assets to pay its necessary taxes and obligations without forcing the sale of its illiquid properties." In a subsequent opinion (106 AFTR2d 2010-6309, Sept. 14, 2010), the district court again addressed the validity of interest deductions on the deemed borrowing by the estate from the partnership. The IRS argued that the loan lacked economic substance. The Family Trust had paid $148 million to the IRS in February 2001, so the IRS argued that no borrowing was necessary and that the loan "was a complete sham." The court found that the loan satisfied the economic substance test and that it was entered into to preserve the liquidity of the estate. "While it is true that Mrs. Williams' advisors, at first, did not believe the Partnership was established, and drew a check from Family Trust accounts to pay taxes, the trust [apparently the court meant the Partnership] *did* exist and there in fact *was* a liquidity problem for the Estate." In addition, the IRS argued that the interest payments should not be deductible because they were paid from "property not subject to claims" (because the Family Trust and the trusts that it funded [Trust A and Trust M] were not part of the probate estate) and that interest payments made after the statute of limitations for assessing additional taxes could not be deducted because of the limitation in § 2053(b). However, the court reasoned that § 2053(c)(2) defines "property subject to claims" as property includible in the gross estate that is burdened with the payment of the deducted expenses and it does not matter whether the property passes outside of probate. Under the decedent's will, administration expenses would to be paid from the Family Trust or residuary estate (which passed to the Family Trust), and therefore the Family Trust assets were subject to claims, and interest payments on the loan could be deducted in full, even after the statute of limitations on additional assessments had run. The court allowed a deduction for $52,018,200 of interest on the loan as requested by the Plaintiffs—calculated up to five days before the loan was due.

The court rejected an interest deduction for amounts loaned from an FLP to the estate in Estate of Black v. Commissioner, 133 T.C. 340 (2009). See generally Liss, Estate of Black: When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?, 112 J. TAX'N (June 2010). An FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock. In this case, the company stock that was owned by the FLP was in fact sold by the FLP. That seems to be the key distinguishing factor from the prior cases that have allowed interest deductions for Graegin loans. John Porter (the attorney representing the estate) points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in Black substituted its business judgment for that of the executor.

In Estate of Stick v. Comm'r, T.C. Memo. 2010-192, the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan.

Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes. In that situation, the decedent created a family limited partnership with 90% of his assets, and died 5 ½ years later. The estate borrowed funds from the FLP to pay federal and state estate taxes under a 10-year note with principal and all interest payable on maturity, with a prohibition against any prepayments. The stated interest rate was 1% over the prime rate and 3% more than the 15-year mortgage rate on the date of the note. The estate's 99% interest in the FLP was pledged as security for the note. The ruling gave various reasons for denying a deduction for the interest expenses. (The IRS did not refer to the creation of the FLP as a self-imposed illiquidity as one of the reasons.) First, the IRS reasoned that the loan was not necessary to the administration of the estate because one of the decedent's sons who was a co-executor of the estate was the remaining general partner of the FLP, the FLP was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to access the funds. The IRS rejected the notion that the estate could not require a distribution from the partnership since the estate possessed only a 99% assignee interest:

> "It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an 'upfront' estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.)"

Second, the IRS reasoned that the interest may not be repaid, and even if it is, the repayment has no economic impact on the parties. The limitation of the deduction for amounts actually paid "ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries." In this case the interest payments have no economic effect on the beneficiaries. If the estate has any funds for making payments, the estate would make the payments to the FLP to pay the interest, which would proportionately increase the value of the beneficiaries' interests in the FLP. More likely, the FLP will distribute assets to the estate, which will then repay those assets back to the FLP in payment of the loan. "Since the parties have virtually identical interests in the Estate and the partnership, there is no change in the relative net worth of these parties as a result of the loan transaction. Rather, other than the favorable tax treatment resulting from the transaction, it is difficult to see what benefit will be derived from this circular transfer of funds." The IRS attempted to further support this argument by analogizing to income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances involving circular transfers for making payments on purported loan transactions.

Some IRS agents have indicated informally that claiming an interest deduction on a Graegin loan for borrowing from a family limited partnership will draw close scrutiny as to whether §2036 applies to include the partnership assets in the estate (without any discount).

(5) Timing of Interest Deduction For Interest on Loan Borrowed to Pay Federal Estate Tax.

(i) *Estate of Graegin* Approved Up-Front Deduction. In Estate of Graegin v. Comm'r, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation.
The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. ¶88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

For an excellent general discussion of the use of Graegin notes, see Harrison, Borrowing to Pay Estate Tax, TRUSTS & ESTS. 46 (May 2009).

(ii) Approval by IRS; Subsequent Cases. The IRS approved a Graegin-type situation in Letter Ruling 199903038. Letter Ruling 199952039 reached the same conclusion in a very similar fact situation involving a ten year note providing for annual interest payments with a balloon principal payment at the end of ten years. Letter Ruling 200020011 allows a current deduction for the projected interest payments after the loan is amended to provide that it cannot be prepaid and that upon default all interest that would have been owed throughout the loan term must be paid at the time of default.

The IRS's position in the letter rulings that all interest that would have been owed for the entire loan term must be paid upon default of the note may present usury problems in some states. An alternative planning possibility may be to have the lender waive the right to accelerate the note in the event of default. Therefore, if there is a default, the terms of the note would continue to apply, and interest would continue to run to the end of the term of the loan.

Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes. The ruling reasons, in part, that "the only reason the loan transaction was entered into was to obtain an 'upfront' estate tax deduction for the interest expense….The interest deduction cannot be the justification for an otherwise unnecessary loan." (The TAM is discussed in detail in Section IV.D.2.c.(4) of this outline.)

The Tax Court refused to allow deducting the present value of interest payments to be made on a 20 year note. Estate of Lasarzig v. Comm'r, T.C. Memo. 1999-307. The court noted that no prior cases had allowed such deduction in a situation in which a taxpayer "seeks an extended delay (up to 20 years) so that a nonparty (family trusts of beneficiaries) can benefit from improved market conditions that may or may not occur."

In Estate of Gilman v. Comm'r, T.C. Memo 2004-286, the estate borrowed funds to pay (1) federal and state estate taxes, (2) compensation to executors (who were also employees of the estate's closely held business and the will specified that they were not to receive executor's commissions but should continue to receive compensation from the business), and (3) miscellaneous expenses. In a series of complicated transactions, the estate restructured the business, and as part of the restructuring, the estate received notes that would be paid in full on January 1, 2004, and the residuary beneficiary (a foundation) received the member interests in the restructured entity (an LLC). The IRS argued that the loan was unnecessary because the estate had enough liquid assets to pay its taxes and administration expenses. The court disagreed, because the estate's assets were illiquid. The court allowed the estate to deduct interest up to January 1, 2004 (the date the notes were due) on amounts borrowed to pay federal and state estate taxes. However, it did not allow deducting interest on amounts borrowed to pay the compensation (because the estate was not required to pay the compensation) or the other miscellaneous expenses (because there was no evidence as to what expenses were included in that amount).

Various cases over the last several years have addressed Graegin loans from partnerships in which the estate owned an interest. Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. 2009) (interest deduction allowed); Keller v. U.S., 104 AFTR 2d 2009-6015 (2009) and 106 AFTR2d 2010-6309 (2010), ($114 million borrowed after death from FLP on a 9-year note; deduction allowed). The deduction for interest on amounts borrowed from the family partnership was denied in Estate of Black v. Commissioner, 133 T.C. 340 (2009). These cases are discussed above in detail.

IRS officials have stated informally that the IRS is continuing to look for vehicles to contest Graegin loans, particularly in situations involving family limited partnerships. The IRS's concern is that a deduction will be allowed but the interest in fact will not have to be paid over the entire term of the note.

(iii) Example of Extremely Favorable Results of Up-Front Deduction. The economics of this up-front deduction can be staggering. For example, assume a $10 million taxable estate. If sufficient lifetime gifts have been made so that the estate is in a 45% bracket, the estate would owe $4.5 million in estate taxes. However, assume the estate borrows $1.493 million [this amount is calculated in an interrelated calculation] from a closely-held company under a 15 year note, at 12.0% interest, with a balloon payment at the end of the 15 year period. The accumulated interest payment due at the end of the 15 years would be $6.681 million. Under the Graegin analysis, the interest expense would be currently deductible, yielding a taxable estate of $10 - $6.681 or $3.319 million, which would result in a federal estate tax (at a 45% rate) of $1.493 million. The $6.681 million of interest would be paid to the company (which in turn, is owned primarily by family members.) The overall result is a very considerable estate tax savings. **The estate tax that is due 9 months after the date of death is reduced from $4.5 million to a little under $1.5 million.**

The interest income would be subject to income tax over the 15-year period, and the IRS will take the position that the interest on loans to pay taxes is nondeductible personal interest. However, many families are willing to pay income taxes over the payment period if they can reduce the estate taxes that are due nine months after the date of death. Be aware that if a QTIP trust or funded revocable trust is the borrower rather than a probate estate, the IRS may argue that under §2503(b) only interest actually paid within the estate tax statute of limitations period may be deducted.

(iv) New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans. The §2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plan for 2009 includes a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

3. Valuation of Disputed Claims Against Estate.

One possible debt deduction is for claims against the estate that are uncertain in amount at the date of death. There is a split among the circuit courts of appeal on this issue. Aghdami, Effect of Post-Mortem Facts On Claims Against the Estate, TR. & EST. 18 (May 2004); Loeb, Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims.

The line of cases on the opposite side strictly follow the 1929 Supreme Court decision in Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929), and its general rule that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death. Cases in the Fifth, Ninth, Tenth, and Eleventh Circuits now agree in refusing to consider post-death events in valuing claims against the estate of uncertain value at the date of death. Estate of Van Horne v. Comm'r, 720 F.2d 1114 (9th Cir. 1983); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Estate of Smith v. Comm'r, 198 F.3d 515 (5th Cir. 1999), nonacq. 2000-19 IRB; Estate of McMorris v. Comm'r, 243 F.3d 1254 (10th Cir. 2001); Estate of O'Neal v. U.S., 258 F.3d 1265 (11th Cir. 2001).

Observe that this factor can also benefit the IRS. For example, one attorney reported having an estate audit over property worth $700,000 with known environmental problems and reported on the Form 706 an estimated value net of the clean up costs of $250,000. Within two years after the date of death, the estate had actually spent $2.5 million of clean up costs. The IRS objected to considering the actual expenditure. (The preamble to the final regulations discussed below confirms that the Treasury and IRS believes that the general principle described in the regulation, providing generally that a deduction is allowed for the amount actually paid, "is binding on both estates and the Commissioner.")

The IRS has issued final regulations, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amount for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved and paid. Treas. Reg. §20.2053-1(d)(5).

Some of the changes made from the proposed regulations in the final regulations are as follows.

a. Effective Date of Regulations. The regulations apply to decedents dying on or after October 20, 2009.

b. Exceptions.

(1) Claims and Counterclaims in Related Matter. If the estate includes a claim or cause of action or other particular asset and there is a claim against the estate in the same matter or that is “integrally related to that asset,” the claim may be deducted on the estate tax return if the claim meets the other requirements for deducting administration expenses other than the “reasonably ascertainable” requirement and if (i) the value of the claim is determined from a “qualified appraisal” by a “qualified appraiser” (using the rules under §170(f)(11)(E)) and (ii) the aggregate value of the related claims or assets included in the gross estate exceed 10 percent of the gross estate. The claim may be deducted only up to the value of the related claim or asset value. The value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(b).

(2) Claims Totaling Not More Than $500,000. The estate may deduct any non-ascertainable claim (that meets the other general requirements for deductions under §2053) up to $500,000 (in addition to claims that can be deducted under the “counterclaim exception” described above). However, the “full value” of each such claim must be within the aggregate $500,000 limit for the estate. For example if there are three claims against the estate valued at $200,000 each, two of the claim could be deducted under this exception, but not the third claim because the full value of the third claim would not be covered by the $500,000 limit. Treas. Reg. §20.2053-4(c)(3)Ex. 2. As with the “counterclaim exception,” there must be a qualified appraisal by a qualified appraiser of each such claim deducted under this exception, and the value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(c).

(3) Practical Effect of Exceptions. Notice 2009-84, issued in conjunction with the release of the final regulations to §2053, state that “[a]s a result of these exceptions, the Treasury Department and the Service anticipate that the number of protective refund claims filed to preserve a deduction under section 2053 will be significantly smaller that was anticipated by commentators to the proposed regulations.” However, few estates may elect to use these two exceptions. Planners generally recommend not taking an estate tax deductions for non-ascertainable claims while litigation is still ongoing or threatened for fear the value placed on the estate tax return would be used in the underlying substantive litigation. This fear would be exacerbated if the return not only places a value on the claim but also is supported by a “qualified appraisal.” Furthermore, it may be difficult to find “qualified appraisers” who have the expertise to value contingent claims in litigation. In the past, trial attorneys or judges with substantial experience in litigating claims have been used at trial to support the date of death estimated value of claims against an estate. In many situations, they would seem to have the best experience in evaluating such claims in litigation, but they probably do not meet the detailed requirements of a “qualified appraiser” under §170(f)(11)(E)(ii) (i.e., they probably do not have an appraisal designation from a recognized professional appraiser organization or regularly perform appraisals for which the they receive compensation).

c. Settlements. There is not requirement (as there was in the proposed regulations) that a settlement be within the range of reasonable outcomes (as long as there is a bona fide issue in an active and genuine contest and adverse parties negotiate at arms’ length in reaching the settlement). The IRS can consider the cost of defending a lawsuit or the effects of delay arising from litigation would impose a higher burden than paying the settlement amount, but unenforceable claims may not be deducted despite any settlements.

d. No Affirmative Duty to Report. The regulations provide that the IRS “will take into account events occurring after the decedent’s death” even for claims that can be ascertained and deducted on the return or claims that come within the exceptions that are deducted currently. While the regulations do not explicitly impose an affirmative duty on the executor to report to the IRS if the full amount of any such deducted claim is not paid, the preamble to the final regulations noted that “[s]ome commentators questioned whether the proposed regulations would impose a duty on the executor to report amount that were claimed as deductions on the estate tax return, but were subsequently not paid or not paid in full, and whether such a duty could be enforced after the period of limitations on assessment has expired.” The preamble’s response is that “[t]he Treasury Department and the IRS did not intend for the proposed regulations to impose a duty on the executor that could be enforced after the expiration of the period of limitations on assessment,” and the final regulations eliminate the duty to report provision.

e. Protective Claim For Refund.

(1) Timing. The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or 2 years after the payment of tax).

(2) Identification of Claims. The protective claim for refund must identify each claim or expenses and describe the reasons and contingencies delaying actual payment of the claim. (Amounts do not have to be listed.)

(3) Consideration of Protective Refund Claim. The protective claim for refund is considered after the executor has notified the IRS "within a reasonable period that the contingency has been resolved." While no specific time period is specified beyond "reasonable period," the executor cannot delay raising the protective claim with the IRS indefinitely after the contingency has been resolved.

(4) Further Guidance. The preamble to the final regulations indicates that the IRS will issue further guidance on the process of using protective claims for refund.

(5) Notice 2009-84: Entire Return Not Open to Offset Protective Refund Claim. The Supreme Court has held that the IRS can examine each item on a return to offset the amount a refund claim, even after the period of limitations on assessment has run. Lewis v. Reynolds, 284 U.S. 281, 283 (1932). However, the IRS in Notice 2009-84 agreed that it would limit the review of protective claims for refund to preserve the ability to claim a deduction under §2053 "to the evidence relating to the deduction under section 2053," and not exercise its authority to examine each item on the return to offset a refund claim. This limitation does not apply if the IRS is considering acclaim for refund not based on a protective claim regarding a deduction under §2053 in the same estate. Also,, the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." (Accordingly, there may be an advantage in not having resolved the underlying lawsuit regarding the claim against the estate until after the period on additional assessments has run—to the extent that there may be items on other parts of the estate tax return that the IRS might question if it could.)

(6) Effect on Marital or Charitable Deduction. The possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. (This applies only the regulation "to the extent that a protective claim for refund is filed." Presumably, the IRS anticipates that returns will not need to reduce the marital or charitable deduction even before the protective claim for refund has been filed.) However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

(7) Chief Counsel Advice 200848045. An email subject to the Freedom of Information Act, CCA 200845045, provides a general overview of protective claims, including the following:

- Reg. § 301.6402-2 does not require that a particular dollar amount be asserted but the claim must "identify and describe the contingencies affecting the claim." This requirement "is interpreted liberally by the Service. So long as the claim is sufficiently clear and definite [to] apprise us of the essential nature of the claim, it will be accepted as having met the requirement." This is important because providing too much detail about what makes the claim contingent may give the other side in the litigation insight into the taxpayer's perceived weaknesses in its case.

- The IRS will delay action until the contingency is resolved, suggesting that the IRS will take no action on the protective claim until is provided further information about facts that resolve the contingency.

- A "general" claim may be amended following the running of the statute of limitations to supply missing information that caused the claim to be "general," but an untimely new claim may not be filed after limitations have expired. The distinction is that the claim is treated as a time-barred new claim "if it would require the investigation of new matters that would not have been disclosed by the investigation of the original claims" or if it assets a different legal ground for the refund.

- A supplemental submission cannot be an amendment (and therefore it is a time-barred new claim) "if the Service took final action on the original claim by rejecting the original claim or allowing it in whole or in part."

f. Claims by Family Members, Related Entities or Beneficiaries. The proposed regulations created a rebuttable presumption that claims by family members, related entities or beneficiaries are not legitimate and bona fide. The final regulations remove the rebuttable presumption. It also adds a non-exclusive list of factors that may be considered in determining that such a claim is legitimate and bona fide. Those factors include whether the claim is: (i) In the ordinary course of business; (ii) Not related to an expectation of inheritance; (iii) Substantiated by contemporaneous evidence; or (iv) Made pursuant to an agreement that can be substantiated. Treas. Reg. §20.2053-1(b)(ii-iii).

g. Recurring Noncontingent Obligations. The proposed regulations provided that only the date of death (or alternate valuation date) present value of recurring noncontingent obligations (such as an obligation under a divorce decree to make alimony payments) could be deducted under §2053. The present valuing concept does not apply for contingent payments after the contingency is resolved—the actual amount of those payments can be deducted in full without any present value limitation. To be consistent, the IRS dropped the present value limitation for recurring noncontingent obligations in the final regulations, and they can be deducted in full on the return. A claim subject to a contingency related to death or remarriage is till treated as a noncontingent claim for this purpose. Treas. Reg. §20.2053-4(d)(6)(i) & 20.2053-4(d)(7)Ex. 8. However, the preamble to the final regulations notes that the Treasury and IRS believe that the appropriate use of present value in determining §2053 deductions merits further consideration, and there is an ongoing project on the Treasury Priority Guidance Plan for that issue.

4. Circular Calculation Often Required. Beginning in 2005, there is a 100% deduction for state death taxes. §2058. The state death tax is typically calculated based on the federal taxable estate and the federal taxable estate is determined after all deductions, including the deduction for state death taxes. An interrelated circular calculation is required in those circumstances.

E. Marital Deduction Planning.

1. QTIP Planning Considerations.

a. General Requirements. The executor may elect to claim a marital deduction with respect to "qualifying terminable interest property." §2056(b)(7). The basic requirements for qualifying for QTIP treatment are (i) the property must pass from the decedent, (ii) the surviving spouse must be entitled to all of the income from the property for life, payable annually or in more frequent intervals, and (iii) no person may have the power, exercisable during the spouse's life, to appoint the property to any person other than the spouse. §2056(b)(7)(B)(ii). In addition, if the property meets the above requirements, QTIP treatment will be allowed only if an election is made by the executor on the federal estate tax return. §2056(b)(7)(B)(v). The IRS may grant "9100 relief" to allow a late election for a testamentary QTIP trust, but the IRS takes the position that it cannot grant 9100 relief to allow a late QTIP election for an inter vivos QTIP trust. Ltr. Rul. 201109012 (revoking Ltr. Rul. 201025021).

b. Impact of Defective QTIP Election at Surviving Spouse's Subsequent Death. If the QTIP election following the first spouse's death is valid, the trust must be included in the surviving spouse's estate under §2044, and the surviving spouse's estate (and its beneficiaries) cannot elect to "undo" the QTIP election. Warner v. United States, 98 AFTR2d 2006-6136 (C.D. Calif. 2006). However, if a QTIP election is made on the original federal and state tax return in a defective manner, but the marital deduction nevertheless was allowed, the IRS takes the position that the trust assets will be includible in the estate of the surviving spouse under §2044. One court of appeals has agreed with the IRS's approach. Estate of Lucille Shelfer v. Comm'r, 86 F.3d 1045 (11th Cir. 1996); Estate of Mildred Letts v. Comm'r, 109 T.C. 290 (1997), aff'd, 212 F.3d 600 (11th Cir. 2000).

The duty of consistency was not applied where the taxpayer and the IRS made a mutual mistake of law as to whether or not the surviving spouse had a general power of appointment. Estate of Posner v. Comm'r, T.C. Memo 2004-112. In a detailed historical review of the duty of consistency, the court concluded that it does not apply to a mutual mistake by the taxpayer and the IRS on a pure question of law, and that the duty did not apply because of the mutual mistake of law as to how the husband's will would be construed under state law.

The IRS relied on the "duty of consistency" in Tech. Adv. Memo. 200407018, where the decedent's will had left his wife a life estate in his oil paintings and left her a life estate with a general power of appointment in his other tangible personal property. The executor had claimed the marital deduction for a particular artwork, believing it to be a pastel that would subject to the general power of appointment. However, it was later determined to be a painting, so the wife's executors (at her later death) argued that the general power of appointment should not apply to the pastel. The IRS ruled that the wife's executors were estopped from denying the existence of a general power of appointment under the duty of consistency, because the husband's and wife's estate were in privity.

The IRS is asserting the "duty of consistency" argument with more frequent consistency. Cluck v. Comm'r, 105 T.C. 324, 331-336 (1995); LeFever v. Comm'r, 103 T.C. 525, 541-545 (1994), aff'd, 100 F.3d 778 (10^{th} Cir. 1996) (beneficiaries who consent to special use valuation will be estopped from later disavowing the election); Janis v. Comm'r, T.C. Memo 2004-117 (inconsistent valuation positions for estate tax vs. income tax basis purposes), aff'd, 461 F.3d 1080 (9th Cir. 2006).

c. Effect of Unnecessary QTIP Election. An unnecessary election of QTIP treatment for a credit shelter trust can be disregarded pursuant to Rev. Proc. 2001-38, 2001-1 C.B. 1335. The QTIP election is disregarded if it is not needed to reduce estate tax at the first spouse's death. The IRS's position is that Rev. Proc. 2001-38, which treats a QTIP election as null and void where it is unnecessary, only applies where the QTIP election is unnecessary in its entirety for a particular trust. In Letter Rulings 200219003 and 200422050, the IRS ruled that a taxpayer cannot partially revoke a QTIP election under the procedure described in Rev. Proc. 2001-38.

d. Rev. Rul. 2006-26—Impact of Accounting Rules on Marital Deduction for Retirement Plans. Under the Uniform Principal and Income Act, the portion of retirement plan distributions that is income is 10% of the minimum required distribution. For example, assume the only asset in a marital trust (requiring mandatory income payments to the surviving spouse) is a $1 million IRA. Assume the IRA has a 20 year payout, and in the first year, $50,000 is distributed. How much is income to be distributed to the spouse? Ten percent of the $50,000, or $5,000. The spouse will not be happy with that answer, and the IRS agrees that amount is too low. The Ruling says that acceptable income from an IRA is either the actual internal income of the retirement plan or a unitrust percentage between 3-5%.

This will not create problems for most plans because since 1989, the IRS has made clear that they view the marital trust and the IRA payable to the marital trust as totally separate and both must satisfy the "all income" requirement. Since 1989, planners have drafted marital trusts to add a clause requiring the trustee to distribute the income of the trust AND to distribute all income of any retirement plan of which the trust is the beneficiary. The Revenue Ruling makes clear that if the trust contains that provision, nothing has to be changed. Also, the Ruling makes clear that if the spouse has the right to force the trustee to withdraw the IRA income, the trust can qualify for the marital deduction.

e Combination of 5 or 5 Power and Partial QTIP Election. If the surviving spouse holds a "5 or 5" withdrawal power (i.e., the right to withdraw the greater of $5,000 or 5% of the trust assets) over a trust, the Tax Court held in Estate of Hollingshead v. Comm'r, 70 T.C. 578 (1978) that only the 5% that could be withdrawn by the surviving spouse in the first year would qualify for the marital deduction under §2056(b)(5) (mandatory income/general power of appointment trust). (The taxpayer had argued in that case that the actuarial value of the 5 or 5 power over the surviving spouse's life expectancy should qualify for the marital deduction, but the court disagreed.) This suggests the planning strategy of including a "5 or 5" withdrawal power for the surviving spouse in a QTIP trust. Five percent of the trust would qualify for the marital deduction under §2056(b)(5) as indicated in the Hollingshead case, and the estate could make a partial QTIP election for the remaining 95% of the trust. At the surviving spouse's death, the 5% of the trust that qualified for the marital deduction under §2056(b)(5) because of the withdrawal power in the first year would not be includible in the surviving spouse's estate. The spouse would no longer hold a power over that 5% taxable under §2041 and the lapse of the power would not have been treated as a taxable release because of the "5 or 5" exception in §2514(e). The 95% of the trust attributable to the partial QTIP election would be included in the surviving spouse's estate under §2044. The effect would be that 5% of the trust at the surviving spouse's death would not be includable in the estate of the surviving spouse.

2. Funding Issues; Consider Discounts in Funding Marital Bequests and Credit Shelter Bequests.

For a general discussion of the complex issues that may arise in funding marital trusts, see Soled, Wolf & Arnell, Funding Marital Trusts: Mistakes and Their Consequences, 31 REAL PROP., PROB, & TR. L.J. 89 (1996).

If a controlling interest in an asset is left to the marital share, a control premium may be appropriate in determining the value of that asset. See Estate of Chenowith v. Commissioner, 88 T.C. 1577 (1987) (bequest of 51% of stock of family company to surviving widow entitled to premium "control element" to increase marital deduction). However, this principle may also work in reverse. The IRS has taken the position in several Technical Advice Memoranda that valuation discounts should be considered in funding marital bequests.

A 1999 Tax Court Memorandum case is the first case recognizing that the value of assets passing to a spouse must take into account minority interests for purposes of determining the marital deduction. In Estate of Disanto v. Commissioner, T.C. Memo. 1999-421 the surviving wife signed disclaimers so that only a minority interest in closely held stock passed to the wife. The court held that the stock passing to the wife must be valued as a minority interest for purposes of determining the amount of the marital deduction.

See also Estate of Schwan v. Comm'r, T.C. Memo. 2001-174 (discussion of this issue in charitable deduction case).

If a marital bequest is under-funded, the surviving spouse may be treated as having made a gift. Tech. Adv. Memo. 9116003. See Rev. Rul. 84-105, 1984-2 C.B. 198. But see Katherine Bergeron v. Commissioner, T.C. Memo. 1986-587 (surviving spouse who failed to assert her rights to claim proper share of estate, which resulted in overfunding of bypass trust, did not make current gift because probate court decree could be amended). Furthermore, the amount "over-funded" to a bypass trust for the surviving spouse's benefit would probably be included in the surviving spouse's estate under §2036(a)(1).

Various interesting questions can arise at audit with respect to an alleged under-funding of a marital bequest (and particular issues are raised if a QTIP trust is under-funded). See generally Lewis, Marital Deduction Planning for Family Business Owners, ABA Section of Real Property, Probate and Trust Law 11th Annual Spring CLE Symposia (2000).

Gift Tax. If the IRS determines that an excess amount is allocated to the non-elected portion (to reduce the estate tax that will be due at the donee-spouse's subsequent death), is the original donor treated as having made an additional gift? Is the donee-spouse treated as making a gift—because a lesser amount will be in the donee-spouse's gross estate under Section 2044 at his or her subsequent death than if the elected portion had been fully funded? If the spouse makes a gift, how would the value of the gift from the QTIP trust be determined in light of the spouse's identical retained interest in the "non-elected" and "elected" portions of the QTIP trust? Would section 2519 have any application, to cause a deemed gift of the entire QTIP trust? Does section 2702 have any application in light of the fact that the spouse's retained rights under the QTIP trust would not constitute "qualified payments" under section 2702? Is the "deemed gift" portion valued as a minority block or as a "swing vote" block if the asset transferred to the QTIP trust is stock of a closely-held entity?

GST Tax. What are the GST implications of any deemed gift? GST exemption cannot be allocated to the non-elected portion of the QTIP trust, because of the ETIP rule. (The exception from the ETIP rule for QTIP trusts applies only if the "reverse" QTIP election is made. Reg. § 26.2632-1(c)(2)(ii)(C).) Does the donee-spouse become the transferor with respect to a portion of the non-elected portion if the elected portion is under-funded—or is the original donor still treated as the transferor for both the elected and non-elected portions of the trust for GST purposes? What if the original donor's GST exemption is allocated to the non-elected portion of the trust at the spouse's death, only to find out years later that the original donee-spouse is a partial grantor of a portion of the non-elected portion of the QTIP trust so that it is no longer fully GST exempt?

Estate Tax. The donee-spouse will have a mandatory income interest in the non-elected potion. If the donee-spouse is deemed to be a contributor to the non-elected portion of the trust, does this subject the entire non-elected portion to the spouse's gross estate under section 2036 or only a portion of the trust?

Gift Statute of Limitations. The donee-spouse presumably can begin the statute of limitations with respect to an allegation of a deemed gift due to underfunding of the elected portion of the QTIP trust by filing a gift tax return and making disclosure of the funding issues on the gift tax return. Treas. Reg. § 301.6501(c)-1(f)(4). Is the gift tax return filed for the year in which the elected portion is funded or when the spouse's right to object to the under-funding is lost?

Consider the situation (which may be fairly typical in a split family situation) where the decedent wishes to leave the surviving spouse one-half of his or her assets but wishes to leave the other one-half of his or her assets into a QTIP trust (to assure that one-half of the assets will end up passing to the decedent's children). If the assets funded to the two bequests are valued separately, how can the estate fund the bequests if it consists primarily of one major asset (such as an interest in a closely held business?) After taking into consideration minority discounts, the value passing to the two separate bequests may be substantially less than the gross estate (even though the entire estate qualifies for the estate tax marital deduction), ostensibly requiring the payment of substantial estate taxes.

In some situations, funding a specific pecuniary amount may be very difficult. For example, there may be a pecuniary bequest (formula or otherwise) of $1.4 million. A 51% interest in the closely held business may be worth $1.8 million, and a 49% interest in the business may be worth $1.2 million.

Observe that the problems of funding marital bequests with discounted assets that are valued lower than the gross estate values of the assets are diminished where the assets used to fund the marital bequests are limited partnership interests in a family partnership. The limited partnership interests typically are discounted whether they represent 1% or 99% of the limited partnership interests (assuming the decedent did not own a general partnership interest that gave the decedent the power to liquidate the partnership or to force the liquidation of the decedent's interest in the partnership.) Therefore, the gross estate value and the marital deduction value of the limited partnership interests would be the same. (Query, if the partnership assets are included under §2036, will the transfer of a portion of the limited partnership interests in satisfaction of a marital bequest be treated as a transfer of a proportionate portion of the assets for marital deduction purposes?)

Possible methods of avoiding the difficult valuation problem, in the appropriate circumstances, may include the following:

* Have the executor to fund the marital bequest with a note. The residuary estate would then be burdened with the note as a liability that would be distributed along with the residuary assets to the residuary beneficiaries.

A strategy that may have worked before April 25, 2008: Have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, consider merely distributing minority block of stock, and value the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. §20.2032-1(c)(1)(phrase "distributed, sold, exchanged or otherwise disposed of" includes surrender of stock in complete or partial liquidation of a corporation but not "mere changes in form" such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under §351); Kohler v. Comm'r, T.C. Memo 2006-152, *nonacq.* AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations prohibit this strategy, with an effective date of April 25, 2008 once the regulation is finalized. Prop. Treas. Reg. §20.2032-1(f).

* For fractional interests in real estate, use a co-ownership agreement at the first spouse's death that will eliminate the discount, by providing that either co-tenant can sell the property and

distribute the proceeds pro rata.

* For stock, use a pro rata funding but have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control).

* Sell the majority interest to a Family Trust for a note, then fund the Marital Trust with a part of the note, and fund the Family Trust with the balance of the note (which the Family Trust would then owe to itself).

* Distribute a majority interest in an asset (that exceeds the marital bequest amount) to the Marital Trust, and have the Marital Trust give the estate back a note for the excess value. (For example, assume there is a $2MM Family Trust and a $8MM Marital Trust and the only asset is a 51% interest in a closely held company that is worth $10MM. If the Marital Trust is funded with 8/10 of the 51% interest, it will not be worth $8MM. Fund the Marital Trust with the entire 51% controlling interest, and have the Marital Trust give a note back to the estate for $2MM. The Marital Trust might later end up paying off the $2MM note with an interest in the company (which would be valued at a discount, thus requiring more shares than if there were no discount).

* Fund the bequest using a "defined value" formula conveyance. For example, a pecuniary bypass trust bequest could be funded by a conveyance having a defined value—reduced only by the amount necessary that will not result in an increased estate tax.

* To avoid the valuation problem on funding marital bequests, make the marital gifts during lifetime. In that event, there would not be a mismatch between the amount of the gift and the allowed marital deduction. (But lifetime gifts would lose the benefit of a basis step-up at death.)

For a general discussion of the valuation problems in funding marital bequests, see Moore, Honey, Who Shrank My Deduction?, 11 PROB. & PROP. 8 (1997).

3. Consider Appropriate Discounts at First Spouse's Death Even if No Estate Taxes are Due.

If no estate taxes are due at the first spouse's death (because of the marital deduction), very often no valuation adjustments for minority/marketability purposes are listed in the first spouse's estate tax return in order to achieve a higher basis step-up. Alternatively, assets may be included in the first spouse's estate without a discount in order to avoid the necessity of obtaining expensive appraisals in a "no tax" estate. This approach may lead to an inconsistency when, at the surviving spouse's subsequent death, his or her executor attempts to take a minority/marketability discount. Query whether the over-valuation penalty might apply if the asset is sold during the surviving spouse's lifetime and the income tax return is filed based on the step-up in basis without taking into account the valuation discount. No cases or rulings have addressed that issue.

F. Filing of Estate Tax Return and Payment of Estate Tax.

1. General Filing and Payment Requirements.

Estate tax returns must be filed within nine months after the date of death. §6075. Extensions of time to file may be made on Form 4768. An extension of time to file will not operate as an extension of time to pay, and vice versa. Reg. §§20.6081-1(c) & 20.6161-1(c). Reasonable cause must be shown for any extension. The maximum extended filing date is fifteen months from the decedent's death. I.R.C. § 6081(a); Treas. Reg. § 20.6081-1(a). There is no appeal from a denial by the Service Center of a request for extension of time to file.

Final regulations provide for an automatic six-month extension of time to file an estate tax return. Treas. Reg. § 20.6081-1(b), effective for estate tax returns due after July 25, 2001.

Separate failure to file and failure to pay penalties apply unless the failure is due to reasonable cause. A number of cases have held that reliance on professional to file an estate tax return does not constitute reasonable cause for purposes of the failure to file penalty. E.g., United States v. Boyle, 469 U.S. 241 (1985). The Ninth Circuit has extended that same approach to the failure to pay penalty. Baccei v. U.S., 107 AFTR 2d 2011-898 (9th Cir. 2011) (reliance on CPA, who filed an extension request for filing the estate tax return but did not request a payment extension).

Under §6161(a)(2), the federal estate tax may be extended upon a showing of reasonable cause for up to ten years. Regulations under prior law provided that the extension could not be granted for more than one year at a time. Reg. §20.6161-1(a)(2)(i). Presumably this limitation is continued under §6161(a)(2) in its present form. A request for extension of time under section 6161 is filed on Form 4768.

The estate tax is due nine months after the date of death. §6075. An extension of time to file does not grant an extension of time to pay. §6151(a). However, payment extensions may be requested under §6161 or 6166. Filing and payment extensions are requested by filing Form 4768; a separate Form 4768 is filed for each of the extension of time to file and time to pay. Some states tie their payment extensions to the federal extension, and may impose a state tax if no federal extension of time to pay was requested. Some IRS agents have stated informally that the IRS is no longer returning automatic filing extension requests as approved, even if a payment extension is included with the request.

Some attorneys routinely request an extension of time to pay in any filing extension, in case the amount (if any) tendered to the IRS with the extension request turns out being less than the total amount of tax due when the return is ultimately filed. One attorney suggests the following example: "The personal representative has made good faith efforts to determine the amount of tax due. An extension of time to pay is requested in the event that it is determined that additional tax is due when the return is filed."

The last page of the instructions to the Form 706 issued in August 2003 included (for the first time) a summary list of documents that must be attached to the Form 706, as well as a list of necessary steps that should be followed to complete the Form 706. The 2006 Form 706 included a new question on Part 4, Question 12e: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?" The 2007 Form 706 (dated September 2007) added several new requirements: (1) The instructions to Schedule F requires including detailed information about discounts; (2) Part 4 requires checking a box if the decedent held any power over any foreign accounts; and (3) Part 4 requires reporting any private annuities, even if they are not included in the gross estate. The 2009 Form 706 (dated September 2009) did not contain any significant substantive changes (other than updating the applicable exclusion amount to $3.5 million and updating the indexed special use valuation and §6166 2% portion numbers).

2. Extension of Time to Pay Tax Attributable to Closely-Held Business Under §6166.

If the estate qualifies for an extension of time to pay estate taxes over 14 years (5 years interest only) under section 6166, that deferral is typically extremely advantageous. If the estate is illiquid, it typically would have no ability to borrow funds from a third party on as favorable terms. The advantages of a section 6166 extension include the long term (14 years) of the extension, only interest payments are required for the first five years, the interest rate is low, and there is very little interference with the estate's activities (there are no restrictive covenants on amounts of compensation, distributions, loans etc. for the entity, and the IRS does not contact the estate periodically to inquire as to the entity's operations and financial health). As a practical matter, an estate would never be able to borrow from a bank 50% of the value of the collateral for 14 years, and only have to deal with the bank once a year when payments are made. Section 6166 borrowing gives a better economic result than borrowing from a bank.

Although section 6166 deferral is a very convenient if it is available, realize that planning so that the estate can continue to qualify for section 6166 can hamstring transfer planning with the business interest (which is often the most highly appreciating asset in the estate). It may be much better to do transfer planning with the business interest and give up on section 6166 deferral.

If the tax estimate that is paid with the extension request is more than the actual non-deferred amount, the taxpayer cannot get back the excess payment or have it applied to the first installments. The excess payment simply pays down the deferrable tax liability, and the remaining deferrable liability is deferred over 14 years.

For an outstanding review of section 6166 and issues in paying estate taxes, see Blattmachr, Gans, Madden, Untangling Installment Payments of Estate Tax Under Section 6166, 36 EST. PL. (July 2009); Harrison, Borrowing to Pay Estate Tax, TRUSTS & ESTS. 46 (May 2009); Belcher, Paying the Estate Tax Attributable to a Private Business Using IRS Section 6166, IRC Section 303, and *Graegin*-Style Promissory Notes, 39TH ANNUAL HECKERLING INST. ON EST. PL. ¶600

(2005).

a. Length of Deferral; Due Date for Payments; Amount of Tax Deferrable; Interest. An extension of time to pay under §6166 allows payment of the estate tax in two or more, but not more than ten, equal annual installments commencing the fifth year after the due date on which the estate tax return would otherwise be due. §6166(a)(3).

The date for each payment is based on the original due date for the payment of tax without regard to extensions. The first principal payment is due five years after that date and subsequent annual installments are required on the same date in later years, up to ten years. §6166(a)(3). Therefore, payments could be made over a fourteen year period (the last payment would be due at the beginning of the fifteenth year after the initial tax due date).

The amount of the estate tax that may be deferred under §6166 bears the same ratio to the total tax that the estate's interest in the closely held business bears to the adjusted gross estate (as defined in §6166(b)(6)). §6166(a)(2).

The first installment of tax under a §6166 deferral is five years from the date the estate tax return is due. During this initial four year period, only interest on the deferred portion of the tax must be paid. §6166(f)(1). (However, the interest only rule for the first four years does not apply to the portion of the deferred tax attributable to a holding company or to interests in qualifying lending and financing businesses. §6166(b)(8)(A)(ii), 6166(b)(10)(A)(ii).)

Two/Four Percent Interest Rate. For estates of decedents dying before 1998, the portion of the deferred estate tax equal to $345,800 (the estate tax attributable to $1.0 million) less the unified credit ($192,800) will have an interest rate of 4%. §6601(j). Therefore, only $153,000 of the deferred tax bears interest at 4%.

For estates of decedents dying after 1997, the four percent rate is changed to two percent. The 2% interest rate will be imposed on the amount of deferred estate tax attributable to the first $1,000,000 in taxable value of the closely held business (i.e., the first $1,000,000 in value in excess of the effective exemption provided by the unified credit and any other exclusions). I.R.C. §6601(j)(1-2).

The 2% portion steadily increased because of increases in the applicable exclusion amount (from $625,000 in 1998 to $3.5 million in 2009) and because the $1,000,000 amount is adjusted for inflation, rounded down to the next lowest multiple of $10,000, after 1998. The $1,000,000 amount has increased to $1,140,000 in 2004, $1,170,000 in 2005, $1,200,000 in 2006, $1,250,000 in 2007, $1,280,000 in 2008, $1,330,000 in 2009, $1,340,000 in 2010, and $1,360,000 in 2011. Rev. Proc. 2010-40, 2010-46 I.R.B. 1. As a result, the maximum amount of tax which can be deferred at 2 percent interest has increased from $410,000 in 1998 to: $532,200 in 2004 and $546,600 in 2005 (taking into account both the $1.0 million inflation adjusted amounts for those respective years and the applicable exclusion amount of $1,500,000), $552,000 in 2006, $562,500 in 2007, and $576,000 in 2008 (taking into account the $1.0 million inflation adjusted amounts in those respective years and the applicable exclusion amount of $2.0 million); and $598,500 in 2009.

The 2% interest rate is intended to provide an additional benefit to owners of closely held businesses. An anomaly under the current low interest climate is that the interest rate on the 2% portion of the tax (i.e., 2%) exceeds the interest rate that is payable on the balance of the deferred estate tax when the general underpayment interest rate is 4% (i.e., .45 x 4% = 1.8%). (The underpayment rates for the four quarters of 2008 were 7%, 6%, 5%, and 6%, respectively. The underpayment rate for the first quarter of 2009 was 5% and the rate for the second through fourth quarters of 2009 and the first through third quarters of 2010 is 4%. At a 5% or higher underpayment rate, the special 2% rate is lower than the interest rate on the balance of the deferred tax under §6166.)

Interest on Balance of Deferred Amount. For estates of decedents dying before 1998, the balance of the deferred estate tax bears interest at the normal statutory rate charged on deficiencies. §§6601, 6621. For estates of decedents who die after 1997, the interest rate on the balance of the estate tax is 45% of the normal rate in underpayments (and the interest is not deductible). I.R.C. §6601(j)(1)(B). For example, if the ordinary estate underpayment rate is 5%, the interest rate on the estate tax deferred under Section 6166 that does not qualify for the special 2% rate is 2.25%.

Interest on a §6166 deferred is not deductible.

b. Requirements for Qualification. (1) The decedent must be a citizen or resident of the United States. §6166(a)(1). (2) The value of the decedent's interest in a closely held business must exceed 35% of the "adjusted gross estate" (defined in §6166(b)(6)). (Gifts made within three years of death are considered in determining whether the 35% requirement is satisfied, but not for purposes of determining the amount of tax that may be deferred. §2035(d)(4).) (3) The deferral only applies to an "interest in a closely held business." If the IRS denies (or terminates) a §6166 election, the taxpayer has the right to petition Tax Court for a declaratory judgment under §7479. See Rev. Proc. 2005-33, 2005-24 I.R.B. 1231.

c. Interest in Closely Held Business.

Trade or Business Requirement for Real Property Interests; Rev. Rul 2006-34.

Revenue Ruling 2006-34 is the first time the IRS has given public guidance since 1975 on whether real property interests owned by a decedent or an entity in which decedent had an interest qualifies under §6166. The ruling addressed 5 different situations.

Guiding Principles. Some of the principles gleaned from the new ruling are:

(i) To qualify, the decedent must conduct an active trade or business or hold interests in a partnership, LLC or corporation that carries on an active trade or business as opposed to "the mere management of passive investment assets." (When the IRS or a court uses the word "mere," bad news follows.)

(ii) The activities of agents or employees are properly considered in determining if an active trade or business exists. The use of independent contractors will not disqualify the interest so long as the decedent has not ceded so much of the day-to-day operations that the decedent's activity is reduced to "merely holding investment property." The IRS is acknowledging that the use of an independent contactor is not fatal. The Ruling broadens the way the IRS will look at facts and circumstances.

(iii) When an unrelated management company is employed to perform most of the management activities, the ruling says that suggests that an active trade or business does not exist. Reading between the lines, you are "dead in the water" if you use an independent management company to perform most of the activities.

(iv) The IRS is offering a **new safe harbor** we did not have before. If the decedent owns at least 20% of the management company that performs most of the management activities, the decedent will likely meet the trade or business requirement. There is no requirement that the decedent be actively involved in the management activities of the management company—it is just a 20% ownership test. This is not the same 20% test as in 6166(b)(1), which refers to the portion of the business that is in the estate. This 20% rule has nothing to do with the ownership of the business for which §6166 treatment is sought. It is just the ownership of the management company that is managing that interest.

(v) One of the situations allows 6166 treatment in the common situation where the real estate is owned separate from the operation of the business (an auto dealership in that example).

(vi) Revokes portions of prior rulings. The IRS is changing some of the positions that it took in the earlier 1975 Rulings. In Rev. Rul. 75-365, the decedent owned a fully equipped business office that handled management of the decedent's real estate. (It collected rental payments, received payments on notes receivable, negotiated leases, made occasional loans, directed maintenance of the properties by independent contractors, maintained a records and kept regular office hours.) The prior ruling said section 6166 was not available. That prior ruling is revoked.

Rev. Rul. 75-367 concluded among other things that where the decedent owned residential tracts and performed daily repairs, maintenance, etc, the residential tracts did not qualify for section 6166. That portion of Rev. Rul. 75-367 is revoked.

d. IRS Requires Security as a Condition for Granting Section 6166 Extension. Internal Legal Memorandum 200627023 addresses the §6166(k)(1) security , §6165 surety bond, and §6324A installment lien provisions. It takes the position that the government can demand a surety bond or special lien any time that tax being deferred under §6166 is still unpaid, and that there is no statute of limitations on its rights to seek security. The issuance of a closing letter will not affect the IRS's right to seek or increase its security. The Memorandum takes the position that the IRS can terminate a §6166 election whenever it is unable to obtain appropriate security and that the taxpayer has no §7479 declaratory judgment right of appeal to the Tax Court (and §7479(b)(2) requires exhausting all administrative remedies within the IRS.)

Following the implementation of this policy, practitioners have reported that it is almost impossible (or inordinately expensive) to obtain a bond to the federal government to cover the 14-year period of the section 6166 deferral. If the IRS requests posting of a bond or lien, and if the estate is not able to post a bond, the IRS at one time required a lien on real estate. IRS agents assumed that there was substantial leeway as to how much real estate collateral was required. The real estate did not have to be owned by the estate. Requiring a real estate lien can be particularly difficult if the closely held business does not own the real estate on which the business is located, but rents it from other family entities. Some attorneys reported being successful convincing the IRS agent to accept a lien on the business interest itself (which is the asset in the gross estate) rather than requiring a lien on hard assets. However, some attorneys report that some agents required hard assets as collateral. One attorney reports of a case in which such a lien on hard assets of the business would disrupt the business, and the family refused to give a lien in order to obtain a §6166 deferral. The attorney was able to use the inability to qualify for a §6166 deferral to justify lengthy Graegin notes.

Some practitioners report that making the process as easy as possible on the special procedures group within the IRS may help in getting a cooperative attitude. Otherwise, they may just lien all of the real property in the estate regardless of how many multiples of the liability that represents. Typically, however, most local IRS offices are comfortable with a lien on real estate that equals or exceeds the amount of the deferral.

A federal bankruptcy case, which addressed the effect of a tax lien on the owner of a business, may impact the way that the IRS approaches liens. In re: Roth; IRS v. Skiba, 93 AFTR2d 2004-1663 (W.D. Pa. 2004) In that case, the business went into bankruptcy, and the court held that the IRS was just an unsecured creditor of the corporation because the IRS only held a lien on the taxpayer's stock in the corporation, not the corporation's assets. In light of this case, there has been a concern that the IRS may become even more inclined than ever to require a lien on real estate and not just the stock of the closely held business.

The Tax Court held that the IRS does not have the authority to impose an absolute bond or special lien requirement by merely revising the Internal Revenue Manual. Estate of Roski v. Comm'r, 128 T.C. 113 (2007). The case outlines the history of the Commissioner changing his mind four times over the last 15 years regarding whether a bond is required for a §6166 election. Interestingly, the IRS argued that the Tax Court did not have jurisdiction to review this administrative decision regarding §6166 under the authority in §7479 to bring declaratory judgments relating to §6166. The court noted the obvious "glaring contradiction" of the IRS's argument that §7479 only gives the Tax Court authority to review the eligibility requirements of §6166 (which does not include a bond requirement) while simultaneously taking the position that the provision of a bond or special lien is required. The court reasoned that the substantive requirements of §6166 are in §§6166(a) and (g), and none of the requirements include securing a bond or special lien. Rather than imposing a substantive requirement, §6166(k)(1-2) incorporates the IRS's discretionary authority under §6165, which says that the IRS "may" require a bond. "Implicit in this grant of discretion is a statutory obligation to exercise discretion." The court concluded that "[b]y adopting a bright-line rule in every case, the Commissioner has shirked his administrative duty to state findings of fact and reasons to support his decisions that are sufficient to reflect a considered response to the evidence and contentions of the losing party and to allow for thoughtful judicial review." The court denied the IRS's motion for summary judgment. In footnote 9, the court specifically declined to address whether the IRS could have exercised its discretion through the promulgation of a regulation as opposed to just amending the Internal Revenue Manual without any opportunity for notice and comment. See generally Haxton, The Section 6166 Balancing Game: An Examination of the Policy Behind *Estate of Roski v. Commissioner*, 62 TAX LAWYER 525 (2009).

The IRS issued Notice 2007-90, 2007-46 IRB in response to Roski. The Notice clarified that the IRS's general concern is that the general estate tax lien under §6324(a) extends for only 10 years after the date of death. Therefore, a 14 year deferral under §6166 would be secured only for 9 years and 3 months (after the due date of the estate tax return). The IRS intends to issue regulations regarding the appropriate standards to be applied by the IRS in exercising its discretion of whether a bond or special lien is required for a §6166 extension, and requests comments as to appropriate standards. As interim guidance, the IRS indicates that it will apply the following factors: (a) duration and stability of the business, (b) ability to make payments timely, and (c) compliance history of that business.

If the executor elects to grant a special lien for estate tax deferred under §6166, the lien is governed by §6324A. A Chief Counsel Memorandum filed February 25, 2009 and Internal Legal Memoranda issued in 2007 and 2008 describe the procedures for determining the appropriate collateral under §6324A. In light of the significant uncertainty and differing treatment across the country regarding the amount and type of collateral that is required for a §6166 election, a detailed discussion from the IRS regarding the collateralization requirement is most welcome.

Chief Counsel Memorandum Dated February 25, 2009

A Chief Counsel Memorandum (CC:PA:B03:LUDaly, POSTS-113182-07) dated February 25, 2009 describes various procedures regarding bonds and liens as security for §6166 deferrals. Conclusions reached in the memorandum include the following.

1. A *bond* to secure a §6166 deferral can be required up to double the amount of tax due. (Therefore, the bond amount can include the deferred tax plus interest as long as the interest does not exceed the amount of tax deferred.) A *lien* to secure a §6166 deferral can be requested for collateral having a value equal to the deferred tax and the aggregate amount of interest payable over the first 4 years of the deferral period (i.e., the "required interest" as defined in §6324A(e)(2).)

2. The IRS does not have to request the maximum bond or lien amount. The IRS must use its discretion to determine on a case-by-case basis the appropriate amount reflecting the amount of estate tax payable in installments that is at risk of default. (The IRS cannot accept an alternate form of security, such as a personal guarantee; that "would frustrate Congress's intent.")

3. The Office of Appeals can determine the value of property proffered by the estate as collateral for the special estate tax lien under §6324A. IRS Appeals can also determine whether the type of property proffered as collateral is adequate.

> "Under section 6324A(b)(1), 'section 6166 lien property' means interests in real and other property to the extent such interests can be expected to survive the deferral period and are designated in the agreement referred to in the lien agreement defined in section 6324A(c)…. We note that the IRS has the statutory right to monitor the value of the section 6166 lien property and the creditworthiness of the estate throughout the deferral period. Whether property may be expected to survive the deferral period is based on all facts and circumstances and made on a case-by-case basis. For example, a decrease in the value of corporate stock may be an indication that the company may not survive the deferral period, but that factor alone, does not automatically mean that the company will not survive. In addition, property encumbered by liens may not be expected to survive the deferral period if there is little equity in the property. Should Appeals determine that the property proffered by the executor is inadequate section 6166 lien property, Appeals may negotiate with the estate to secure acceptable section 6166 lien property. The property designated as section 6166 lien property is not required to be property included in the estate of the decedent and may, in fact, be property of another person, so long as each person having an interest in the property is a party to the section 6324A(c) lien agreement."

Observe that this language is not as direct as Internal Legal Memoranda 200747019 and 200803016 (discussed below) in indicating that the closely held business interest itself may generally be used as the collateral for the §6324A lien, but the language does not contradict the directions in the 2007 and 2008 Memoranda.

4. The value determination is based on the fair market value of the collateral on the date the §6324A lien agreement is signed by all interested parties (which may obviously be different than the date of death value or the value reported on the estate tax return. What if property valued under the special use valuation rules of §2032A or an FLP interest or other discounted asset is the

collateral? The conclusion states "The value of the collateral should be based on the property's current and anticipated use and on the interest which the government would have in the property if the lien were foreclosed on." If the land is being used as farmland, it would seem likely that the government would not continue to farm the land but would sell it for its highest and best use value. Nevertheless, the body of the memorandum provides that "[i]f property is being used as farmland under a section 2032A election, then the value should reflect that use." The body of the memorandum makes very clear with respect to discounts that "if a FLP interest was discounted on the Form 706, the same discounts may apply to the interest given as collateral."

5. Any encumbrances on the property should be taken into account, so that the property is valued at its net value for purposes of determining if the property is adequate collateral.

Internal Legal Memorandum 200747019, "Taking Stock as Collateral for the Special Estate Tax Lien Under Section 6324A". ILM 200747019 has a detailed discussion of the statutory authority regarding collateralization requirements and provides helpful answers to a number of questions regarding the amount of collateralization required, when stock of the closely held business may be used as collateral, and procedures for perfecting the lien and for monitoring the sufficiency of the collateral over time.

(a) When Must the IRS Accept Closely Held Stock as Collateral? The closely held stock may be used as collateral (and must be accepted by the IRS) when the three requirements in §6324A are satisfied.

(1) The stock must be expected to survive the deferral period. §6324A(b)(1) (A). To make this determination the IRS should first value the business, using the most relevant financial information supplied by the estate (including appraisals, annual reports and other relevant financial documents). Based on the valuation, the IRS must next judge whether the business can be expected to survive the deferral period. "There is a risk that the Service may err in its conclusion, but Congress intended that the Service bear such a risk."

(2) The closely held stock must be identified in the written agreement. §6324A(b)(1)(B). This means that the executor must file a written agreement showing that all of the persons having an interest in the collateral agree to the creation of the special lien and those persons must be bound by the agreement. §6324(c)(1).

(3) "The value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest." (While the ILM does not cite Code support for this statement, it is consistent with the "maximum value of required property" described in §6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

The ILM then makes perfectly clear that the IRS *must* accept only the closely held stock as collateral if these requirements are met. (While the ILM does not cite Code support for the statement that the collateral must be sufficient to pay the deferred taxes plus the required interest, it is consistent with the "maximum value of required property" described in §6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

(b) What Criteria Are Used to Determine the Adequacy of the Stock? Whether a stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period. However, "[t]he Service should not assume that a stock's failure to retain its value automatically means that a company will not survive the deferral period. Indeed stock accepted as collateral may decrease in value, requiring the Service to request additional collateral under §6324A(d)(5).

(c) What Requirements May Be Imposed to Determine Whether There Has Been a Disposition or Withdrawal of Funds That Triggers Acceleration? Section 6324A(d)(5) states that if the value of the collateral is less than the unpaid portion of the deferred amount and the required interest, the IRS may require additional collateral (but not exceeding such unpaid portion). If additional collateral having a value equal to such unpaid deficiency is not added to the lien agreement within 90 days of demand, such failure will be treated as an act accelerating payment under §6166(g). The ILM states that the Service has statutory rights under §6324A to determine whether there has been a disposition of interest or withdrawal of funds that would trigger the acceleration of payment under §6166(g)(1). [I do not find that authority that broad in §6324A, but merely to determine if the value of the collateral falls below the unpaid deferred amount and the required interest.] The IRS can require relevant financial information from the estate to monitor the value of the collateral. "Specifically, the Service could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period."

(d) <u>How Should the IRS Secure Its Interest in Stock Pledged As Collateral</u>? The IRS should file a Notice of Federal Tax Lien (NTFL), Form668-J, in the office mandated by applicable state law. §6324A(d)(1); 6323(f). Stock is generally considered personal property and is situated at the residence of the taxpayer at the time the NTFL is filed. §6323(f)(2). "Since the taxpayer in this case is an estate, applicable state law will determine where the NTFL will be filed." (The ILM does not suggest whether this will typically at the place of the residence of the decedent or at the place of residence of the executor.) In addition to filing the NTFL, the ILM recommends that the Service take possession of the stock certificates. While purchasers of the stock would take it encumbered with the special estate tax lien (because purchasers are not listed as having a superpriority in §6324A(d)(3)), the ILM recommends that the IRS take possession o f the certificates to avoid potential litigation.

(e) <u>What Steps Should the IRS Take to Protect Its Interest in Other Assets In the Gross Estate That Are Not Used as Collateral for the §6324A Special Lien</u>? The recording of a §6324A special lien divests the IRS of any lien under §6324 for that same property with respect to the same estate—but not other assets. §6324A(d)(4).

There are two other lien provisions, other than the §6324A special estate tax lien on designated collateral for §6166 extensions. One is the general estate tax lien under §6324(a), which attaches to all assets of the gross estate that arises at the date of death and lasts for 10 years (which period of time cannot be extended). The other is the general tax lien under §6321 that arises only after estate taxes become due and following assessment, demand and refusal or neglect to pay. The general tax lien does not have priority over a purchaser or certain others until a Notice of Federal Tax Lien is filed.

> "Accordingly, to protect its interest in the remainder assets of the gross estate more than 10 years after decedent's death, the Service could file a NFTL under section 6321…Whether the Service should file a NFTL in a particular situation is a business decision to be made by the Service."

(f) <u>Should Full Audits be Required of All Estates That Propose Using Closely Held Stock as Collateral</u>? There is no legal requirement to do so; this is a business decision for the Service.

(g) <u>What Procedure Should be Used to Determine If the Closely Held Business Interest Collateral Is Adequate Security</u>? The proper procedure to follow is a business decision to determine if the three statutory requirements in §6324A (as discussed in Item 1 above) are met. If the IRS decides to reject the closely held business interest as collateral, it "should detail, in writing, the basis for the rejection."

(h) <u>What Procedure Should be Used to Deny or Terminate a §6166 Election If the Property Initially Proffered As Collateral Is Insufficient</u>? If the proffered collateral is less that the unpaid deferred amount and required interest, the IRS may require additional security, and if the estate does not provide the additional security requested within 90 days after notice and demand, the estate's refusal will be treated as an event accelerating payment of installments under §6166(g). The IRS will issue a preliminary determination letter, "such as Letter 950, which contains a notice of Appeal rights." Following the enactment of §7479 in 1997, this decision may be contested in the Tax Court (for example, if the estate thinks the value of the property is greater than the amount of unpaid deferred tax plus required interest) by filing a timely petition after exhausting administrative remedies. (After receiving the Letter 950, the estate must request an Appeals conference to exhaust administrative remedies. After that conference, the IRS will issue a final determination letter "such as Letter 3570." The estate may then petition the Tax Court for a declaratory judgment under §7479. The procedures are described in Rev. Proc. 2005-33, §4.01(1), 2005-24 I.R.B. 1231.

(i) What Procedure Should Be Used to Review the Continuing Sufficiency of Collateral? The IRS has the implicit right to monitor the value of the collateral to determine if the value has become less than the unpaid deferred tax and required interest. If so, the IRS can ask for additional collateral. While the decision of whether to monitor and the procedure for monitoring the value is a business decision for the IRS, the report strongly recommends that the IRS does monitor the sufficiency of the collateral.

Internal Legal Memorandum 200803016, Considerations for Using LLC Interest as Collateral. ILM 200803016 is a similar Notice addressing when LLC interests may be used as collateral to secure a §6166 deferral. The Notice is similar to ILM 200747019 in providing that the IRS *must* accept the LLC interest itself as collateral if certain conditions are satisfied. The analysis is similar to ILM 200747019.

3. Transferee Liability Of Beneficiaries. The beneficiaries of an estate have personal liability for unpaid estate taxes. §6901(a)(1) (probate estate); §6324(a)(2) (non-probate assets included in the decedent's gross taxable estate).

There is a limit on the amount of the liability. For transferee liability under §6901, federal courts have generally held that the transferee's liability is the value of the transferred assets on the date of transfer. E.g., Commissioner v. Henderson's Estate, 147 F.2d 619 (5th Cir. 1945). For non-probate transfers, §6324(a)(2) limits the liability to "the extent of the value, at the time of the decedent's death, of such property, received from the decedent."

Transferee liability applies to the donee of a gift within three years of the decedent's death under §2035(d)(3)(c) even though the gifted asset itself is not brought back into the decedent's estate under §2035. E.g., Armstrong v. Comm'r, 114 T.C. 94 (2000).

It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself. The Eleventh Circuit Court of Appeals has held that a life insurance beneficiary's total liability for tax and interest may exceed the estate tax value of the property received. Richard M. Baptiste v. Comm'r, 29 F.3d 1533 (11th Cir. 1994). The Eighth Circuit had previously reached the opposite result in a case involving Richard Baptiste's brother, Gabriel (who was an equal beneficiary of the same life insurance policy), holding that the limitation on liability to the value of property at the date of death applies to tax and interest. Gabriel Baptiste, Jr. v. Commissioner, 29 F.3d 433 (8th Cir. 1994), cert. denied, 513 U.S. 1190. See generally Hahn, The Scope of Transferee Liability in Estate and Gift Tax Cases, 74 TAXES 72 (1996); see also Poinier v. Commissioner, 858 F.2d 917 (3rd Cir. 1988) (transferee liability for gift taxes; transferee liable under §6324(b) for gift tax and interest, but only to the extent of the value of the gift).

For estate tax purposes, there is no "transferee," and no therefore no transferee liability unless the transfer occurs within the statute of limitations period for assessing additional estate taxes against the estate. If no transfers are made to beneficiaries within the 3 yr statute of limitations on additional assessments, there will be no transferee liability. See Illinois Masonic Home v. Comm'r, 93 T.C. 145 (1989).

Observe that the transferee liability for gift tax attaches even as to annual exclusion property. The donee is personally liable up for gift tax up to the value of the donee's gift even if the donee received only an annual exclusion gift which did not contribute to the unpaid gift tax. See Bauer v. Comm'r, 145 F.2d 338 (3d Cir. 1944).

Fiduciaries may be personally liable for payment of transfer taxes under the transferee liability doctrine. See Tractenberg, Transferee Liability Can Reach Trustee as Well as a Beneficiary, 21 EST. PL. 259 (1994).

Even if the IRS fails to assert a tax deficiency against the transferor prior to the running of the statute of limitations against the transferor, a transferee may nevertheless be liable for estate, gift or generation-skipping transfer tax. This is illustrated by the recent Kulhanek and Mangiardi cases.

Collection Action Against Transferees 17 Years After Date of Death; U.S. v. Kulhanek, 106 AFTR2d 2010-7263 (W.D. Pa. 2010). In this case, the IRS "came knocking on the door" of the recipients of retirement benefits and life insurance and collected estate taxes from them 17 years after the decedent's death!

Facts. The defendants were recipients of a $300,000 retirement account and a $10,000 life insurance policy. Each of them received distributions shortly after the decedent's death. The estate tax return was filed in 1992, making a § 6166 election. The stock of the business interest was sold in 1999. Over nine years later, the IRS filed an action against the defendants pursuant to § 6324(a)(2), which addresses transferee liability, to collect unpaid estate taxes of about $200,000 plus statutory interest.

Analysis. Under § 6324(a)(1) there is an absolute 10-year limit on the special automatic estate tax lien, without extensions or tolling. However, the court said that the IRS was not proceeding under that section but under the transferee liability provision of §6324(a)(2), which does not contain the absolute 10-year limitation by its terms. Because transferee liability is derivative of the transferor's liability, courts addressing the limitations applicable to § 6324(a)(2) have looked at the generally applicable statutes of limitations created under §§ 6501-6502.

Section 6501 requires that the IRS assess tax within three years after the return was filed. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, and that period can be suspended or extended. There was a tolling of the statute of limitations in this case under §6503(d) during the § 6166 deferral period. Because the § 6166 election preceded the assessment of tax liability, the assessment did not trigger the running of the statute of limitations until the end of the § 6166 extension period. The collection action was filed almost 9 1/2 years after the §6166 deferral period ended by reason of the sale of the stock — so it was filed within the allowed 10-year period.

Planning Concerns. (1) Transferees are personally liable up to the value they received at the date of the original transfer to them (in this case the date of death), even if they do not have that much value still remaining from those assets at the time of the later collection action. Recipients of gifts and recipients of assets following an individual's death must understand that this potential personal liability exists, and that it could arise well over a decade later without notice.

(2) There is no indication in this case that the IRS ever made an assessment against the defendants personally under the transferee liability provision, despite the fact that § 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS must assess tax against the estate within three years of filing the estate tax return (§ 6501(a)), so § 6901(c) requires assessment against the transferee within four years after the return was filed. The case did not discuss whether the IRS made an assessment against the recipients of the retirement accounts and life insurance policy within four years (which would be unusual), and did not address the effect of a failure to make such an assessment. Again, this raises the concern that transferees may conceivably first get notice of an unpaid estate tax liability when a Complaint is filed many years (in this case 17 years) after the date of death. (In this case, presumably the defendants had notice that an estate tax liability was unpaid, because they were the decedent's daughters, although the case did not indicate whether they were also the executors of the estate.) The potential injustice of this possibility, without prior assessment against the transferees, was raised in the recent Mangiardi case, discussed immediately below.

No Necessity for Assessment Against Transferee, Estate of Mangiardi v. Comm'r, T.C. Memo. 2001-24. In this case, the IRS proceeded to collect estate taxes from an IRA beneficiary eight years after the IRA owner's death, without ever having assessed tax against the beneficiary — and the IRS won.

Facts. The decedent's estate consisted almost entirely of nonprobate assets, a revocable trust valued at $4.6 million and IRAs valued at $3.4 million. The IRAs passed to the decedent's nine children. The decedent died in April, 2000 and the estate tax return was filed in July, 2001. The IRS granted six extensions for payment of the estate tax under § 6161. The extensions ended in December, 2004. The letter granting the last extension said that it could not be extended past

December, 2004, because "we must ensure that the transferee assessments are made prior to the assessment expiration date to make those assessments." (The four-year period for making assessments against transferee would end four years after filing of the estate tax return, or in April, 2004.) However, assessments were never made against the IRA beneficiaries.

About 1 ½ years after the last extension expired (in July 2006), the IRS gave notice of intent to levy to collect tax. Maureen Mangiardi, a co-trustee of the revocable trust and statutory executor (perhaps one of the decedent's children) timely submitted a hearing request, arguing that the IRS was precluded from collecting estate tax liability from the IRA beneficiaries because the time for making a transferee assessment against them under § 6901 had expired. That proceeding was ultimately concluded in January, 2008 when the IRS sent a notice of determination that it could collect the estate tax liabilities either from the executor or from the beneficiaries without a prior assessment against the transferees under § 6901.

Analysis. The issue is whether a § 6901(c) assessment against transferees (which would have been required in this case within four years of filing the estate tax return) is required before the initiation of a collection action under the transferee liability provisions of § 6324(a)(2). The court held that it was not, and allowed the collection action to continue. The court's reasoning was rather terse, acknowledging that "[f]ew courts have considered this issue directly; however the Courts of Appeals for the Third Circuit and Tenth Circuit have held that respondent may collect estate tax from a transferee pursuant to section 6324(a)(2) without a prior assessment against the transferee under section 6901. United States v. Geniviva, 16 F.3d 522, 525 (3d Cir. 1994); United States v. Russell, 461 F.2d 605, 607 (10th Cir., 1972)," and that it found those cases persuasive.

The court also upheld the IRS's denial to accept $700,000 as an offer-in-compromise. The court reiterated that the IRS could proceed against the IRA beneficiaries in the amount of the IRA distributions, and the IRS had determined that the reasonable collection potential "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." The court agreed that the IRS did not abuse its discretion in refusing the offer-in-compromise because the petitioner did not offer an acceptable amount.

Reasoning That § 6901(c) Assessment is Not Required. The Geniviva case reasons that § 6901(c) and § 6324(a)(2) are "cumulative and alternative — not exclusive or mandatory" (quoting *Russell*). The Geniviva case relies on a Supreme Court case for this result:

Before 1926, when section 6901 was enacted, the only means by which the Government could impose liability against the transferee was a bill in equity or an action at law brought under the precursor to section 6324 [citation omitted]. Section 6901 did not eliminate or limit such an action; rather, it provided an ADDITIONAL means by which the Government could enforce the collection of taxes. Leighton v. United States, 289 U.S. 506, 507-08 (1933). Thus, in Leighton the Supreme Court held that a failure by the Government to personally assess the shareholders of a defunct corporation did not bar an action to impose transferee liability against them… Leighton has never been overruled, either by the Court or by statute, and is binding upon us.

At least one district court opinion refused to go along with this reasoning. *United States v. Schneider, 92-2 U.S.T.C.* ¶60,119 (D.N.D. 1992). Geniviva distinguished that case, but noted the extreme unfairness of not requiring assessment against the transferees:

> [W]e express a certain sorrow that what seems inherently unfair is also quite in accordance with the law, and note a compassion for the equitable position of the appellants. They received their inheritance apparently believing that the affairs of their late mother's estate had been competently represented both professionally and personally, and handled in accordance with the law. Years later they found out that the estate had been poorly advised and represented, and had an unresolved, serious tax problem. Now they find themselves defendants in a lawsuit for the collection of those taxes, and under circumstances amounting to a forfeiture of their entire inheritance.

Planning Concerns. (1) The Geniviva court was correct that the result seems "inherently unfair." In a case where there is a § 6166 deferral (like the Kulhanek situation), it is conceivable that the IRS could first contact IRA or life insurance beneficiaries up to 24 years (the § 6166 14-year deferral period plus the additional 10 years allowed under § 6324(a)(2), by reference to § 6502) after the decedent's death that there are unpaid estate taxes, and that they are personally liable for the unpaid taxes (plus accrued interest over 24 years!) up to the amount of the benefits they received from the decedent 24 years earlier, without ever having had prior notice from the IRS of an assessment against them. Yes, that seems "inherently unfair."

(2) This concern is exacerbated with respect to IRA beneficiaries or beneficiaries of other retirement accounts. For example, in Kulhanek the IRS concluded that a reasonable offer-in-compromise "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." That simple conclusion ignores that the IRA beneficiaries will owe income taxes at ordinary income tax rates on the IRA receipts. For example, using the Kulhanek facts assume that beneficiaries of the $3,433,0 IRA were in the 35% income tax bracket when they received their distributions years earlier. They would have paid income taxes of $1,201,552, leaving them net proceeds of $2,231,454. That does not matter; they are still personally liable under § 6324(a)(2) for the full $3,433,007 that they received from the decedent. Even assuming they still have the $2,231,454 net proceeds many years later, they would still have to cough up the additional $1,201,552 out of their other assets. Yes, there is a § 691(c) deduction against the income tax for estate tax attributable to the IRD asset, but the statute of limitations for getting a refund of those income taxes has long passed. Hello bankruptcy!

(3) A belief that the transferees' concern about liability lasted for four years after the estate return was filed because of the limitations period for assessment under § 6901(c) is wrong under the reasoning of these cases. Transferees may have potential liability for estate tax many years beyond that. In many ways, the § 6901(c) time limit is meaningless.

3. Special Automatic Estate Tax Lien. The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under §6324(a) on that property is extinguished by the special estate tax lien for §6166 deferred tax under §6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, except that if property is transferred to a purchase or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under §2204, the lien no longer applies to the transferred property but the lien attaches to the consideration received from the purchaser. §6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien. A release of lien is requested by filing Form 4422, and can be allowed if—

i. the remaining property in the estate is double the value owed the IRS,

ii. payment is made to the IRS equal to the value of the property being discharged,

iii. the government does not have a valuable interest in the specific property, or

iv. sale proceeds are to be substituted for the discharged property.

The general estate tax lien divests when the sale proceeds are "for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof." This exception was addressed in First American Title Insurance Company v. United States, 95 AFTR2d 2460 (W.D. Wash. 2005), aff'd 520 F.3d 1051 (9th Cir. 2008). The court applied a strict tracing requirement described in Northington v. United States, 475 F.,2d 720 (5th Cir. 1973). The court granted the IRS's motion for summary judgment because it determined that the title company could not affirmatively demonstrate that the payments were used for charges against the estate, and that the taxpayer must petition a court for allowance and that non-intervention powers do not qualify as allowance. See generally Note, 59 TAX LAWYER 901 (2006).

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. IRS §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2)

The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

a. Example of Application of Lien. The First American Title Insurance Co. v. U.S. case illustrates how scary the special estate tax lien can be. 2005-1 USTC ¶60,501 (W.D. Wash. 2005), aff'd, 520 F.3d 1051 (9th Cir. 2008). This case illustrates that even sophisticated parties (such as title companies) they can still get caught by this special lien. The decedent died in 1981, owing several major assets, including Frisko Freeze that runs hamburger joints. The decedent's daughter filed the estate tax return and paid part of the estate tax and received an extension on the excess. The estate distributed three houses to the daughter, which she subsequently sold to three purchasers who each obtained title insurance. The IRS revalued Frisko Freeze and assessed more estate taxes. The daughter and estate filed for bankruptcy. The IRS sent letters to the purchasers of the homes threatening foreclosure, unless the taxes were paid. The title insurance companies paid the increased taxes and sued the government for refund, arguing that the sale proceeds were used to pay taxes so the estate tax lien should be divested. The title insurance companies lost that argument because they could not "trace" the use of the proceeds to the payment of taxes, and even if they could, the court held that the payment had not been approved by the court as required by §6324(a)(1). The title companies were left "holding the bag."

b. Practical Problems and Lessons in Dealing With the Estate Tax Lien. Ed Manigault suggests the following practical aspects of dealing with the estate tax lien.

(1) Last Minute. Invariably, the estate tax lien issue comes up last minute in deals.

(2) Hard to Spot; Transferee As Seller. The seller may not be a decedent's estate, but the child of decedent, who within the prior 10 years received assets from the estate.

(3) Hard to Spot; Disregarded Entity. If assets were purchased from an LLC that either is or was a disregarded entity previously owned by a decedent, the IRS may take the position that the LLC is disregarded for all tax purposes and that all assets of the LLC are subject to the estate tax lien, even if the LLC *at the time of the sale* was taxed as a partnership.

(4) Practical Problem of Obtaining Sensitive Information. The attorney for a prospective purchaser may approach the estate. "I cannot identify my client, but I need to know information about when the decedent died, the assets of the estate, the amount of the estate taxes, when estate taxes have been paid, etc." What is the likelihood of receiving that information until the transaction has proceeded far down the line? In some situations, sellers may be unwilling to share sensitive estate tax information with counsel for the purchaser or perhaps even with the corporate attorney handling the sale transaction for the seller.

(5) IRS Will Not Accept Wire Transfers. As discussed below, it may be possible to get a release of lien by payment of the estate taxes from the purchaser (i.e., the purchaser may pay part of the purchase price directly to the IRS in partial payment of the estate taxes), but the IRS only accepts checks. It will not accept a wire transfer. The transaction may have to be delayed several days until the check clears. This is particularly difficult when the lien issue arises, as it often does, at the last minute.

(6) Drafting Cannot Solve the Problem. Just adding representations and warranties in the sale documents does not solve the problems. The documents will say that the seller is getting marketable title, and that estate taxes are paid or provided for. However, if taxes in fact are not paid, the purchaser of the asset may still be responsible.

(7) Due Diligence. The purchaser should ask for a copy of the Form 706 if the asset is being sold by an estate. However, even that will not necessarily highlight problems. In the First American Title case, the purchaser was primarily interested in the houses, but the estate tax problem arose over the closely held corporation in the estate. It is hard for the purchaser to know what is going on with all of the other assets of the estate. Even if the advisor is comfortable with assets shown on the estate tax return, what about assets that might have been omitted?

(8) Joint and Several Liability. As a result of the inherent uncertainties, sale agreements generally put all sellers in the position of being jointly and severally liable for the taxes. Therefore, all beneficiaries would be on the hook if there is an estate tax problem.

(9) Escrow for All Proceeds? It is not surprising that funds may need to be placed in escrow in order to obtain the release of the estate tax lien. However, the transactional attorneys may be quite surprised to find that the IRS may require all, not just a portion, of the sale proceeds to be placed in escrow before the IRS grants a certificate of discharge of the lien.

(10) Consider Owning Assets in Revocable Trust or Entity. As discussed below, there are fewer restrictions on the lien if assets are held in a revocable trust or entity.

c. Release of the Estate Tax Lien. There are various methods of releasing the lien, but often they take time and may not be helpful in a time-sensitive M&A deal.

(1) Release of Lien from IRS. The IRS may release the lien entirely or as to specific assets. §6325. The IRS has discretion to issue a certificate of discharge if it is otherwise protected (meaning that other assets subject to the lien are twice the tax liability (§6325(b)(1)), or if an amount equal to the IRS interest in the property is paid to the IRS, or if the proceeds are held in escrow. The escrow approach is often required in the context of business transactions, but negotiating the agreement can take considerable time. Ed Manigault was recently involved in a case where three months was required to negotiate the arrangement with the IRS — and all of the proceeds were placed in escrow, not just 45% (because the lien attaches to all of the asset).

(2) Payment of Estate Expenses. The lien is released if (i) proceeds of the purchase are used to pay charges against the estate or administration expenses, AND (ii) those expenses are allowed by a court with jurisdiction. (The First American Title Insurance Company case discussed above, emphasizes the importance of both the tracing and court order requirements.) This method has limited utility in many corporate deals because of the time requirement of obtaining a court order. (This method applies to both probate property and non-probate property.)

(3) Discharge Under §2204. If the executor has been discharged from personal liability under §2204, a transfer of property to a purchaser for full consideration, or a holder of the security interests will divest the lien from the transferred property. §6323(h)(6), 6326(h)(1). (Instead, a substitute lien is placed on the consideration received from the sale. §6324(a)(3).) (This method applies to both probate property and non-probate property.)

(4) Non-Probate Property Exception for Bona Fide Purchasers. A transfer of non-probate property to a purchaser or holder of the security interest divests the lien from the transferred property. §6324(a)(2)(first sentence). However, a lien is then placed on all of the property of the transferor (not just the consideration received in the transfer). §6324(a)(2); Rev. Rul. 56-144.

(5) Exception for Purchasers of a "Security". If someone pays full value for a "security", they receive the security free of the estate tax lien; that sounds like BFP protection. However, an important concern is that this exception only applies to stock or other securities, not to a partnership or LLC interest. Also, it does not apply if the purchaser had "actual knowledge or notice" of the existence of the lien. In light of the uncertainties surrounding the "actual notice or knowledge" requirement, purchasers cannot rely on this exception.

d. Mitigating the Lien Using Revocable Trusts or Entities. If there will be substantial sales after an individual's death, various steps can be taken to mitigate lien problems that may arise in making sales.

(1) Revocable Trusts. Assets in revocable trusts would be non-probate assets that could be sold to a purchaser for full value divested of the estate tax lien.

(2) Assets in Entities. In Beaty v. U.S, 937 F.2d 288 (6th Cir. 1991), the estate sold its partnership interest to the partnership in return for land owned by the partnership, and the land was distributed beneficiaries. The estate tax lien did not attach to that land. Under the reasoning in this case, the estate tax lien only attaches to property included in the estate, i.e., the partnership interest and not the assets in the entity.

V. DISCLAIMER PLANNING.

A. General Requirements.

Section 2518(b) defines a qualified disclaimer as an irrevocable and unqualified [yes, a "qualified" disclaimer must be “unqualified”] refusal by a person to accept an interest in property if—

1. such refusal is in writing,

2. such writing must be delivered to the transferor of the interest, his legal representative or the holder of the legal title to the property to which the interest relates or the person in possession of the property

3. such delivery is made no later than the date which is 9 months after the later of—

    a. the date on which the transfer creating the interest in such person is made, or

    b. the day on which such person attains age 21,

4. such person has not accepted the interest or any of its benefits,

5. as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer,

6. the interest passes either—

    a. to the spouse of the decedent, or

    b. to a person other than the person making the disclaimer.

If the disclaimer is not a “qualified disclaimer”, it typically is treated as a gift. If property passes as a result of the disclaimer to a pre-September 25, 1985 irrevocable trust that is grandfathered from the GST tax, the transfer is treated as an addition to the trust after September 25, 1985, which will cause a pro rata portion of subsequent distributions from the trust to be subject to the generation-skipping transfer tax. Ltr. Rul. 200001012.

For a detailed discussion of state property law issues regarding disclaimers, see Hirsch & Gans, Perfecting Disclaimer Reform: Suggestions for a Revised Uniform Act, 31 EST. PL. 185 (April 2004); LaPiana, Some Property Law Issues in the Law of Disclaimers, 38 Real Prop., Prob. & Tr. L.J. 207 (2003).

B. Nine Months Time Limit Requirement.

The nine-month period is applied very strictly. The disclaimer must be filed within nine months after the later of the date on which the transfer creating the interest is made or the date on which the disclaimant attains age twenty-one. Reg. §25.2518-2(c)(1).

C. Planning Flexibilities with Partial Disclaimers.

1. Can Disclaim Specific Assets From Trust.

After a specific trust asset is disclaimed, it must "leave" the trust and pass to someone other than the disclaimant. Reg. §25.2518-3 (a) (2); Ltr. Ruls. 9244012, 9038031, 8922036. A removal of the disclaimed property to another trust under the same instrument is sufficient. Ltr. Rul. 8951041. The same rule applies if a person merely wishes to disclaim income derived from a specified trust asset - that trust asset must leave the trust if the beneficiary continues to accept income from remaining properties in trust.

2. Formula Disclaimers are Permitted.

The regulations and various private letter rulings indicate that a formula disclaimer may be a qualified disclaimer. Reg. §25.2518-3(d), Ex. 20 (fractional disclaimer; numerator of fraction is the smallest amount which will allow estate to pass free of federal estate tax and denominator is the value of residuary estate); Ltr. Ruls. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return), 9646010, 9435014, 9338010 (pecuniary formula disclaimer of amount sufficient to utilize estate's unified credit). A number of rulings have permitted disclaimers under reverse pecuniary formulas. E.g., Ltr. Ruls. 200130034, 200001045, 9437029, 9435014, 9319022, 9310020, 9115062, 9014005, 9009007, 8502084. See Estate of McInnes v. Commissioner, 64 T.C.M. 840 (1992). For an example of various formula disclaimer clauses, see Horn, Enhancing the Use of Spousal Disclaimers That Salvage Exemptions but Do Not Forgo

Enjoyment, 29 ACTEC J. 265 (Spring 2004).

Using formula disclaimers may afford interesting planning opportunities. The use of a disclaimer to pass a defined value to family members, with the excess passing in a manner that is not subject to gift or estate tax, is not new. See Akers, An Overview of Post-Mortem Tax Planning Strategies, 34th ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶1217.7 (2000). However, this use of disclaimers has been receiving increasing attention. See Handler & Chen, Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS, J. TAX'N (April 2002).

3. Bequest With Disclaimed Assets Passing to Charity or Spouse; Disclaim Excess Over Specified Amount.

An appropriately structured will may permit using formula disclaimers to transfer assets under a defined value type approach. For example, a will might make a bequest to beneficiaries other than the decedent's spouse. The will would provide that any disclaimed assets would pass to a donor advised fund at a Communities Foundation (or other charity) or to the surviving spouse in a manner that would qualify for the estate tax marital deduction.

The beneficiaries could disclaim all of the estate over a specified dollar value, based on federal estate values. If the IRS asserted that the values on the estate tax were too low, the excess value would pass to charity (or to the spouse) and would not generate additional estate tax. A case involving this type of plan was Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding "x" dollars (before payment of debts, expenses and taxes) in which the decedent's will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate's appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. In that case, the charity negotiated a fixed payment for their rights to the disclaimed formula share of the estate. The case was settled before trial.

This type of clause was also addressed by the Tax Court in Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008). The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a CLAT and 25% to a foundation. (Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of slightly over $6.5 million. The specific formula disclaimer clause provided, in part, as follows:

> "Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…."

The clause went on to define "fair market value" by reference to "as such value is finally determined for federal estate tax purposes."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. Under the disclaimer, the additional $3.1 (i.e., $9.6 – 3.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount transferred so that there would be no (or minimal) additional gift tax over the intended amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

The Tax Court held that the disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the disclaimer regulations, so no estate tax charitable deduction was allowed for amounts passing to the CLAT under the disclaimer. The estate did not appeal that finding. The Tax Court held that the disclaimer to the foundation did not have any of the technical disclaimer problems and that the disclaimer was not contingent on a subsequent event and did not violate public policy; an estate tax charitable deduction was allowed for the full increased gross estate amount that passed to the foundation under the disclaimer. The IRS appealed that determination.

The Eighth Circuit held that the formula disclaimer was recognized and all of the increased value that passed to the foundation qualified for the estate tax charitable deduction. The Tax Court decision was affirmed. The court gave broad reasons in support of its rejection of the IRS's public policy argument against clauses that reduce the incentive of the IRS to audit returns.

The IRS argued that the amount passing to charity was contingent on a subsequent event and that no charitable deduction should be allowed under Treasury Regulation §20.2055-2(b)(1). The Eight Circuit reasoned that the regulation requires the existence of *"a transfer at the date of death;"* not "the existence or finality of an accounting evaluation." The only outstanding issue was valuation, and "[t]he foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain." There is a difference between post-death events that change the actual value of an asset and events that "are merely part of the legal or accounting process of determining value at the time of death." Cases cited by the IRS all involved situations where the actual transfer was dependent on various contingencies (such as a daughter dying without descendents, and a trust that allowed the family beneficiary to invade corpus).

Furthermore, estate tax charitable deduction regulations regarding charitable lead annuity trusts recognize that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" to qualify as a guaranteed annuity interest. Treas. Reg. §20.2055-2(e)(2)(vi)(a). Therefore, references to values "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify the availability of a charitable deduction.

In addition, the IRS argued that the clause violated public policy because it removes the IRS's incentive to audit the estate tax return. The Eighth Circuit agreed that the disclaimer of all amounts in excess of a fixed-dollar amount "may marginally detract from the incentive to audit estate tax returns." In some situations, that might permit "a charitable deduction equal to the increase in the estate, resulting in no increased estate tax." (However, footnote 2 observed that under the facts of this case, there is no offsetting charitable deduction for the 75% of the increased value that passed to the CLAT.) The IRS's argument is that strategies such as a fixed-dollar amount partial disclaimer that operate to allow an additional deduction to offset any increased value should be disallowed on policy grounds "because of the potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."

The court gave three reasons, for rejecting the IRS's public policy argument even if the effect is that increasing values in audits would not increase the estate tax collected as a result of the audits. First, the <u>IRS's role is to enforce tax laws, not just maximize tax receipts</u>. Second, there is no clear Congressional intent of a policy to maximize the IRS's incentive to audit returns. (Indeed, "Congress sought to encourage charitable donations by allowing deductions for such donations.") Third, other mechanisms exist to ensure that values are accurately reported. "State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." Furthermore, "the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value" and serve a "watchdog function." In this case the disclaimant was the executor and a board member of the foundation. Because of her fiduciary obligation, any self-dealing "would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests …"

D. <u>Passing Without Any Direction By Disclaimant; Disclaimer Involving Foundations</u>.

Section 2518(b)(4) requires that the disclaimed property pass, as a result of the disclaimer, but "without any direction on the part of the person making the disclaimer." Disclaimers by or in favor of a spouse are not excepted from this rule.

1. Disclaimant as Fiduciary.

If the disclaimant is a fiduciary of a trust or fund to which the disclaimed property passes, he or she can exercise fiduciary powers to preserve or maintain the disclaimed property without being treated as accepting the property or any of it benefits. However, the disclaimant fiduciary cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Treas. Reg. § 25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Treas. Reg. § 25.2518-2(e)(1)(i) & 25.2518-2(e)(5)Ex.(12). Cf. Ltr. Rul. 200406038 (disclaimer recognized where mother of decedent executed an amendment to LLC agreement that removed her as LLC co-manager before disclaiming her bequest of in interest in the LLC).

2. Disclaimant Cannot Hold Power of Appointment.

A significant disadvantage to making a disclaimer is that the disclaimant cannot retain a limited power of appointment over disclaimed assets. Reg. § 25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). Holding a limited power of appointment provides a great deal of indirect “persuasive influence“ over family members.

3. Disclaimant as Director of Foundation Receiving Disclaimed Assets.

One situation where this issue arises is if the disclaimant is a director of a foundation that receives the assets as a result of the disclaimer. The IRS maintains that the disclaimant’s participation in selecting charitable grant recipients would prevent the disclaimer from being a qualified disclaimer because of the “passes without any direction” requirement. See Rev. Rul. 72-552, 1972-2 C.B. 525. One method of allowing a disclaimer in this situation is for the foundation’s bylaws to be amended to prohibit the disclaimant and his or her spouse from participating in the selection of grant recipients. See Ltr. Rulings 200649023; 200519042; 199929027; 9317039 & 9141017. Alternatively, the will could provide that disclaimed assets would pass to a separate fund of the foundation over which the disclaimant held no powers. Ltr. Ruls. 201032002; 200420007; 19992902, 200420007 & 200519042. An alternate solution is to have the disclaimed property pass to an advised fund of a community foundation E.g., Ltr. Rul. 9532027; 200518012 (disclaimer valid even though disclaimant would serve as advisor for donor advised fund and make nonbinding recommendations to the foundation regarding fund distributions, but the foundation would have ultimate authority and control over distributions).

E. Disclaimer by Trustee of Power to Make Distributions to Beneficiaries Other Than Spouse — But May Be Questionable Unless Beneficiary Consents.

Various divergent cases and rulings have addressed whether a trustee can disclaim a power to make a distribution to a non-spouse beneficiary, in order to qualify the trust for QTIP treatment. In Cleveland v. United States, 88-1 U.S.T.C. ¶13,766 (C.D. Ill. 1988), a marital deduction was allowed for a trust, for which a corporate trustee had disclaimed its power to utilize income or principal for the children's college education. However, while some IRS rulings have approved disclaimers of powers, most have refused to recognize a disclaimer of a "tainted" power in order to qualify a trust for QTIP treatment. E.g., Tech. Adv. Memo. 8729002 (disclaimer by surviving spouse as trustee of power to invade corpus for children ineffective to qualify the trust for QTIP treatment).

A published revenue ruling now makes reliance upon a disclaimer of a power particularly questionable. Rev. Rul. 90-110, 1990-2 C.B. 209; see also Tech. Adv. Memo. 9818005.

One private letter ruling, however, recognized the validity of a trustee’s disclaimer of the power to make distributions to an unlimited number of charities for purposes of determining that the trust (which made the ESBT election) was a qualified shareholder of an S corporation. The ruling implicitly makes the determination that the disclaimer of the power to make distributions to an unlimited number of charities is valid under applicable local law. Letter Rul. 200401011.

Another ruling that recognized renouncing of powers by a trustee is Letter Ruling 200404013. In that ruling, an irrevocable trust named the grantor’s wife and a bank as co-trustees. The trust acquired a joint and survivor life insurance policy on both spouses’ lives. The wife executed an instrument renouncing her right as trustee to change the policy beneficiary, to revoke any change of beneficiary, to assign the policy, and to revoke an assignment of the policy. The ruling concluded that the wife, as trustee, would have no incidents of ownership in the policy held by the trust.

The Tax Court has refused to give effect to renunciation of powers by trustees for purposes of determining whether the trust qualifies for the estate tax marital deduction. Estate of Charles Bennett v. Comm'r, 100 T.C. 42 (1993). The court observed that there was no statement of intent regarding qualification for the marital deduction in the will or trust agreement, and no extrinsic evidence of the decedent's intent was presented. The Tax Court concluded that it would not permit the trustees "to disclaim powers, duties and discretions that would amount to a renunciation of their trusteeships." See Tech. Adv. Memo 9135003.

F. Partial Disclaimer After Some Benefits Have Been Accepted; Expectation of Future Benefit as Acceptance.

1. General Rule.

One of the statutory requirements of a qualified disclaimer is that the disclaiming person "has not accepted the interest or any of its benefits". Because of this requirement, before planners are able to determine whether disclaimers would be appropriate for a particular estate beneficiary, the beneficiary should be wary of accepting any benefits from the estate.

2. Jointly Owned Assets.

In several lenient rulings, the IRS has allocated the entire amount of a withdrawal to the disclaimant's personal interest in a jointly owned asset. Ltr. Ruls. 9218015 & 9214022. However, in other cases withdrawals have been allocated one-half to the decedent's interest and one-half to the surviving joint owner's interest. E.g., Ltr. Ruls. 9214022; 9012053. The acceptance of benefits issue is a difficult issue with respect to jointly owned property (including community property assets), and the surviving joint owners should be very careful before accepting any benefits from the jointly-owned assets before the disclaimer decision has been made. An example of a well-planned strategy for leaving the flexibility to disclaim a joint account passing by right of survivorship is illustrated in Letter Ruling 199932042. This ruling suggests the following planning steps if the surviving joint account owner wants to leave open the possibility of disclaiming the decedent's interest in the account:

(1) The survivor can receive income checks after the first account owner's death, but the checks should either be deposited into a joint bank account, or preferably, be held to be placed one-half in an estate account;

(2) The executor should open an estate account as soon as possible;

(3) Thereafter, income checks should be deposited one-half into the estate account;

(4) The surviving account owner should decline to sign any authorization to transfer the entire account entirely into a new account solely in the survivor's name (although that fact alone ended up not precluding making a disclaimer in the ruling);

(5) The survivor should not withdraw any funds or income from the joint account or from the estate account which receives the estate's one-half of the account funds; and

(6) One-half of the assets in the joint account should be transferred to an account in the name of the decedent (perhaps with a specific written understanding that the funds will be transferred to the survivor's account under the survivorship arrangement if the survivor decides not to disclaim the assets.)

Hopefully, there are other assets that the survivor can use until the joint account funds can be divided in this manner. After the funds are divided, the survivor could use the funds transferred to his or her own separate account. If the survivor subsequently decides not to disclaim the account, the decedent's one-half of the funds could be transferred to the survivor.

Letter Ruling 200503024 allowed a disclaimer of the decedent's interest in a joint brokerage account held with rights of survivorship, even though the survivor re-titled the account into her name and ordered sales, purchases and withdrawals from the account. The disclaimer was allowed with respect to the decedent's interest in the securities and cash in the account that was not subject to sales, purchases, or withdrawals by the surviving wife.

Letter Ruling 200832018 also allowed a disclaimer from a joint brokerage account. Merely retitling assets did not constitute an acceptance of benefits. The surviving wife accepted some distributions from the account, but the ruling concludes that the amount that she received is a severable asset and the wife could make pecuniary disclaimer of assets originally held in the account less the amount of the prior distributions and income earned thereon. In addition, the wife was deemed to have accepted portions of the account that she authorized to be reinvested, but those newly acquired assets were severable so she could make a pecuniary disclaimer of the balance the her predeceased husband's interest in the account. A further complexity in that ruling is that the wife held a testamentary power of appointment over trusts into which the disclaimed assets would pass, and wife disclaimed her power of appointment over the trust.

3. Expectation of Future Benefit as Acceptance.

The Tax Court has treated an implied promise by the decedent's surviving husband that the disclaimant would be better off for making a disclaimer as consideration for the disclaimer, and section 25.2518-2(d)(1) of the Treasury regulations provides that acceptance of consideration for making a disclaimer is equivalent to acceptance of the interest itself. The Fifth Circuit Court of Appeals reversed the Tax Court opinion, concluding that the mere expectation of a future benefit will not render a disclaimer invalid. Estate of Monroe v. Comm'r, 124 F.3d 699 (5th Cir. 1997). Mrs. Monroe died in 1989, survived by her husband (age 92). Wife's will left many specific bequests, with the residuary estate passing to her husband. Her estate owed estate taxes as a result of the specific bequests. Husband and his nephew approached 29 of the potential legatees about disclaimers and all of those 29 legatees signed disclaimers aggregating about $900,000 of bequests. Within a few days (or in some cases a few weeks) after signing the disclaimers, each disclaimant received a personal check from the husband, bearing the notation "gift" in the approximate amount of the respective disclaimed bequests. The disclaimants included a grandniece and her children who were the beneficiaries of a bequest in trust of $500,000 of bonds (which had a present value of $535,781). The IRS took the position that the disclaimers were invalid, reasoning that husband's subsequent "gift" payments were made in return for the disclaimers, and the acceptance of consideration for the disclaimers amounted to acceptance of the bequeathed interests.

The facts did not reflect that the surviving husband ever told the disclaimants specifically that they would receive assets in exchange for giving the disclaimers (except for one household employee who testified that the surviving husband had promised to "take care" of him if he disclaimed his bequest). All of the other legatees merely assumed certain consequences of their decisions. Some testified that they either were afraid of refusing to abide by the survivor's wishes or expected to get the money back from him later.

The Fifth Circuit concluded that mere expectation of a future benefit in return for executing a disclaimer will not render it "unqualified". Id.

4. Disclaimer of Qualified Plan Benefit After Receiving Minimum Required Distribution for Year of Participant's Death. Rev. Rul. 2005-36 answers a thorny question on which the IRS and previously given no direct guidance. Rev. Rul. 2005-36, 2005-26 I.R.B. 1368.

a. No Acceptance of Benefits of Entire IRA. If a beneficiary withdraws the minimum required distribution("MRD") from an IRA for the year in which the decedent died (often in order to avoid a 50% penalty under §4974 on the failure to withdraw the MRD), the ruling confirms that the beneficiary can still disclaim his interest in the IRA. However, the amount withdrawn may not be disclaimed (because of the "no acceptance of benefits" requirement for valid disclaimers), and the beneficiary is also deemed to have accepted income earned post-death on the MRD. This situation often arises for IRAs in which the owner died late in the year without having taken the MRD for that year. The beneficiary must act quickly to take the MRD to avoid the 50% penalty, often before the beneficiary has had time to consider whether to make a disclaimer.

b. MRD Requirement Where Multiple Beneficiaries. The ruling has an example in which a surviving spouse withdrawals the MRD. The spouse later disclaims a pecuniary amount of the IRA balance, and the disclaimed portion passes to a child as the contingent beneficiary. The ruling confirms that the spouse's withdrawal of the MRD is sufficient for the entire IRA, and the MRD does not have to be allocated among the beneficiaries of separate accounts. (It is not clear whether this applies for all separate accounts established for multiple beneficiaries or only where the separate accounts are created as the result of a disclaimer.)

c. Effect of Disclaimer on Determining Identity of "Designated Beneficiaries". The ruling confirms that a person who disclaims his or her entire interest in an IRA is not considered a "designated beneficiary" as long as the disclaimer is made on or before September 30 of the calendar year following the year of the participant's death. Therefore, even for the situation in which a participant dies in December 31, and disclaimer within nine months (ON September 30) would still mean that the disclaiming person would not have to be counted in determining the lifespan and the move to the amount of over which post-death distributions must be made.

G. Disclaimers of Joint-Tenancy Property.

The ability to disclaim joint tenancy property at the first tenant's death is very important in many estates. An often incurred problem is that spouses, perhaps unknown to their planners, own most of their assets in joint tenancy so that insufficient assets pass under the first decedent spouse's will to fully fund a bypass trust. In such cases, a qualified disclaimer by the surviving joint tenant could be made following the death of the first joint tenant to die. The property or property interest subject to the disclaimer would pass, subject to state law, as if the surviving spouse had predeceased the decedent (e.g., to the decedent's children or to a credit shelter trust). In this manner, the decedent's unified credit could be utilized to a greater advantage.

A number of cases have addressed whether the time period for beginning the nine month measuring period runs from when the joint tenancy is initially created or from the death of the first joint tenant. For "revocable" joint-tenancy accounts, such as bank accounts, the nine-month period generally does not begin until the death of the first joint tenant. However, for "irrevocable" joint tenancies, such as real property, the IRS traditionally took the position that the nine-month period began from the date of creation of the joint tenancy. Reg. §25.2518-2(c)(4)(i) (prior to amendment effective December 31, 1997). This position was upheld in several early Tax Court cases, but various cases have now rejected this earlier regulatory position. A regulation effective December 31, 1997 adopts the more liberal position that had been recognized in the cases. Treas. Reg. §25.2518-2(c)(4).