The Power of Post-Mortem Estate Planning

By

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I. Introduction

Volumes have been written on the details that must be considered in administering a decedent's estate. Executors have over two dozen estate and income tax elections that they must consider in the course of the administration. Disclaimers are also a powerful tool that cannot be overlooked in post-mortem planning. And finally, with another sunset looming in the future, practitioners and their clients must plan in the face of uncertainty. This paper discusses many of the details that today's executor must consider.

II. Coming Attractions

Both the Administration and Treasury have significant agenda items that affect post mortem estate planning. While nothing is certain until the ink is dry, many of these proposals have been on the drawing board for several years and may eventually be enacted. Therefore, practitioners need to anticipate the impact of such legislative and regulatory action on their estate plans.

A. President's Budget

The General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals include the following:[1]

● Restoring the 2009 Estate, Gift, and GST Exemptions and Rates. The administration proposes to make permanent the estate, generation-skipping transfer (GST), and gift tax parameters as they applied during 2009. The top tax rate would be 45 percent and the exclusion amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. These changes would apply for decedents dying and transfers made after December 31, 2012.

● Portability Made Permanent. The provision allowing a surviving spouse to use the deceased spouse's unused estate tax exclusion, which expires for decedents dying after December 31, 2012, would be made permanent.

● Basis Consistency and Reporting. The basis of property in the hands of the recipient could be no greater than the value of the property as ultimately determined for estate or gift tax purposes. Executors and donors would be required to report the valuation and basis to recipients and to the IRS.

● Valuation Discounts. Certain additional restrictions would be ignored under IRC § 2704 in valuing transfers of a family-controlled entity to a family member if the restriction would lapse or be removed by the transferor and/or the transferor's family. These rules would apply to transfers after the enactment date.

● Specified Term for GRATs. A GRAT would be required to have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These rules would apply to trusts created after the enactment date.

● GST Trust Duration. Any GST exclusion allocated to a trust would terminate after 90 years. This rule would apply to trusts created after the enactment date and to additions made to an existing GST trust after that date.

[1] General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (Feb. 2012), *available at* www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

● Coordination of Income and Transfer Tax Rules of Grantor Trusts. New rules would eliminate the ability to transfer wealth to a grantor trust while the grantor continues to pay the income tax on the property. They would accomplish this by: (a) including the assets of an irrevocable grantor trust in the grantor's gross estate for estate tax purposes, (b) subjecting distributions from the trust during the grantor's life to gift tax, and (c) subjecting the assets to gift tax if the grantor ceases to be treated as an owner of the trust for income tax purposes during his life. These rules would apply for trusts created on or after the enactment date and contributions to an existing trust made on or after the enactment date.

● Extension of Estate Tax Lien on Section 6166 Deferrals. The 10-year estate tax lien under § 6324(a)(1) would be extended to apply throughout the §6166 deferral period, effective for estates of decedents dying on or after the effective date and for decedents dying before the enactment date as to which the current 10-year lien period had not expired on the effective date.

B. Treasury's Priority Guidance Plan

The Department of Treasury updates its Priority Guidance Plan each quarter, listing items they plan to issue guidance on and posting the projects completed since the last update. The latest guidance plan was issued on April 27, 2012 and contained the following items that may affect post-mortem estate planning:[2]

● Portability. According to informal sources at the IRS, guidance on portability is top priority with the Estate and Gift Tax Section. The Service has already published guidance on making the election (Notice 2011-82) and extended the due date of the election for decedents dying in the first half of 2011 (Notice 2012-21). But there are numerous other issues affected by portability, namely clarifying the amount of the portable election in the case of multiple marriages.

● Alternate Valuation. The IRS proposes to finalize the proposed regulations on alternate valuation.[3] Proposed regulations were issued on April 25, 2008, subsequently withdrawn, and replaced with new proposed regulations on November 18, 2011

● Expenses and Claims Against the Estate. Although final regulations were issued on expenses and claims against the estate under § 2053 in October 2009, there remain some open issues that the IRS needs to resolve. Namely, the IRS plans to issue guidance on using present value concepts in determining a deduction for expenses and claims. Some commentators believe that these regulations could impact *Graegin* loans.

● Protective Claims. The IRS issued limited guidance in 2011 for filing protective claims under § 2053 in Rev. Proc. 2011-48 to keep the statute of limitations open for amending a return to deduct payments made after the 3-year statute of limitations expires. . However, it plans to issue more specific guidance that will include a new Schedule PC to attach to Form 706.

● Valuation Discounts. Similar to the President's Budget item discussed above, the IRS plans to issue regulations regarding valuation of certain restrictions on gifts of closely held partnerships and corporations.

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[2] Department of the Treasury 2011-2012 Priority Guidance Plan (Apr. 27, 2012), *available at* http://www.irs.gov/pub/irs-utl/2011-2012_pgp_3rd_update.pdf.

[3] *See* discussion at III.C.3 of this outline.

III. Tax Elections

The executor has an incredible array of tax elections at his disposal. Some elections involve only timing differences while others involve permanent differences. Not all beneficiaries are affected equally by the elections. Some elections are more important than ever before in a zero estate tax environment and others are temporarily inapplicable. It is critical that the executor be aware of all the possible elections. Although many of them can be made on an extended or amended return, others have no such flexibility. If the executor fails to make an election to the detriment of the beneficiaries, he can be liable for breach of fiduciary duty. The discussion below covers the most common elections. However, it is by no means an exhaustive list.

A. Elections Affecting the Decedent's Final Income Tax Return

Certain income and deductions can be reported on either the decedent's final income tax return, the estate's Form 1041, or Form 706 and the executor should determine the best place to report them. While the income and estate tax rates are the same in 2010-2013 (35 percent), the executor should also consider how items reported on one return may affect the other. For example, a deduction on the decedent's final income tax return will reduce the estate's liability for the decedent's income tax because the income tax refund or liability is included on the Form 706. A few common items to consider are discussed below.

1. Medical Expenses

The executor may elect to deduct some or all of the decedent's medical expenses paid after the date of death either on the decedent's final income tax return or on the estate tax return.[4] To be deducted on the final income tax return, they must be paid within one year after the decedent's death. Estates that do not file Form 706 or owe any estate taxes should deduct the medical expenses on the final Form 1040. In order to claim them on the Form 1040, the executor must attach a statement that the amount has not been allowed as a deduction on Form 706 and waive the right to do so.[5] Expenses that are lost on the Form 1040 due to the 7.5 percent of AGI floor are not allowed as a deduction on Form 706.

2. Installment Sales

If an installment sale occurs in the year of death, the executor may wish to elect out of the installment method and report the gain on the decedent's final income tax return. This creates an additional estate tax deduction on Form 706 for the income tax liability, which may save more in estate taxes than the income tax deduction under § 691(c) for estate taxes paid on the IRD recognized when the note payments are collected.

3. Savings Bond Interest

Any taxpayer may elect to report all previously unreported Series E or EE Bond interest as income in the current year and thereafter report it as accrued under § 454(a). The executor can make this election on a decedent's final Form 1040.[6] Even though reporting the income on the decedent's final income tax return may increase the decedent's final income tax liability, this

[4] IRC § 213(c); Rev. Rul. 77-357, 1977-2 C.B. 328.

[5] Reg. § 1.213-1(d)(2).

[6] Rev. Rul. 68-145, 1968-1 C.B. 203; Rev. Rul. 79-409, 1979-2 C.B. 208 (executor may also elect to accrue interest on Series E Bonds held in revocable trust at time of death).

debt can reduce the decedent's federal estate tax.[7] The election is not binding on the transferee of the bonds.[8] Therefore, the beneficiaries who receive the bonds may defer tax on the interest accrued after the decedent's death until redemption even though the executor elected to recognize the income up to the date of the decedent's death.

4. Partnership and S Corporation Income Allocations

Partnership and S corporation income can either be deferred or accelerated into the decedent's final income tax year simply by an election made at the entity level. Accelerating income can create an income tax liability on the decedent's final income tax return, which entitles the estate to a deduction under § 2053. Also, bunching income into the decedent's final income tax return can shelter it from taxes if the decedent has large medical expenses, charitable contributions, capital loss carryovers, or net operating loss carryovers. Otherwise, many of these valuable deductions may expire unused.

Both partnerships and S corporations can choose to allocate income under an "interim closing of the books" or a "proration" method.[9] Under the interim closing of the books method, the books are actually closed on the decedent's date of death. Income actually earned before his death is allocated to his final income tax return. This method can produce vastly different results than the proration method, which divides the total income for the entire year by 365 days and allocates a portion to the decedent's final return based on the number of days he was alive. The executor should communicate with the entity to determine the best method. Although the executor does not make the election, he can often influence the manager of the entity.

B. Elections Affecting the Estate's Income Tax Return

1. Taxable Year End

An estate may adopt any tax year it chooses as long as it qualifies as a permissible accounting period.[10] Typically, this means a calendar year or fiscal year that ends on the last day of the month.[11] Once chosen, the tax year can only be changed by permission from the IRS. Neither the filing of a Form SS-4, *Application for Federal ID Number*, nor an extension determines the year-end.[12] A taxable year of a new taxpayer is adopted by filing its first federal income tax return using that taxable year.[13] This choice of tax year offers an estate a great deal of flexibility, especially when it is facing significant and immediate income tax consequences.

Choosing a noncalendar year also offers a deferral advantage. Because most beneficiaries have calendar years, they will report their share of the distributed income in their tax year within which the estate's tax year ends.[14] By eliminating the estate's compressed income tax brackets through distributions and deferring the time the beneficiaries must report their share of the income, the executor can achieve significant tax savings.

[7] Ltr. Rul. 9232006.
[8] Reg. § 1.454-1(a).
[9] Reg. § 1.706-1(c)(2)(ii); IRC § 1377(a).
[10] Reg. § 1.441-1(c).
[11] Reg. § 1.441-1(b)(1)(iv).
[12] Reg. § 1.441-1(c).
[13] *Id.*
[14] Reg. § 1.662(c)-1.

Estates of decedents who die in 2010 should particularly consider a non-calendar year that extends the estate's first tax filing as far as possible. For example, the estate of a decedent who died on November 15, 2010 can elect an October 31 tax year. This defers the filing date of its first Form 1041 to February 15, 2012, which allows the executor maximum flexibility on making funding or sale decisions that affect the income tax of the estate or the beneficiaries.

Estates of decedents who die before a tax rate increase should particularly consider a non-calendar year because they can enjoy the lower income tax rates longer. For example, if a decedent dies on November 15, 2012 and his executor elects an October 31 tax year, its income from November 15, 2012 to October 31, 2013 is subject to a maximum 35 percent tax rate instead of the 39.6 percent rate that applies in 2013, plus the 3.8 percent Medicare tax.

2. Charitable Contributions Made After Year End

An estate or trust is entitled to deduct charitable contributions paid during the year on the prior year's income tax return.[15] Thus the fiduciary has the benefit of hindsight to determine which year is more preferable to claim the deduction. If the estate or trust does not have sufficient income in the current year to absorb the deduction or if the deduction would offset favorably taxed capital gains, it may be wise to make the election to deduct it in the prior year. The fiduciary should make his decision well before the prior year return is filed in order to avoid amended income tax returns for the fiduciary and perhaps the beneficiaries.

3. No Double Deductions

In general, deductions that are allowable on Form 706 under §§ 2053 (expenses and debts) or 2054 (losses) are not also allowed as an income tax deduction on Form 1041.[16] Thus, most deductions must be claimed on either Form 706, Form 1041, or split between them.[17] If the estate wishes to deduct expenses on its Form 1041 rather than the Form 706, it must attach an election to Form 1041 that irrevocably waives the right to deduct the expenses on Form 706. The prohibition against double deductions does not apply to deductions in respect of a decedent (DRD) under § 691(b). Examples of such expenses are interest and property taxes accrued prior to the decedent's death, which can be deducted on both Form 706 and 1041.

4. Distributions In-Kind

Generally an estate or trust recognizes no gain or loss when it distributes property in-kind to a beneficiary.[18] The distribution is valued at the lesser of the property's basis or its market value and the beneficiary takes a carryover basis.[19] An exception to this rule applies if property is distributed in satisfaction of a pecuniary bequest.[20] The executor may, however, elect to recognize the gain or loss on an in-kind distribution.[21] In that case, the beneficiaries' basis in the property is the estate's adjusted basis plus any gain or loss recognized on the distribution. In other words, the beneficiary's basis is the market value of the property. The election is made on

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15 IRC § 642(c)(1); Reg. § 1.642(c)-1(b).
16 IRC § 642(g).
17 Reg. § 1.642(g)-2.
18 IRC § 643(e).
19 IRC § 643(e)(1).
20 IRC § 643(e)(4).
21 IRC § 643(e).

a year by year basis. Once made for a year, is revocable only with the IRS's consent. Moreover, the election applies to all distributions made during the taxable year. It cannot be made on an asset by asset basis.

There are good reasons for and against making a § 643(e)(3) election. The election may be beneficial if the fiduciary wants to make sure the income tax is paid on the property's appreciation. Thus it may be an accommodation to the beneficiaries or intended to avoid surprise on their part when the property is sold. The estate may also have unused deductions or capital losses that can offset the income.

However, good reasons to avoid the election include a beneficiary who will be taxed in a lower tax bracket on sale of the property. Or the beneficiary may have capital losses that can offset his gain on sale of the property. A big reason to avoid the election is if the beneficiary is not likely to sell the property soon or will hold it until his death, in which case he may obtain a stepped-up basis under § 1014.

5. Estimated Tax Payments

Trusts and estates must pay estimated income tax payments in the same manner as individuals. Estates, but not trusts, are exempt from this requirement for the first two taxable years.[22] Qualified revocable trusts that make the § 645 election may take advantage of the two-year exemption from paying estimated taxes that is available to estates.[23]

Trusts may also elect to treat any part of an estimated tax payment as having been made by a beneficiary.[24] Estates may also make this election, but only for their final year. The election may be made as to one or more beneficiaries. A beneficiary that is treated as having made a payment is deemed to have received a distribution on the last day of the trust or estate's taxable year and is deemed to have paid the estimated tax on January 15 of the following year.[25] The election may be made regardless of whether the trust or estate has overpaid its own tax and it only applies to estimated taxes, not withholding.

From a practical standpoint this election is rarely made due to the short time period within which the election must be made. The election must be made by the 65th day after the close of the estate or trust's tax year.[26] There is no extension of time within which to make this election. Thus, by the time the fiduciary considers it, the deadline has usually passed.

6. Trust Treated as an Estate - Section 645

Under § 645(a), if both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) make a proper election, the trust will be treated and taxed for income tax purposes as part of the estate rather than a separate trust. The election applies for two years from the date of the decedent's death if no Form 706 is required to be filed. Therefore, if a QRT makes the election to be treated as part of the estate of a decedent who is filing a Form 706 to make the portability election only, the election lasts for only two years because no Form 706

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[22] IRC § 6654(l).
[23] Reg. § 1.645-1(e)(4).
[24] IRC § 643(g).
[25] IRC § 643(g)(1)(B-C).
[26] IRC § 643(g)(2).

would be required to be filed.[27] If a Form 706 is required to be filed the election period runs from the date of the decedent's death to 6 months after the date of the final determination of the estate tax liability.[28] The § 645 election once made is irrevocable.[29]

A "qualified revocable trust" means any trust (or portion thereof) that was treated under § 676 as owned by the decedent by reason of a power in the decedent to revoke, determined without regard to § 672(e).[30] The § 645 election allows a trust to take advantage of the following tax rules that apply to estates:

(1) The charitable set aside deduction under § 642(c);

(2) A longer period of time to hold subchapter S stock without disqualification under § 1361(b)(1);

(3) Allowance of a $25,000 passive loss deduction for rental real estate activities under § 469(i)(4);[31]

(4) A fiscal year election will be allowed, which is not available to a trust filing its own return. This may be a significant benefit for decedents who die in 2010 with a large part of their property in a revocable trust.

(5) Recognizing loss upon the satisfaction of a pecuniary bequest with assets that have a fair market value less than basis pursuant to IRC § 267(b)(13).

(6) The tax items of one entity such as passive activity losses, net operating losses, capital losses or investment interest, which may otherwise be limited, may be offset by the other entity's passive income, taxable regular income, capital gains and losses, or investment income.

(7) No obligation to make estimated tax payments for two years.

A possible detriment of making the § 645 election is the uncertainty about how to allocate the tax benefits from combining the tax attributes of both entities. It may be a good idea to prepare a tax allocation agreement between the fiduciaries. Neither the preamble nor the final regulations provide any rules for allocating the tax liability between the QRT(s) and the estate. However, the trustee(s) and the executor should allocate the tax liability in a manner that reasonably reflects the tax obligations of each entity. The failure to do so may result in unintended income or estate tax consequences.

Upon termination of the § 645 election period, the assets in the combined entity are deemed to be distributed to the estate and the trust. A distribution deduction under § 661 is allowed and the distributee trust includes the amount in its gross income under § 662. Net capital gains are also carried out with DNI as they would be in a liquidating distribution.[32] If the estate

[27] Notice 2011-66, IV.
[28] IRC § 645(b)(2); Reg. § 1.645-1(f)(2).
[29] Reg. § 1.645-1(e)(1).
[30] IRC § 645(b)(1).
[31] Reg. § 1.645-1(e)(2).
[32] Reg. § 1.645-1(h)(1).

continues past the end of the § 645 election period, it maintains the same federal ID number, but the QRT must obtain a new ID number.[33]

7. Distributions Within First 65 Days of the Year

Estates and trusts may elect to treat all or part of a distribution made within the first 65 days of the taxable year as paid on the last day of the preceding taxable year.[34] Once made, the election is irrevocable.[35] To make the election, the executor or trustee must check the box on page 2 of Form 1041 filed on or before the extended due date of the return. However, the executor or trustee must also remember to actually make distributions within the first 65 days of the taxable year or else the election does no good.

C. Elections Affecting the Estate Tax Return

1. Portability

The 2010 Tax Relief Act allows "portability" between spouses of the estate and gift tax exclusion for deaths in 2011 and 2012. This means that the unused exemption amount of the last deceased spouse is available to the survivor if the last deceased spouse's executor elects that it may be used. [36] This "deceased spousal unused exclusion amount," known as the DSUEA, is in addition to the surviving spouse's own basic exclusion amount ($5,120,000 in 2012). The surviving spouse may use the DSUEA for lifetime gifts or at death. However, it is not available for GST transfers. The portability election is irrevocable.

The DSUEA is the *lesser* of the basic exclusion amount ($5,120,000 in 2012) or the excess of the last deceased spouse's basic exclusion amount over the deceased spouse's taxable estate under § 2001(b)(1).[37] The basic exclusion is adjusted for inflation in multiples of $10,000 starting in 2012.

The Joint Tax Committee's Technical Explanation provides three examples of portability, which reinforce the concept that it can no more than double the exemption of a surviving spouse. And in most cases it will be less than double because the surviving spouse's exemption is adjusted for inflation while the last deceased spouse's basic exemption is not. Moreover, the DSUEA can be less than the last deceased spouse's unused exclusion if Congress reduces the basic exclusion amount. This is because the DSUEA is defined as the *lesser* of the current basic exclusion amount or the last deceased spouse's unused exemption amount. Thus if the basic exclusion amount is reduced to $1 million and the last deceased spouse's unused exemption was $4 million, the surviving spouse's DSUEA would be limited to $1 million.

Election. For a surviving spouse to utilize the decedent's unused exemption, the statute requires the executor to make the portability election on a timely filed (including extensions) estate tax return and compute the unused exemption.[38] However, on September 29, 2011, IRS Notice 2011-42 announced that the filing of a "complete," "properly prepared," and timely

[33] Reg. § 1.645-1(h)(3).
[34] IRC § 663(b); Reg. § 1.663(b)-1(a)(1).
[35] Reg. § 1.663(b)-2(a)(1).
[36] IRC § 2010(c).
[37] IRC § 2010(c)(4).
[38] IRC §2010(c)(5).

(including extensions) Form 706 will constitute the portability election, regardless of whether the gross estate exceeds the exclusion threshold or is otherwise required to file a Form 706.[39] Executors should use the Form 706 issued for the year of the decedent's death, if possible. Until the IRS revises the Form 706 to contain a computation of the DSUEA, a complete and properly-prepared Form 706 will be deemed to contain the computation. If the executor does not wish to make the election, he should follow the Form 706 instructions will describe how to notify the Service. An executor not wishing to make the portability election and not otherwise required to file Form 706, will effectively preclude the election by simply not filing a timely Form 706.

No election is allowed if the estate tax return is late. However, Notice 2012-21 grants decedents who died in the first half of 2011 up to 15 months after the date of death to file Form 706, even if no extension was filed within 9 months of death. The estate can obtain additional time to file by filing Form 4768. However, many small estates filing only to make the portability election will not need that extra time.

An executor may not wish to make the election where the children from a first marriage do not want to incur the expense of filing a Form 706 to preserve the DSUEA for their stepmother. Some planners suggest adding a will clause that requires the executor to cooperate with the surviving spouse if the surviving spouse requests that the election be made, but to also require the surviving spouse to pay the cost of preparing the Form 706.[40]

The portability election allows the IRS to examine a decedent's return at any time after the normal 3-year statute of limitations and adjust the unused exemption, but no other items on the return.[41] Congress empowered the IRS to issue regulations to carry out the provisions of § 2010.[42] These regulations are on the IRS's Priority Guidance Plan.[43]

Compare to Bypass Trust Planning. Even though the portability provision expires after 2012, prudence dictates that planners assume it will continue. Regardless of whether Congress extends this benefit after 2012, most planners believe that portability is a poor second choice compared to trusts for preserving the deceased spouse's unified credit amount. The possible exception would be if the surviving spouse intends to make gifts soon after the first spouse's death to utilize the DSUEA, in which case there is nothing to preserve.

Even with portability, there are many compelling reasons for continuing to use bypass trusts at the first spouse's death rather than relying on portability, including:

(a) the deceased spousal unused exclusion amount is not indexed and may even decline,

(b) the unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse,

(c) growth in the assets is not excluded from the gross estate of the surviving spouse unlike the growth in a bypass trust which is excluded,

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39 Notice 2011-82, 2011-42 IRB 516 (Sept. 29, 2011).

40 Jerome Hesch, Estate Tax Law Changes in 2011, BNA Tax & Accounting Webinars (Feb. 10, 2011).

41 IRC §2010(c)(5)(B).

42 IRC §2010(c)(6).

43 Department of the Treasury 2011-2012 Priority Guidance Plan (Apr. 27, 2012), *available at* http://www.irs.gov/pub/irs-utl/2011-2012_pgp_3rd_update.pdf.

(d) portability may be repealed,

(e) there is no portability of the GST exemption whereas a bypass trust can preserve the deceased spouse's GST exemption, and

(f) trusts offer asset protection, management, and long-term preservation of the assets.

A disadvantage of bypass trust planning over portability is that the assets in the bypass trust are not stepped-up on the death of the surviving spouse like they would be with portability. However, planners even have solutions for that. It has been suggested that the bypass trust could provide for a committee or independent trust advisor who could give the surviving spouse a power of appointment over all or part of the assets in the bypass trust, exercisable only with the consent of appointed nonadverse parties.[44] Such a "springing power" would cause the assets subject to the power to be included in the surviving spouse's estate at her death under § 2041. This technique would work well with all types of appreciated trust assets, except income in respect of a decedent such as an IRA.[45]

Therefore, many estate planners believe that trust planning will continue as usual despite the availability of portability. Nonetheless, portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death. Moreover, many small estates will use both a bypass trust and portability. The decedent's estate may pass to a bypass trust and the remaining unused exemption can be carried over to the surviving spouse.

2. Executor Commissions

If an executor wants to waive his commissions, he should formalize his decision within 6 months of appointment.[46] Otherwise, his gratuitous service could be treated as income to the executor followed by a gift to the residuary beneficiaries. Nonetheless, the executor may still be able to show that he intended to serve on a gratuitous basis "if all of the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve gratuitously."[47]

3. Alternate Valuation

An estate may elect to value the estate assets six months after the decedent's death instead of on the date of death. This can save significant estate taxes if values have declined since the date of death. To qualify for this election, the gross estate and the combined estate and GST taxes must decline as a result of making the election.[48] This generally means that the alternate valuation date (AVD) election will be made on the estate tax return of a single person, although not always. The election is irrevocable and may only be made if the estate tax return is filed no later than one year after the extended due date of the estate tax return.[49] The executor may apply for an extension of time to make the AVD election under Reg. § 301.9100-1 and Reg. § 301.9100-3 and relief may be granted, provided the return was filed no later than one year after

[44] Jerome M. Hesch, Estate Tax Law Changes in 2011, BNA Tax & Accounting Webinars (Feb. 10, 2011).

[45] IRC § 1014(c).

[46] Rev. Rul. 64-225, 1964-2 C.B. 15.

[47] Rev. Rul. 66-167, 1966-1 C.B. 20; Breidert v Commissioner, 50 T.C. 844 (1968), *acq.*, 1969-2 C.B. xxiv.

[48] IRC § 2032(c); Reg. § 20.2032-1(b)(1); *see also* Prop. Reg. 20.2032-1 (11/18/11); Ltr. Rul. 201109014 (late election allowed on an amended Form 706 where the original Form 706 was filed within one year of the extended due date, but no election was made.).

[49] IRC § 2032(d).

the due date (including extensions).[50]

If an asset is sold or distributed before the end of the six-month period, it is valued at the date of sale or distribution.[51] The actual sales price is used to value a marketable security on the AVD rather than the high-low average.[52] Post-death factors during the 6 month period may also affect the AVD value.[53] On November 18, 2011 the IRS published a new set of proposed AVD regulations, withdrawing an earlier set issued in April 2008. The thrust of both sets of proposed regulations was to prevent artificial means of reducing as asset's value within 6-months of death. Such means could include forming a family limited partnership to obtain discounts or distributing a fractional interest in property to obtain a discount on the remaining portion on the alternate valuation date.

The 2011 proposed regulations identify transactions that constitute distributions, sales, exchanges, or dispositions of property and require the property subject to the transaction to be valued separately on the transaction date. A special aggregation rule applies if a portion property included in the estate is disposed of and a portion is still held on the 6-month date or if property is disposed of in two or more transactions during the AVD so that none of it remains on the 6-month date.[54] In both cases, the AVD value of each portion of the property is a fraction of the fair market value of the property on the transaction date multiplied by 100 percent of the value of the property. This precludes any discounts for creating fractional interests.

> **Example (1).** At D's death, D owned property with a fair market value of $100X. Two months after D's death (Date 1), D's executor and his family members formed a limited partnership. D's executor contributed all of the property to the partnership and received an interest in the partnership in exchange. The investment of the property in the partnership is a transaction described in the proposed regulations. As a result, the alternate valuation date of the property is the date of its contribution and the value to be included in D's gross estate is the fair market value of the property immediately before its contribution to the partnership. The result would be the same if D's estate had contributed the property to a corporation, publicly traded or otherwise, or other entity after D's death and prior to the 6-month date.[55]
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> **Example (8).** At D's death, D owned 100% of the units of a limited liability company (LLC). Two months after D's death (Date 1), D's executor sold 20% of the LLC units to an unrelated third party. Three months after D's death (Date 2), D's executor sold 40% of the LLC units to D's child. On the 6-month date, the estate held the remaining 40% of the LLC units. The alternate valuation date of the units sold is their sale date (Date 1 and Date 2, respectively). The alternate valuation date of the units remaining is the 6-month date since they have not been disposed of. The value of the units disposed of on Date 1 and Date 2 is 20% and 40% of the fair market value as of Date 1 and Date 2 of all the units (100%) includible in D's gross

[50] Preamble to TD 9172 (1/3/2005).
[51] IRC § 2032(a).
[52] Rev. Rul. 70-512, 1970-2 C.B. 192
[53] Prop. Reg. § 20.2032-1(f) (Nov. 18, 2011).
[54] Prop. Reg. § 20.2032-1(c)(1)(iv) (2011).
[55] Prop. Reg. § 20.2032-1(c)(5) (2011).

> estate. Similarly, the value of the units held on the 6-month date is 40% of the fair market value on the 6-month date of all of the units (100%) includible in the gross estate. Thus the partial sales creating minority interests do not reduce the value of the remaining LLC interests held by D for AVD purposes.[56]

Another special rule applies to distributions from entities received during the 6-month AVD. The distribution is valued on the distribution date and the entity is valued on the 6-month AVD as long as the sum of the distribution and the value of the entity after the distribution are equal to the value of the entity prior to the distribution. If not, the entire interest in the entity is valued on the distribution date. The proposed regulations provide this example:[57]

> **Example (6).** (i) At D's death, D owned a Partnership interest includible in his gross estate. During the alternate valuation period, the Partnership made a partially liquidating cash distribution to each of the partners. On the date of the distribution, the fair market value of D's interest in the Partnership before the distribution equaled the sum of the distribution paid to D's estate and the fair market value of D's interest in the Partnership immediately after the distribution. Thus, the alternate valuation date of the property distributed is the date of the distribution, and the alternate valuation date of D's interest in the Partnership is the 6-month date.
>
> (ii) If, instead, the fair market value of D's interest in the Partnership before the distribution did not equal the sum of the distribution paid to D's estate and the fair market value of D's interest in the Partnership (not including any post death earnings) immediately after the distribution, then the alternate valuation date of D's entire interest in the Partnership would be the date of the distribution.[58]

If it looks like the alternate valuation will be used, it may be wise to sell appreciating assets or distribute them to beneficiaries so that they do not jeopardize the AVD. In addition, closely held entities should distribute their post-death earnings so that they can be excluded from the AVD valuation.[59] Amounts earned, but not distributed by the entity within 6 months of the decedent's death are include in the alternate valuation.[60]

4. Special Use Valuation Section 2032A

Certain real estate used in a farm or a trade or business may be valued at less than its "highest and best use" under § 2032A. The maximum decrease in value allowed is $1,040,000 for persons dying in 2012.[61] Minority and marketability discounts can be considered in determining the property's highest and best use.[62] The special use value applies for GST purposes as well as for estate tax purposes.[63] The statute specifies certain valuation factors that

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[56] *Id.*

[57] Prop. Reg. § 20.2032-1(c)(5) (2011).

[58] Prop. Reg. § 20.2032-1(c)(5) (2011).

[59] Reg. § 20.2032-1(d)(4) (May 1, 2009).

[60] Ltr. Rul. 200343002.

[61] Rev. Proc. 2011-52, 2011-45 IRB (Oct. 20, 2011).

[62] Estate of Hoover v. Comm'r., 69 F.3d 1044 (10th Cir. 1995), *rev'g*, 102 T.C. 777 (1994), *acq.* 1999-1 I.R.B; Ltr. Rul. 200448006.

[63] IRC § 2624(b).

must be used in valuing a farm, trade, or business.[64]

The election is made on Form 706.[65] It may be regular or protective and is irrevocable. If the election is not timely filed, § 9100 relief may be available. The election must be accompanied by an agreement signed by all persons with an interest in the "qualified real property" that they consent to personal liability for the recapture tax if the special use ceases or they dispose of their interest in the property. The recapture tax is the lesser of the tax savings using special use valuation or sale proceeds in excess of the special use value attributable to the interest disposed of.[66] The IRS has ruled that transfers of special use farmland to LLCs nor the LLC's lease of the land to a partnership will trigger recapture of the special use valuation.[67]

To qualify for the special use valuation the decedent must have been a citizen or resident of the United States at the time of death.[68] The property must be (1) located in the United States, (2) acquired from or passed from the decedent to a "qualified heir," (3) used for a "qualified use" at the time of death by the decedent or a member of the decedent's family, and pass a 50 and 25 percent test.[69] The statute narrowly defines each of these terms.

The 50 percent test requires that the "adjusted value" of the gross estate consist of real or personal property that was (1) used for a "qualified use" by the decedent or "member of the decedent's family" on the date of death, and (2) "acquired from or passed from" the decedent to a "qualified heir."[70] The adjusted value means the value less allowable deductions under § 2053(a)(4).[71] The 25 percent test requires that 25 percent or more of the adjusted value of the gross estate consist of real property that was (1) acquired from or passed from the decedent to a qualified heir, and (2) during five or more years of the eight year period prior to retirement, disability or death, there was material participation by the decedent or a member of the decedent's family, and for five or more years of the eight year period prior to death there was a qualified use with respect to the real property by the decedent or a member of the decedent's family. For purposes of the 50 and 25 percent tests, community property is treated as though the decedent owned all of it.[72]

5. QTIP Election

The executor may elect to claim a marital deduction for all or a portion of an interest in qualified terminable interest property (QTIP). QTIP property is property that passes from the decedent and in which the surviving spouse has a qualifying income interest for life.[73] A qualifying income interest for life means that all trust accounting income must be payable to the surviving spouse at least annually for life, no one (including the surviving spouse) has a power to distribute or appoint the assets to any person other than the surviving spouse during the surviving

[64] IRC § 2032A(e)(7), (8).
[65] IRC § 2032A(d)(1); Reg. § 20.2032A-8.
[66] IRC § 2032A(c).
[67] Ltr. Ruls. 201129106, 201129018, and 201129020 (Aug. 4, 2011).
[68] IRC § 2032A(a)(1)(A).
[69] IRC § 2032A(b)(1).
[70] IRC § 2032A(b)(1)(a).
[71] IRC § 2032A(b)(3)(B).
[72] IRC § 2032A(e)(10).
[73] IRC § 2056(b)(7)(B).

spouse's lifetime, and if the trust holds unproductive assets, the trust instrument must require, or permit the surviving spouse to require, the trustee to either make the property productive or convert it to productive property within a reasonable time.[74] However, there are certain exceptions for residential property and tangible assets held for use by the surviving spouse.

The QTIP election is made simply by listing the property on Schedule M and deducting its value. The election may be made on an original or amended return filed before the extended due date of Form 706.[75] A protective QTIP election can also be made if the executor reasonably believes there is a bona fide issue concerning whether an asset is includable in the decedent's gross estate or whether it is eligible for the QTIP election.[76]

Once made, the election is irrevocable.[77] However, the IRS will grant relief where the QTIP election was unnecessary to reduce the predeceased spouse's estate tax to zero.[78] But the IRS will not revoke QTIP elections made pursuant to a formula designed to reduce the tax to zero.[79] Nor will it revoke protective QTIP elections. A request to revoke the QTIP election is made on the surviving spouse's Form 706 or by a private letter ruling before filing the surviving spouse's Form 706.

An interest that is contingent on the executor's QTIP election may also qualify for the marital deduction.[80] This arrangement, known as a *Clayton*-QTIP trust after the *Clayton* case, leaves property to a single trust that qualifies as a QTIP trust, but provides that any portion of the trust for which the executor fails or refuses to make the QTIP election shall pass to a bypass trust. This allows the executor to decide how much to allocate to the bypass trust or retain in the QTIP trust by the extended due date of the Form 706.[81]

IRA or other qualified retirement plan benefits payable to a marital trust can also qualify as QTIP property. Revenue Ruling 2006-26 provides that for an IRA or qualified plan to qualify as QTIP property, the surviving spouse must be entitled to all of the income from the IRA or qualified plan determined as if the IRA or qualified plan were a separate trust. In addition, the executor or trustee must make a separate QTIP election for the IRA or qualified plan.[82] An automatic QTIP election applies to a survivor's annuity payable from a qualified plan or from the decedent's employment, unless the executor elects out.[83]

The assets subject to the QTIP election are included in the surviving spouse's gross estate.[84] The estate tax can be recovered from the QTIP trust. But, if the surviving spouse waives the right to have the estate tax paid from the QTIP trust, the tax will be recovered from other

[74] IRC § 2056(b)(7)(B)(ii); Reg. § 20.2056(b)-5(f)(5); Reg. § 20.2056(b)-7(h), Ex. 2 (unproductive assets).
[75] TAM 8523006.
[76] Reg. § 20.2056(b)-7(c)(1).
[77] IRC § 2056(b)(7)(B)(v).
[78] Rev. Proc. 2001-38, 2001-1 CB 1335.
[79] Ltr. Ruls. 200219003, 200422050, and 200540003
[80] Reg. § 20.2056(b)-7(d)(3).
[81] Clayton Est. v. Comm'r., 976 F.2d 1486 (5th Cir. 1992).
[82] Rev. Rul. 2006-26, 2006-1 CB 939.
[83] IRC § 2056(b)(7)(C).
[84] IRC § 2044(a).

estate assets. The will or other document must specifically waive the recovery right.[85]

6. QDOT Election

The marital deduction is generally not allowed for property passing to a noncitizen spouse unless it is subject to treaty benefits[86] or it passes to a qualified domestic trust (QDOT) that meets the following requirements.[87]

(a) The trust instrument must require that one trustee of the trust be an individual citizen of the United States or a domestic corporation;

(b) No distribution (other than a distribution of income) may be made from the trust unless the trustee who is an individual U.S. citizen or domestic corporation has the right to withhold the estate tax imposed under § 2056A(b) on such distribution;

(c) The trust must meet additional requirements that may be set forth in regulations designed to ensure collection of the estate tax; and

(d) The decedent's executor must properly make the QDOT election.[88]

The QDOT election must be made on the last estate tax return filed before the due date or, if a timely return is not filed, on the first return filed after the due date.[89] The statute provides that no QDOT election can be made more than one year after the time prescribed by law (including extensions) for filing the estate tax return.[90] However, the IRS has granted extensions of time for making the election where the taxpayer acted reasonably and in good faith.[91] The executor may also make a protective QDOT election on Form 706.[92]

In addition, property passing outright to the surviving spouse is eligible for QDOT treatment if, prior to the filing of the estate tax return and on or before the last day a QDOT election can be made, the property is transferred to a trust meeting the above QDOT requirements.[93] Benefits paid under IRAs, qualified pension and profit-sharing plans, annuity contracts, and similar arrangements are also eligible for QDOT treatment if the benefits are not transferrable or assignable.[94]

Revenue Procedure 96-54 provides sample QDOT language that may be used to satisfy the QDOT requirements.[95] Property passing to a trust that does not satisfy the QDOT requirements may be reformed to qualify under § 2056A either in accordance with the terms of the decedent's will or trust agreement or pursuant to a judicial proceeding. The reformation must be completed

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[85] IRC § 2207A(a)(2); Ltr. Rul. 200452010.
[86] Reg. § 20.2056A-1(c).
[87] IRC § 2056(d)(1), (2).
[88] IRC § 2056A(a).
[89] Reg. § 20.2056A-3(a).
[90] IRC § 2056A(d).
[91] Ltr. Rul. 200712010.
[92] Reg. § 20.2056A-3(c).
[93] Reg. § 20.2065A-2(b)(2).
[94] Reg. § 20.2065A-2(b)(3).
[95] Rev. Proc. 96-54, 1996-2 C.B. 386.

by the due date (including extensions) for filing the estate tax return.[96] However, a reformation pursuant to a judicial proceeding need only be commenced on or before that date.[97] In addition, a non-citizen surviving spouse who receives assets not in the form of a QDOT (or a trust that could be reformed into a QDOT), may create a QDOT and transfer assets to it.[98] The property must be transferred or assigned to the QDOT before the estate tax return is filed.[99]

The regulations provide security requirements for QDOTs that differ depending on whether the QDOT assets are over or under $2 million (disregarding debt on the property and excluding up to $600,000 in value of the principal residence and one additional residence including furnishings).[100] The security may include naming a bank trustee or securing a bond.[101] For QDOTs with less than $2 million in assets, the trust instrument may instead provide that no more than 35 percent of the value of the trust assets, determined annually, may be invested in real property that is not located in the United States.[102]

Distributions of principal from the QDOT during the surviving spouse's life are generally subject a special estate tax with certain exceptions for hardship or to pay the beneficiary's tax on taxable income from the QDOT.[103] The special tax for lifetime distributions also applies if the trust ceases to qualify as a QDOT.[104] The amount of the tax is generally the amount of estate tax that would have been imposed if the amount involved had not been deductible. A special estate tax under § 2056A(b) will also be imposed at the death of the surviving spouse as if the QDOT assets were included in the decedent's estate and not the surviving spouse's estate.

7. Reverse QTIP Election

A reverse QTIP election allows the donor spouse of a QTIP trust to be treated as the transferor of the trust for GST purposes.[105] Otherwise, the surviving spouse would be treated as the transferor of the trust for GST purposes. There is no automatic GST allocation for a trust, such as a QTIP trust, that will have a new transferor with respect to the entire trust before the occurrence of any GST with respect to the trust. Thus the reverse QTIP election affirmatively allocates the donor spouse's GST exemption to the QTIP trust and avoids wasting it on the first death. This also preserves the surviving spouse's GST exemption by allowing her executor to use it on other transfers. The reverse QTIP election is made by listing the qualifying property on Schedule R of Form 706. There is no box to check, or formal statement to be attached.

There are no provisions for a partial reverse QTIP election. However, a QTIP trust can be severed into two trusts and a reverse QTIP election made for one of the trusts. The IRS has granted extensions to make the reverse QTIP election where the executor or accountant failed to make the reverse QTIP election on Form 706, but subsequently filed Schedule R and made the

96 Reg. § 20.2056A-4(a)(1).
97 Reg. § 20.2056A-4(a)(2).
98 IRC § 2056(d)(2)(B).
99 Reg. § 20.2056A-4(b)(1).
100 Reg. § 20.2056A-2(d).
101 Reg. § 20.2056A-2(d)(1)(i).
102 Reg. § 20.2056A-2(d)(1)(ii).
103 IRC § 2056A(b); Reg. § 20.2056A-5(c).
104 Reg. § 20.2056A-5(b)(3).
105 IRC § 2652(a)(3).

election.[106] In lieu of a private letter ruling, which requires a fee, Rev. Proc. 2004-47 provides an alternate procedure for certain executors and trustees to make a late reverse QTIP election.[107]

The simplified procedure may be used if a) a valid QTIP election was made; b) the reverse QTIP election was not made on the estate tax return because the taxpayer relied on a qualified tax professional who failed to advise the taxpayer of the need, advisability, or proper method to make a reverse QTIP election; c) the decedent has enough unused GST tax exemption to result in a zero-inclusion ratio for the reverse QTIP trust or property; d) the estate is not eligible for an automatic six-month extension of the election under Reg. § 301.9100-2(b); e) the surviving spouse has not disposed of any of the qualifying income interest for life in the QTIP trust or property; and f) the surviving spouse is alive or no more than six months have passed since the death of the surviving spouse. If relief is not granted under Rev. Proc. 2004-47, the executor may request a private letter ruling under Reg. § 301.9100-3 and pay a $14,000 user fee.

8. Allocation of GST Tax Exemption

In 2010, an individual has $5 million that he or she may allocate to generation-skipping transfers either during life or at death.[108] It can be allocated to outright transfers or transfers in trust. If GST is allocated to a trust, distributions from the trust are forever exempt from GST tax.[109] The GST allocation is irrevocable.[110] On the death of an individual, the GST allocation must be made by the due date for filing the federal estate tax return (regardless of whether a return is required to be filed).[111] If the executor does not allocate GST exemption on the Form 706, any remaining GST exemption is automatically allocated pro rata to direct skips occurring at death, and then pro rata to trusts of which the decedent was the transferor and from which generation-skipping transfers may occur in the future.[112] GST exemption allocations may also be made by formula.[113]

9. Severance of Trusts for GST Purposes

To avoid having a trust that is partially exempt and partially non-exempt from the GST tax, a trust that is included in the decedent's gross estate or created in the decedent's will may be severed into two or more trusts. To be effective, the following requirements must be met:[114]

(1) the trust is severed under a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor (a "mandatory severance"),[115] or

(2) the governing instrument does not require or otherwise direct severance, but the trust is severed under discretionary authority granted either under the governing instrument or local law and the following requirements are satisfied:

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[106] Ltr. Ruls. 200004023, 200833013, and 200838023.
[107] Rev. Proc. 2004-47, 2004-2 CB 169.
[108] IRC § 2631(c).
[109] H Rept No. 99-426 (PL 99-514) p. 826.
[110] IRC § 2631(b).
[111] IRC § 2632.
[112] IRC § 2632(e).
[113] Reg. § 26.2632-1(d)(1).
[114] Reg. § 26.2654-1(b)(1).
[115] Reg. § 26.2654-1(b)(1)(i).

> (a) The terms of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust,
>
> (b) The severance occurs (or a reformation proceeding, if required, is commenced) before the date for filing the federal estate tax return (including extensions actually granted) for the transferor's estate, and
>
> (c) Either (i) the new trusts are severed on a fractional basis, or (ii) if a pecuniary amount is required by the terms of the governing instrument, the trustee is required to pay interest and allocate assets to the pecuniary amount on a fairly representative basis if a value is used other than the date of distribution value.[116]

Trusts resulting from a single testamentary trust do not need to be identical. For example, if a trust provides income to a spouse, remainder to a child and a grandchild, the trust may be severed into two trusts, one that provides income to the spouse, remainder to the child and a second that provides income to the spouse, remainder to the grandchild. However, the resulting trusts must provide for the same succession of interests as under the original trust. Thus, a trust providing income to a child and remainder to a grandchild, may not be divided into one trust representing the present value of the income interest for the child and another trust representing the residuary for the grandchild.[117]

If the new trusts are severed on a fractional basis, the separate trusts resulting from severance do not have to be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a non-pro rata basis if funding is either based on the value of the assets on the date of funding, or done in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding.[118]

10. Deferral of Estate Tax

Section 6166 allows an estate to pay its estate taxes over 14 years (5 years interest only) to the extent it relates to a closely held business. To qualify, the decedent must be a citizen or resident of the United States and the value of the decedent's interest in the closely held business must exceed 35 percent of the adjusted gross estate. The business must be a (i) a sole proprietorship, (ii) a partnership with wither at least 20 percent of the capital included in the gross estate or 45 or fewer partners, or (iii) a corporation with either at least 20 percent of the voting stock includible in the gross estate or 15 or fewer shareholders.

If the estate elects the deferral, the first payment of tax is due 5 years after the due date for filing Form 706.[119] In addition, a 2 percent interest rate applies to the deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. The interest rate on the deferred estate tax in excess of the 2-percent portion is 45 percent of the § 6621 rate.[120] The interest is not deductible for estate or income tax purposes.[121]

While this deferral seems too good to pass up, it has its drawbacks. First, if 50 percent or

[116] Reg. § 26.2654-1(b)(1)(ii).
[117] Preamble to T.D. 8644 (Dec. 26, 1995).
[118] Reg. § 26.2654-1(b)(1)(ii)(C)(1).
[119] IRC § 6166(a)(3).
[120] IRC § 6601(j)(1)(B).
[121] IRC § 163(k).

more of the value of the business is sold, exchanged, withdrawn, or otherwise disposed of during the deferral period, the extension of time to pay ceases and the unpaid portion of the tax is due on notice and demand by the IRS.[122] The IRS can also require a bond or special lien under IRC § 6324A to secure the tax. It will consider the duration and stability of the business, the ability to pay timely, and the compliance history of the business.[123]

In addition, the § 6166 election defers the assessment of any transferee liability until the end of the § 6166 deferral period.[124] In *United States v. Kalhanek*, the estate sold its closely held business seven years after the estate tax return was filed, terminating the § 6166 deferral period.[125] The IRS initiated collection action against the transferees 9 ½ years later. Because this was within 10 years of the end of the deferral period, the beneficiaries were liable to the extent they received property based on its value on the date of death.[126]

D. Other Special Elections

1. QSST or ESBT Election

If the decedent owned S corporation stock, it will be very important for the executor or trustee to make sure that the S corporation's election is not inadvertently terminated by transferring shares to an ineligible shareholder. The estate is an eligible S corporation shareholder for as long as is reasonably necessary during the administration.[127] However, once the shares are transferred to a beneficiary or trust, the new shareholders must be eligible S corporation shareholders. Only U.S. citizens or residents, certain trusts, organizations exempt under §§ 401(a), 501(a), or 501(c)(3) are eligible to own S corporation stock.[128] If the stock is transferred to an ineligible shareholder, the S election is terminated immediately.

If the executor transfers S corporation stock to a trust, the trust must either be a qualified subchapter S trust (QSST) or an electing small business trust (ESBT). These elections must be made no later than 2 years after stock is transferred to a testamentary trust.[129] The beneficiary makes the QSST election whereas the trustee makes the ESBT election. If the decedent owned S corporation stock in a revocable living trust, the election must be made no later than 2 years after his death.[130] If the trust makes a valid § 645 election and the estate is required to file a Form 706, the trust can extend the time to hold S corporation stock to 6 months after the determination of the final estate tax liability.[131] If the estate is not required to file a Form 706, a § 645 election does not extend the time to hold S corporation stock past two years after the decedent's death.

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[122] IRC § 6166(g)(1).

[123] Notice 2007-90, 2007-46 IRB; see also ILM 200747019 and 200903016 (describing the procedures for determining the appropriate collateral under IRC § 6324A)

[124] IRC § 6503(d).

[125] United States v. Kulhanek, 106 AFTR 2d 2010-7263 (W.D. Pa. 2010).

[126] IRC § 6324(a)(2).

[127] IRC § 1361(b)(1)(B).

[128] *Id.*

[129] IRC § 1361(c)(2)(A)(iii).

[130] IRC § 1361(c)(2)(A)(ii).

[131] IRC § 1361(b)(2).

To qualify as a QSST, the trust may have only one current income beneficiary who is a U.S. citizen or resident and the trust must distribute all its income annually.[132] The requirements for an ESBT are more flexible. An ESBT may have multiple beneficiaries and may retain or distribute its income.[133] However, the ESBT pays a flat tax on the earnings of the S corporation at the highest fiduciary income tax rate, which is 35 percent (39.6 percent beginning in 2013). ESBT income will also be subject to the 3.8 percent Medicare tax beginning in 2013.[134]

2. Section 754 Election

When a partner dies under pre-2001 Act law, the basis of his partnership interest is adjusted to its fair market value on the partner's death, or the alternate valuation date, less any amount attributable to income in respect of a decedent.[135] But this adjustment has no effect on the inside basis of the partnership property. So if the partnership sells an asset right after a partner dies, the partner's successor will report his share of gain or loss just like any other partner as if no basis adjustment occurred. However, if the partnership makes a § 754 election, the inside basis of the partnership *property* is also adjusted to the outside basis.[136]

An adjustment to the inside basis of the partnership assets generally means that the basis of the partnership assets is adjusted to the market value of the partnership interest under § 1014. Thus, the successor partner acquires a basis in his share of the partnership assets as if he had purchased an undivided interest in each asset at market value on the decedent's death. Some assets may receive an increased basis and others may receive a decreased basis. The § 754 election does not affect any other partner or the holding period of the partnership assets.[137] For deaths in 2010 where the executor elects out of the estate tax under, it is possible that the IRS will take the position that the transfer of a partnership interest at death is treated "as if transferred by gift" under § 1022 and therefore no § 754 election can be made to adjust the inside basis of the partnership assets.

The election is made by the partnership on the return for the year during which the partner died.[138] The return must be filed by the extended due date of the partnership return, or within 12 months thereof.[139] Once made, the election is revocable only with the approval of the Commissioner and must be requested within 30 days after the close of the partnership taxable year for which the revocation is intended to take effect.[140] Because the revocation deadline occurs before an initial § 754 election could be made, it is not intended to revoke an election made in error. There are no published rulings on revoking a § 754 election, prospectively or retroactively, except for a few dealing with a special one-time revocation that was permitted for certain pre-2000 requests.[141] If an initial election is made in error, it may be possible to amend

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[132] IRC § 1361(d)(3).
[133] IRC § 1361(e)(1).
[134] IRC § 641(c)(2)(A).
[135] IRC § 1014(a)(1); Reg. § 1.742-1.
[136] IRC § 743(a).
[137] Reg. § 1.743-1(j)(1).
[138] Reg. § 1.754-1(b).
[139] *Id.*; Reg. § 301.9100-2(a)(2)(vi).
[140] Reg. § 1.754-1(c)(1).
[141] Reg. § 1.754-1(c)(2).

the return and claim “mistake of fact, particularly if the taxpayer received no benefit from the election.”[142] An amended return would void the election from inception rather than revoke it.

A partnership interest owned by a QTIP trust is included in the decedent’s gross estate and is treated as passing from the decedent under § 2044. Because there has been a transfer of the partnership interest by death, this enables the partnership to make a § 754 election.[143] However, if the partner dies in 2010, the QTIP assets are not included in the decedent’s gross estate because § 2044 does not apply. Thus there has been no transfer by death under § 743(a), and the partnership cannot make a § 754 election.

A § 754 election can also be made if there is a transfer by sale or exchange of the partnership interest.[144] A distribution of a partnership interest is treated as a “sale or exchange” for this purpose.[145] Accordingly, a distribution of a partnership interest by the estate or trust to a beneficiary should allow the partnership to make a § 754 election. However, some commentators question this result based on the Senate Report to the 1986 Tax Reform Act, which explains that sale or exchange treatment for distributions of partnership interests is limited, and that the Secretary can provide exceptions, such as on the death of a partner.[146] However, the Senate Report may also indicate Congress’s attempt to avoid a possible adverse treatment on the death of a partner. But there are no rulings or cases on this point.

IV. Disclaimers

Disclaimers are one of the most important and powerful estate planning tools available. They can be used to disclaim gifts (§ 2518), inheritances (§ 2046), and generation-skipping transfers (§ 2654(c)). There is no separate disclaimer for income tax purposes. But the income taxes generally follow the property. Disclaimers are much more than a mere refusal to accept property. They can substantially redirect inheritances, reduce estate and income taxes, cure defects in the original disposition plan, and protect property from creditors. Therefore, disclaimers should be considered in every estate plan. Indeed, the failure to consider disclaimers could be considered a breach of fiduciary duty.

Many forward-thinking attorneys anticipate that disclaimers will be used during the estate administration and draft in the will or trust how the disclaimed assets will pass. This disclaimer language in the will also serves to alert the executor that disclaimers should be considered. In cases where the will is silent on where disclaimed assets pass, the assets are generally distributed as if the disclaimant predeceased the decedent. In many of these unplanned situations, disclaimers are not desirable because the disclaimed assets could pass in an unwanted manner.

Disclaimers are also one of the most dangerous tools. A failed disclaimer treats the disclaimant as having accepted the property and made a taxable gift to the taker.

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[142] Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982) (“once a taxpayer makes an elective choice, he is stuck with it.”); but see Grynberg v. Comm’r, 83 T.C. 255 (1984) (exceptions to the doctrine of election for material mistake of fact.)

[143] Ltr. Rul. 200442028.

[144] IRC § 743(a).

[145] IRC § 761(e).

[146] S. Rep. 313, 99th Cong., 2nd Sess., 1986-3 C.B. Vol. 3 924.

A. Basic Requirements

A qualified disclaimer must satisfy the following five basic requirements under § 2518 -

(1) The disclaimer must be irrevocable and unqualified;

(2) The disclaimer must be in writing;

(3) The writing must be delivered to the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of the property within 9 months from the date of the transfer creating the interest or when the disclaimant attains age 21;

(4) The disclaimant must not have accepted the interest or any of its benefits; and

(5) The interest disclaimed must pass to a person other than the disclaimant (unless the disclaimant is the transferor's spouse) without any direction on the part of the disclaimant.[147]

Acceptance. For purposes of the fourth requirement above, acceptance of benefits can be manifested by any affirmative act consistent with ownership of the interest in property.[148] For example, acceptance may include using the property or the interest in property, accepting dividends, interest, or rents from the property, and directing others to act with respect to the property or interest in property. Merely taking title to property, without more, does not constitute acceptance.[149] A disclaimant is not considered to have accepted property merely because title to the property vests immediately in the disclaimant under local law upon the death of a decedent.

In the case of residential property, held in joint tenancy by some or all of the residents, a joint tenant will not be considered to have accepted the joint interest merely because the tenant resided on the property prior to disclaiming his interest in the property. The exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits. In addition, the acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed.

Passage Without Direction. For purposes of determining whether the property passes without any direction on the part of the disclaimant to someone other than the disclaimant, the disclaimant may not have any right to receive the property. This includes outright, in trust, or by intestacy. In other words, the disclaimant cannot disclaim Blackacre if Blackacre passes to a trust of which the disclaimant is the beneficiary unless the disclaimant also disclaims his interest in the trust.[150] In this case, a double disclaimer would be required.

A surviving spouse, however, may disclaim property even though the spouse has an interest in the property after the disclaimer. For example, the spouse can disclaim property that passes to a trust of which the spouse is an income or remainder beneficiary.[151] But the spouse cannot retain the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to federal estate and gift tax.[152] In other words, the spouse may retain a limited

[147] Reg. § 25.2518-2(a).
[148] Reg. § 25.2518-2(d)(1).
[149] *Id.*
[150] Reg. § 25.2518-2(e)(3).
[151] Reg. § 25.2518-2(e)(5), Ex. 6.
[152] Reg. § 25.2518-2(e)(2).

power of appointment over property as long as it is subject to an ascertainable standard.

B. Effect of State Law

Section 2518 provides a uniform set of rules, which if followed, will constitute a valid disclaimer. Disclaimers that fail under state law may still qualify for tax purposes as long as they meet the requirements of § 2518(b). The statute also provides that any transfer of the transferor's entire interest in the property that meets the requirements of § 2518(b)(2) and (3) (disclaimer delivered within 9 months and no acceptance) will constitute a qualified disclaimer.[153] Thus, transfers in lieu of state law disclaimers can be used, but only for full, not partial disclaimers.

However, state law cannot be completely ignored. State law determines the identity of the taker of the disclaimed interest, absent a direction in the will. Therefore, if the property is transferred to someone other than the taker in default under state law, the transferor has made a taxable gift, as occurred in *Tatum v. United States*.[154] There the son disclaimed his interest in property under his father's will believing that it would pass to the grandchildren as if the son had predeceased his father. However, the District Court ruled that under Mississippi law at the time, the disclaimed property would pass to the son under the laws of intestacy as the only living child. Thus the district court held that Tatum's transfer of the property to his sons was a taxable gift.

However, on appeal, the Fifth Circuit said that Mississippi's anti-lapse statute trumped the general proposition that a lapsed bequest becomes intestate property (Miss. Code Ann. § 91-5-7). It provides that when the deceased beneficiary is a child of the testator, the bequest does not lapse but passes as if the legatee had survived the testator and then died intestate. In that case, Tatum Jr.'s interest would have passed to his heirs without any direction on his part, thus meeting the Code's requirement for a qualified disclaimer.[155]

State law also determines whether there has been a valid written transfer as required under § 2518(b)(1). In other words, the state's conveyancing and recording laws must be complied with. In *Hankins Estate v. Commissioner*, the disclaimer was not qualified because the son failed to file it with the local probate court, as state law required.[156] And finally, state law determines whether and when a fiduciary can disclaim property. A fiduciary's disclaimer that is ineffective under state law does not constitute a qualified disclaimer under § 2518.[157]

C. Disclaimers of Less Than an Entire Interest

Section 2518(c)(1) permits a disclaimer of an undivided portion of an interest. Each interest that is separately created by the transferor is treated as a separate interest.[158] For example, an income and a remainder interest are treated as separate interests as long as the transferor created them. If the will bequeaths an income interest in property to A for life, then to B for life, with remainder interest to A's estate, A can disclaim all or a portion of either his income or his remainder interest. A could not, however, disclaim his income interest for a certain number of years. If the will had not created the separate interests, A could not have disclaimed

[153] IRC 2518(c)(3).
[154] Tatum v. United States, 106 AFTR 2d 2010-6556, *rev'd and rem'd* No. 1060852 (5th Cir. 2011).
[155] Tatum v. United States, No. 1060852 (5th Cir. 2011).
[156] Hankins Estate v. Comm'r, 42 T.C.M. 229 (1981).
[157] Rev. Rul. 90-110, 1990-2 C.B. 209.
[158] Reg. § 25.2518-3(a)(1)(i).

an income or remainder interest. However, he could have disclaimed a fraction or percentage (or specific number of shares) of the interest.[159]

Severable property may also be partially disclaimed. Severable property is property that can be divided into separate parts, each of which, after severance maintains a complete and independent existence.[160] For example, shares of corporate stock are severable because each share can function autonomously. But the dividends and voting rights are not severable because they cannot exist without the underlying stock.

D. Formula Disclaimers

The regulations specifically permit fractional, pecuniary, and formula disclaimers.[161] Several private letter rulings have also approved disclaimers of percentage undivided interests, even though the executor could use his discretion in choosing which assets would fund the disclaimer portion.[162] The Eighth Circuit Court of Appeals in *Christiansen v. Commissioner* approved a formula disclaimer of property in excess of a fixed dollar amount that passed to a private foundation.[163] Because the disclaimant was a foundation director, she waived her discretionary authority over assets passing to the foundation in order to avoid the exercise any wholly discretionary power to direct the enjoyment of the disclaimed assets.[164] The IRS claimed that the formula disclaimer was void because it was against public policy and because the amount disclaimed was contingent on some future event (i.e. the value as finally determined for estate tax purposes), which was contrary to Reg. § 20.2055-2(b)(1).

The 8th Circuit dismissed the IRS's public policy argument by distinguishing an earlier Fourth Circuit case, *Commissioner v. Procter*, which voided a formula clause as contrary to public policy because the disclaimed portion reverted to the transferor, which would undo the transfer.[165] But the *Christiansen* formula clause simply directed the gift elsewhere. The Court also dismissed the IRS's contingency argument by saying that: "That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen dies depends only on a settlement or final adjudication of a dispute about the past, not the happening of some future event." Thus formula disclaimers seem to have survived IRS attacks based on public policy and contingency.

E. Savings Clauses

A disclaimer may include a savings clause that attempts to cure a failed disclaimer. For example, it might provide: "to the extent that the disclaimer set forth above in this instrument is

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[159] Reg. § 25.2518-3(d) Ex. (2); Walshire v. United States, 288 F.3d 342 (8th Cir. 2002).

[160] Reg. § 25.2518-3(a)(1)(ii).

[161] Reg. § 25.2518-3(b), (c), (d), Ex. 20; Ltr. Ruls. 200420007, 200130034, 200001045, 19929646010, 9435014, 9338010, 9437029, 9435014, 9319022, 9310020, 9115062, 9014005, 9009007, 8502084.

[162] Ltr. Rul. 8652016 (surviving spouse made a qualified disclaimer of 20% of the value of the Marital Trust even though her son, as executor, had discretion to choose which assets will fund the disclaimer); Ltr. Rul. 8708069 (disclaimed assets should be segregated based on their value at the time of the disclaimer or on a fairly representative basis).

[163] Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008).

[164] Reg. § 25.2518-2(d)(2).

[165] Comm'r. v. Procter, 142 F.2d 824 (4th Cir. 1944).

not effective to make it a qualified disclaimer, [the disclaimant] hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of § 2518 of the Code."[166] Ms. Hamilton used such a savings clause in *Christiansen v. Commissioner* and argued that it should save her disclaimer of property passing to the Charitable Lead Annuity Trust (CLAT), which failed because she retained a remainder interest in the CLAT. However, the Tax Court found that the savings clause was ineffective because "it was this same partial disclaimer excluding the contingent remainder from its scope that would, on her reading of the savings clause, end up including it after all."

The Court also found the savings clause ineffective for two other reasons. First, if it is read as a promise that, once the court enters the decision, Hamilton will *then* disclaim her contingent remainder in some more of the property that her mother left her, it fails because it is made more than nine months after her mother's death. Second, if it is read as meaning that Hamilton disclaimed the remainder when she signed the disclaimer, it fails for not identifying the property being disclaimed and not doing so unqualifiedly under § 2518(b), because its effect depends on the court's decision.[167] Thus, a savings clause cannot be relied on to cure a defective disclaimer.

F. Special Types of Property

1. Jointly Owned Property

Special rules apply to jointly owned property. A disclaimer of an interest in a joint tenancy with right of survivorship or a tenancy by the entirety (other than bank, brokerage, and investment accounts) must be made no later than nine months after the creation of the tenancy, regardless of whether the interest can be unilaterally severed under state law.[168] A disclaimer of the survivorship interest acquired on the death of the first cotenant must be made no later than nine months after the cotenant's death. The interest is deemed to be a one–half interest in the property, regardless of how much consideration the disclaimant furnished, or how much is included in the deceased cotenant's gross estate under § 2040, or whether the interest can be unilaterally severed under state law. However, if the surviving spouse is not a U.S. citizen, she may disclaim any portion of a joint interest that is includible in her gross estate under § 2040 if it was created on or after July 14, 1988.[169]

In the case of joint bank, brokerage, or other investment accounts such as a mutual fund, if a transferor can unilaterally regain his own contributions to the account without the consent of the other cotenant (i.e. the transfer is not a completed gift), the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased cotenant. Accordingly, the surviving cotenant can disclaim the funds contributed by the deceased cotenant within 9 months of his death. The surviving tenant may not disclaim any portion of the joint account attributable to consideration furnished by the surviving joint tenant.

There are a number of favorable rulings dealing with withdrawals from joint accounts that did not prevent a qualified disclaimer. In Letter Ruling 200503024, the IRS allowed a surviving spouse to disclaim her husband's half of assets in a joint brokerage account from which she

[166] Christiansen v. Comm'r, 130 TC 1 (2008).
[167] *Id.*, citing Estate of Focardi v. Comm'r, T.C. Memo. 2006-56; Ward v. Comm'r, 87 T.C. 78, 110-11 (1986).
[168] Reg. § 25-2518-2(c)(4)(i).
[169] Reg. § 25-2518-2(c)(4)(ii).

withdrew cash and directed the broker to buy and sell securities.[170] But her disclaimer could not include any of the cash or securities relating to assets she directed the broker to buy or sell, plus the income earned on those portions. In Letter Ruling 9218015 the IRS allocated the disclaimant's entire withdrawal to his personal portion of a joint account, which allowed the disclaimant to make a qualified disclaimer of the rest of the account.[171] But in Letter Ruling 9012053 amounts withdrawn from a joint account of the decedent and surviving spouse after the decedent's death were treated as withdrawn equally from spouse's and decedent's shares of the account, even though the spouse promptly repaid the withdrawals.

2. Powers of Appointment

A power, including a power of appointment, with respect to property is treated as a separate interest in the property.[172] Thus a beneficiary can disclaim a general power of appointment without also having to disclaim other interests in the income or principal of that property.[173] A disclaimer of a general power of appointment must occur within 9 months of the creation of the power.

3. Trust Interests

Disclaimers of an interest in a trust can take many forms and are laden with potential traps. The discussion below illustrates some of the ways that trust interests can be disclaimed.

a. Disclaiming Trust Income or Principal

An income and a remainder interest in the same trust are separate interests and each may be disclaimed.[174] Thus a person may disclaim an income interest in the trust while retaining an interest in the corpus.[175] Likewise, a person may disclaim an interest in the trust corpus while retaining an interest in the trust income. Disclaimers of trust interests should occur within 9 months of the creation of the trust interest. In no event may a beneficiary disclaim an interest in a trust from which he or she has received a distribution of income, unless the distribution occurred before the disclaimant reached age 21. A distribution of income is an acceptance of benefits under the trust and will disqualify the disclaimer.[176]

b. Disclaiming Portions of Trust Income or Principal

Different interests in the trust income or principal may be separately disclaimed.[177] For example, a beneficiary may have both an interest in the trust remainder and be entitled to receive

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[170] Ltr. Rul. 200503024; *see also* Ltr. Rul. 9214022.

[171] Ltr. Rul. 9218015 (there was no acceptance of the decedent's interest in a joint brokerage account where withdrawals were less than the surviving spouse's community one-half interest at the date of death and she gave the brokerage firm no other instructions regarding the account and its disposition); Ltr. Rul. 9214022 (no acceptance of benefits occurred where the balance in a joint tenancy cash account at all times exceeded the value of decedent's one-half interest; withdrawals were deemed attributable to the survivor's interest.)

[172] IRC § 2518(c)(2); Reg. § 25.2518-3(a)(1)(iii).

[173] Reg. § 25.2518-3(a)(1)(iii), 25-2518-3(d), Ex. (21); *See also* Ltr. Ruls. 9236018, 8935024, 8721012.

[174] Reg. § 25.2518-3(d), Ex. 8, 12, 13, 14.

[175] Reg. § 25.2518-3(d), Ex. 8.

[176] Reg. § 25.2518-2(d)(1); Reg. § 25.2518-3(d), Ex. 18.

[177] Ltr. Rul. 200443030 (IRS approved a disclaimer by a surviving spouse of (1) the decedent's one-half community property; (2) the power to appoint the property; (3) the power to amend the trust; and (4) the power to direct disposition of the disclaimed interest.).

discretionary distributions of corpus during the income beneficiary's lifetime. The beneficiary can disclaim the right to receive discretionary principal distributions during the income beneficiary's lifetime while retaining the right to receive the trust remainder at his death.[178] A disclaimer in this case may be useful to qualify the trust for the QTIP election if the income beneficiary is the decedent's spouse.

A beneficiary can also disclaim a percentage or fraction of his income interest,[179] or a fixed amount of annual income from the trust, or all of the annual income in excess of a fixed amount. But he cannot make a qualified disclaimer of his income interest for a term of years.[180]

c. Disclaiming Income or Principal of an Asset in Trust

The beneficiary of a trust cannot disclaim his income or principal interest in a specific trust asset unless, as a result of the disclaimer and without any direction on the part of the disclaimant, the asset is removed from the trust.[181] For example, if A disclaims 20 percent of the income from stock X in trust, the disclaimer is not qualified if the stock remains in trust. However, if A disclaims the income and the remainder in stock X and as a result, and without any direction from A, stock X is distributed from the trust to other beneficiaries, A's disclaimer is qualified.

d. Disclaiming Assets That Pass to a Trust for the Disclaimant

A disclaimer is not qualified unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant.[182] Thus if a disclaimer (other than by the surviving spouse) does not completely pass an interest in property to a person other than the disclaimant because (i) the disclaimant also has a right to receive the property as an heir, residuary beneficiary, or by any other means; and (ii) the disclaimant does not disclaim these rights, the disclaimer is not qualified with respect to the portion of the disclaimed property that the disclaimant has a right to receive.

A special rule allows the decedent's surviving spouse to make a qualified disclaimer even if the spouse retains an interest in the trust after the disclaimer, as long as the interest passes without direction on the part of the surviving spouse. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), the spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless the power is limited by an ascertainable standard.[183]

If only a portion of property is disclaimed and the portion retained is not "severable" or an "undivided portion," then the disclaimer is not qualified with respect to *any* portion of the property.[184] For example, if a fee simple interest in property is disclaimed and as a result it passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be qualified unless the remainder interest in the property is also disclaimed because the remainder is

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178 Reg. § 25.2518-3(d), Ex. 11.
179 Reg. § 25.2518-3(d), Ex. 4.
180 Reg. § 25.2518-3(a)(1)(i).
181 Reg. § 25.2518-3(a)(2), (d), Exs. 5, 6, and 7.
182 Reg. § 25.2518-2(e)(1).
183 Reg. § 25.2518-2(e)(5), Ex. 4, 5, 6.
184 Reg. § 25.2518-2(e)(3)(ii).

not a severable or an undivided portion.[185] It is not severable because the income interest cannot maintain a separate existence from the remainder.[186] Nor is it an undivided portion because it is not a fraction or percentage of each and every substantial interest in the trust property.[187]

This was Christine Hamilton's fatal mistake in *Christiansen v. Commissioner* when she failed to disclaim her remainder interest in a charitable lead trust to which property passed after her disclaimer.[188] Her failure to disclaim the remainder interest caused the entire disclaimer to fail, not just the portion attributable to her remainder interest.

e. Disclaimant is a Fiduciary

If a beneficiary who disclaims property is also a fiduciary, actions taken in the exercise of fiduciary powers to preserve or maintain the disclaimed property are not treated as an acceptance of the property or any of its benefits.[189] Under this rule, for example, an executor who is also a beneficiary may direct the harvesting of a crop or the general maintenance of a home. A fiduciary who is also a disclaimant, however, cannot retain a "wholly discretionary power to direct the enjoyment of the disclaimed interest."[190] For example, a beneficiary's disclaimer of property passing to a trust of which he is a trustee is not qualified if the trustee exercises or retains a discretionary power to allocate enjoyment of that interest among members of a designated class. A disclaimer of property passing to a charitable foundation on whose board the disclaimant sits is not qualified unless the disclaimant has no authority over the use of the funds, they are segregated from the other assets, and are maintained in a separate account.[191]

Concern arises when a disclaimant has a fiduciary power to "pick and choose" which disclaimed assets go where in a non prorata funding. Pick and choose powers avoid distributing undivided portions of each asset in funding and also avoid a possible IRS argument that there was a distribution of undivided interests followed by a taxable exchange among the beneficiaries.[192] In such cases, the disclaimant/fiduciary should consider, if possible, waiving the discretionary power in favor of an alternate fiduciary or trust advisor.

Some commentators also worry about a disclaimant, who is also a fiduciary, exercising a Clayton-QTIP election, which divides property between a QTIP and a bypass trust depending on which property the fiduciary makes subject to the QTIP election.[193] The fiduciary could also have the power to divide property among beneficiaries based on how the GST exemption is allocated. Although such divisions would "relate back" to the date of death and probably not be considered a 'retention' of a wholly discretionary power, it might be wise for the disclaimant to waive such powers unless the disclaimed assets are placed in a separate account not subject to the fiduciary's discretionary power.

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185 Reg. § 25.2518-2(e)(3)(ii).
186 Reg. § 25.2518-3(a)(1)(ii).
187 Reg. § 25.2518-3(b).
188 Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008).
189 Reg. § 25.2518-2(d)(2).
190 *Id.*
191 Ltr. Rul. 201032010, 201032002, 200802010, 200744005, 200649023, 200616026, 200519042, 200420007, 200204022, 200149015.
192 Rev. Rul. 69-486, 1969-2 C.B. 159.
193 Clayton Est. v. Comm'r., 976 F.2d 1486 (5th Cir. 1992).

f. Disclaiming a Power of Appointment Over a Trust

A power of appointment is a separate interest in property. All or a portion of the power may be disclaimed independently from any other interests separately created by the transferor in the property.[194] A disclaimer of a power of appointment over property is qualified only if any right to direct the beneficial enjoyment of the property that is retained by the disclaimant is limited by an ascertainable standard.

If a trust beneficiary has both an income interest and a power of appointment with respect to the principal, he can disclaim his power over the principal and retain his income interest.[195] However, the disclaimer of one power or interest in property while retaining another power to direct the disposition of that property is not a qualified disclaimer.[196] For instance, if H, who is the income beneficiary and the trustee of a trust, holds both the power to invade corpus for his health, maintenance, support and happiness and a testamentary power of appointment, his disclaimer of the power of invasion, while retaining the testamentary power, is not a qualified disclaimer. [197] However, if H disclaimed the testamentary power and the retained power of invasion were limited by an ascertainable standard, H's disclaimer would be qualified.[198]

4. IRAs

All or part of an individual retirement account (IRA) may also be disclaimed. This can be particularly valuable if the contingent IRA beneficiary is much younger than the primary beneficiary/disclaimant because distributions can stretch out over the longer life expectancy of the younger individual. A disclaimer can also be valuable if a dynasty trust is the contingent IRA beneficiary because the IRA distributions can be accumulated in trust for several generations.

Distributions from an IRA prior to making a disclaimer will not prevent a disclaimer of the balance of the IRA. In a very favorable ruling, Revenue Ruling 2005-36 allowed a beneficiary to disclaim the balance of an IRA even though prior to making the disclaimer, the beneficiary received IRA distributions.[199] The ruling simply points to Reg. § 25.2518-3(c), which provides that a pecuniary amount distributed to a beneficiary from a bequest prior to the disclaimer is treated as a distribution of *corpus*. Thus, it does not constitute an acceptance of IRA benefits, which would otherwise destroy the ability to disclaim any portion of the IRA.

When a nonspouse wishes to disclaim an IRA that passes to a trust as a result of the disclaimer, she should also disclaim her interest in the trust. In Letter Ruling 200846003 the decedent's children disclaimed their interest in an IRA that funded a marital trust of which they were residuary beneficiaries. The IRS held that their disclaimers were ineffective because they did not disclaim their remainder interest in the IRA. Consequently the children incurred a gift tax on transfer of the funds to the surviving spouse and the estate was denied a marital deduction for the IRA proceeds passing to the trust because they passed from the children, not from the decedent, and as such did not qualify under § 2056(b)(7).

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[194] Reg. § 25.2518-3(a)(1)(iii); Reg. § 25.2518-3(d), Ex. 21.
[195] Reg. § 25.2518-3(d), Ex. 21.
[196] Reg. § 2518(b)(4); Reg. § 25.2518-2(e)(1).
[197] Reg. § 25.2518-3(d), Ex. 9.
[198] Reg. § 25.2518-3(a)(1)(iii).
[199] Rev. Rul. 2005-36, 2005-1 C.B. 1368.

5. Life Insurance

There is little guidance on how to properly disclaim life insurance. In Letter Ruling 8702024 the IRS ruled that it was too late for the sister of the decedent to disclaim life insurance proceeds once she had filed a claim with the insurance company, the proceeds were deposited into an account in her name, and she had received a checkbook giving her withdrawal rights.[200] If she had been the surviving spouse with a community property interest in the policy, she could probably have filed a claim with the insurance company and deposited the proceeds in an account in her name without disqualifying the disclaimer as long as she did not accept the checkbook because her actions would be consistent with the ownership of her community half of the policy proceeds. However, she should instruct the insurance company to deposit the disclaimed proceeds into a separate account over which she has no withdrawal rights.

G. Rescinding a Disclaimer

There are many reasons why someone might wish to rescind a disclaimer. Most commonly, the taxpayer discovers that the disclaimer fails to meet the requirements of § 2518 and is treated as a taxable gift from the taxpayer to the taker in default. A taxpayer is not generally permitted to rescind a disclaimer to avail himself of a tax advantage. However, the courts have been sympathetic when there was a material mistake of fact or as to the tax effect or timing of the disclaimer, or the taxpayer received bad advice from his professional advisors.

In *Breakiron v. Guidonis* the taxpayer sought to rescind two disclaimers that would have passed property from two qualified personal residence trusts (QPRTs) to his sister. When he made the disclaimers, he was acting on erroneous advice from his attorney that he could disclaim his remainder interest in the QPRTs within 9 months of their termination.[201] However, the IRS rightly asserted that the time to disclaim his interest in the trusts ran from their creation and assessed him $2.3 million in gift taxes on the transfer of his interest to his sister. The District Court ruled that "while the mistake was not a mere scrivener's error, it was a mistake at the time he disclaimed-not a hindsight decision by the plaintiff to avail himself of a tax advantage. The IRS had an opportunity during the proceeding to adduce evidence that plaintiff's execution of the disclaimers was something other than a mistake, and did not." Thus the Court allowed the disclaimers to be rescinded.

H. Uses of Disclaimers

Disclaimers are not simply an altruistic refusal to accept a gift or inheritance. They are useful for both tax and non-tax purposes. They can be used to rewrite the decedent's will in a manner that is more tax favorable or in keeping with the testator's intent, while keeping the money in the family. They are especially useful for 2010 deaths where the 2001 Act has disrupted planning. Just a few of the ways that disclaimers can be helpful are discussed below.

1. Pure Generosity

Although not very common, a disclaimer might be made out of pure unadulterated generosity. For example, the mother of a decedent disclaims the proceeds of a life insurance policy, which then pays to the estate of her son and passes to the son's surviving widow.

[200] Ltr. Rul. 8702024.

[201] Breakiron v. Gudonis, 106 AFTR 2d 2010-5999 (D.C. Mass. 2010).

2. Unwanted Property

Sometime people inherit property they simply do not wish to own. For example, inherited property may contain environmental hazards. Simply being in the chain of title for a moment can expose an owner, beneficiary, or fiduciary to significant liability. The beneficiaries should consider disclaiming, even unto escheat. This may require a series of disclaimers. Fiduciaries may likewise disclaim under these circumstances without violating their fiduciary duties.

3. Redirect Nonprobate Assets

Many people have significant wealth in nonprobate assets such as accounts styled "joint tenants with rights of survivorship (JTWROS)." This could include cash, certificates of deposit, stocks, bonds, mutual funds, real estate, and even vehicles. Upon the death of a joint owner, the account passes to the surviving joint owner, which often comes as a surprise when the survivor was merely thought to be a convenient co-signer and the property was expected to pass under the will. For example, a daughter adds herself to her mother's JTWROS bank account so that she can sign checks if her mother becomes incapacitated. If the mother dies, the daughter is entitled to the entire account as surviving joint tenant. However, if there are other siblings that the mother intended to benefit, the daughter may want to disclaim an appropriate portion the account, assuming it passes to the other siblings under the will.

4. Reduce Taxes in the Disclaimant's Estate

One of the most common reasons for disclaiming property is to bypass the taxable estate of the disclaimant. For example, a mother bequeaths $1 million to her daughter, who already has a taxable estate. The daughter can disclaim the $1 million and have it pass on to her children without paying any gift taxes on the transfer or estate taxes in her own estate. However, the disclaimer creates a generation-skipping transfer by the mother because the transfer is treated as made directly by the mother to her grandchildren.[202] A wife disclaims her interest in her husband's IRA, which then passes to their children who are the alternate beneficiaries. The wife has avoided estate taxes on her death, but the husband's estate is not entitled to a marital deduction for the IRA proceeds passing to the children.

5. Maximize the Decedent's GST Exemption

Disclaimers can also help fully utilize the decedent's GST exemption. The surviving spouse might consider disclaiming an amount equal to the decedent's remaining GST exemption amount ($5 million in 2010) if it passes as a result of the disclaimer to a bypass trust. If she is trustee of the bypass trust, she should also disclaim any powers of appointment unless they are limited by an ascertainable standard. Although she can be a beneficiary of the trust, she may wish to disclaim her beneficial interest to prevent shrinking the trust through distributions to her.

6. Create a Direct GST Skip

If the transferor's GST exemption has already been fully used, and property passes in trust for the benefit of both children and grandchildren, the children may wish to disclaim their interest in the trust to convert the transfer to a direct skip. Although the disclaimer causes the transfer to be immediately subject to GST tax, it may be cheaper than paying GST taxes on future distributions to skip persons from the trust. This is because the GST tax on a direct skip is levied on the transfer *net* of the GST tax (tax exclusive) whereas the GST tax on a distribution

[202] Reg. § 25.2518-1(b).

from the trust is levied on the gross distribution (tax inclusive). If the children's disclaimer occurs in 2010, there will be no GST tax paid because the GST tax rate in 2010 is zero.[203]

7. Bypass Creditors

Most states permit a beneficiary to disclaim an inheritance in order to prevent the creditors of the beneficiary from attaching the property. Because the disclaimer relates back to the time of death, the property is treated as having passed directly from the decedent to the alternate beneficiary. However, a disclaimer is not effective to avoid an IRS tax lien.[204] In addition, if a disclaimer is filed just prior to filing for bankruptcy, the disclaimer may constitute a voidable transfer under the Bankruptcy Act, depending on the applicable state law. Disclaimers filed after filing bankruptcy have been held to constitute property of the bankruptcy estate if the debtor was entitled to the property within 180 days after filing bankruptcy.

8. Create a Minority Discount

A disclaimer can be an effective way to fractionalize property ownership and obtain minority discounts. For example, disclaiming a portion of a family owned business such that the amount accepted is less than 50 percent can allow a lower valuation in the survivor's estate. In *Estate of DiSanto v. Commissioner*, the husband left a 53.5 percent controlling interest in a closely held corporation to a marital trust.[205] The wife was terminally ill and disclaimed a portion of the inheritance leaving her with a discounted minority interest when she died.

9. Resolve Valuation Uncertainties

Formula disclaimers can avoid an estate tax where the disclaimed asset passes to charity. For example, in *Christiansen v. Commissioner*, the decedent's daughter disclaimed the excess of her inheritance over $6.35 million, with the disclaimed portion passing to charity.[206] The bulk of the estate property consisted of family limited partnership interests, which were discounted by 35 percent. Upon examination of the estate tax return, the IRS contested the discount and ultimately the parties stipulated to a much higher value. However, regardless of the value of the partnerships, the value would not increase the estate tax because the daughter still received only $6.35 million of property and the excess passed to charity. The IRS argued that it should be against public policy to discourage an IRS audit. But the Eighth Circuit disagreed and upheld the formula disclaimers.

10. Stretch Out an IRA

If an older person disclaims an interest in the decedent's IRA and as a result, the IRA becomes payable to a younger person or persons, the IRA can be distributed more slowly because it will be based on the longer life expectancies of the younger individuals.[207] This slower payout is only a short-term advantage, however, because the younger beneficiaries would have had to begin taking distributions when the primary beneficiary died. Nonetheless, the slower payout in the interim can keep the assets in the IRA longer than if no disclaimer had been made.

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[203] P.L. 111-132 § 302.
[204] Drye v. United States, 528 U.S. 49 (1999).
[205] DiSanto v. Comm'r, T.C. Memo 1999-421.
[206] Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir 2009).
[207] Reg. § 1.401(a)(9)-5, Q&A 5(a); Ltr. Ruls. 200850058, 200742026.

11. Qualify Property for the Marital Deduction

Disclaimers can cure a trust that failed to qualify for the QTIP marital deduction because it does not meet all of the requirements under § 2056(b)(7). For example, if property under the decedent's will passes to a trust with beneficiaries other than the surviving spouse, the nonspouse beneficiaries can disclaim their income interests, leaving the spouse as the sole income beneficiary. This qualifies the trust for the QTIP election.

12. Reduce Oversized Trusts

Many wills were drafted with formula clauses designed to work when the applicable exclusion amount was much smaller, which now produces trusts much larger than may be desired. Disclaimers can help reduce the size of these trusts. In Letter Ruling 8708069, the family wished to reduce the size of a residuary trust with the spouse and children as income beneficiaries and the children as remainder beneficiaries. After agreeing on an amount, the children disclaimed that portion of the trust. They also disclaimed their interest under the will and the laws of intestacy. The spouse executed a similar disclaimer, except that she retained her interest under the laws of intestacy. As a result of the disclaimers, the disclaimed portion passed from the trust (for want of a beneficiary) to the spouse under the laws of intestacy. The rest stayed in trust. Thus the disclaimers caused the desired amount of distribution from trust.

Disclaimers can also reduce the size of a marital trust, but care must be taken to avoid § 2519, which can accelerate the gift tax on all of the QTIP property if the beneficiary gifts a portion of his or her income interest in the QTIP trust.[208] Several private letter rulings indicate that if the QTIP trust is first severed, this adverse result may be avoided.[209] In Letter Ruling 201118007 the beneficiary of a QTIP trust petitioned the court to sever the QTIP trust into Trust 1 and Trust 2. Trust 1 will be for the benefit of the children's trusts and Trust 2 will remain in place for the benefit of the surviving spouse during his lifetime and ultimately pass to the children's trusts. After severance the spouse disclaimed his entire interest in Trust 1. The IRS held that the spouse was not deemed to have gifted his income interest in Trust 2 when he disclaimed his interest in Trust 1. Thus, notwithstanding § 2519, a spouse can dispose of part of a QTIP income interest without triggering a gift tax on the whole QTIP property.

13. Permit the Use of Alternate Valuation

The alternate valuation can significantly impact the size of bequests under a will or trust. For example, assume an unmarried decedent has $10 million at the time of his death in 2011, which declines to $9 million 6 months later. Assume also that his will provides for a formula pecuniary marital trust with the residue passing to a bypass trust. Using date of death values, the pecuniary marital trust would be due $5 million and the bypass trust would be due $5 million. Six months later, when the executor funds the bequests, the pecuniary marital bequest would still be due $5 million. But the residuary bypass trust would have declined to only $4 million because the depreciation falls to the residuary.

However, if the alternate valuation date had been elected, the bypass trust would be due $5 million and the pecuniary marital bequest would be due only $4 million. If this is the desired result, a small disclaimer by the spouse could create a small amount of estate tax, which would

[208] Reg. § 25.2519-1(a).

[209] Ltr. Ruls. 201118007, 201024008, 200723014, 200717016, 200602031, and 9140069.

qualify the estate to use the alternate valuation. The alternate valuation must decrease both the value of the gross estate and the estate tax.[210] Therefore, a disclaimer can be quite useful in situations where the alternate valuation could prevent depreciation of the residue.

14. Qualify a Trust to Hold S Corporation Stock

A disclaimer can avoid terminating an S election if a disqualified shareholder acquires stock under the will or trust. Trusts that own S corporation stock must be a "qualified subchapter S trust" (QSST) or an "electing small business trust" (ESBT) or else the S election will be terminated. A QSST may only have one income beneficiary.[211] If it has more than one income beneficiary, a disclaimer by the surplus beneficiaries of their interest as permissible beneficiaries of the trustees' discretionary power to distribute corpus during the life of the income beneficiary may convert the trust into a QSST.[212]

15. Qualify For Special Use Valuation Purposes

Disclaimers have been used to qualify property for the special use valuation under § 2032A. The special use valuation allows up to a $1 million reduction in value of farm or business property that passes to qualified heirs. If the property would qualify but for one or more disqualified heirs, a disclaimer by the disqualified heirs can qualify the property for the special use valuation. For example, if the decedent bequeathed a life estate to a qualified heir with a special power to appoint the remainder to nonqualified heirs, the heir could disclaim the power, causing the remainder interest to vest in a qualified heir and save the special use valuation.

V. Death of an Irrevocable Trust Grantor

One of the most popular estate planning techniques has been contributing or selling appreciating assets to an "intentionally defective grantor trust" (IDGT). This shifts the future growth to the transferee, while the grantor continues to pay the income tax on the income produced by the asset. Shares of a Subchapter S corporation are an ideal asset to transfer to an IDGT because all the S corporation income is taxed to the grantor instead of the trust or the beneficiary.

Assets can also be sold on the installment basis to the IDGT with a very low interest rate, currently 2.89 percent for a 9 year note.[213] Any growth in the asset above this rate is shifted to the transferee. Almost any asset can be sold on the installment basis, except for marketable securities, dealer real and personal property, inventory, and personal property under a revolving credit plan.[214] And even these assets can be sold on the installment basis if they are transferred to a partnership that is then sold on the installment basis.[215] The transfer to the grantor trust is recognized for estate and gift tax purposes, but not for income tax purposes.[216]

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[210] IRC § 2032(c).
[211] IRC § 1361(d)(3)(A)(i).
[212] Ltr. Rul. 8825055.
[213] Rev. Rul. 2012-13, 2012-19 IRB.
[214] IRC § 453(b)(2), (k).
[215] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954).
[216] Rev. Rul. 85-13, 1985-1 CB 184.

However, when the grantor dies or his grantor powers cease, the trust converts to a nongrantor trust. Authorities clearly hold that cessation of grantor powers during the grantor's life is a deemed transfer of property to the trust that may have income tax consequences to the extent the grantor receives any consideration.[217] If the grantor receives no consideration on the conversion, there should be no income tax consequences to either the grantor or the trust. The grantor has merely transferred property to the trust for no consideration and the trust has merely acquired (not sold) property. These are not income producing events.

However, where the grantor is relieved of partnership debt in excess of his basis in a partnership, the IRS and the courts have held that the grantor recognizes income.[218] In addition, a transfer to a trust for less than adequate consideration is a part-sale part-gift, in which the grantor recognizes gain to the extent that the consideration exceeds the grantor's basis.[219] There is no official guidance on whether this same income tax result occurs where the grantor's powers cease because of death. However, there is no reason to believe it would not. No authority holds that a transfer of property to trust for consideration at death or any other time is tax-free.

A. Installment Notes

If the grantor had sold the property to the IDGT on the installment basis and there is a note outstanding at his date of death, there would clearly be consideration from the trust to the grantor in the form of a note receivable. The question is whether gain is recognized upon that transfer and if so who recognizes it – the grantor or his estate? And if the conversion is taxable, does the note qualify for installment sale reporting under § 453 or constitute income in respect of a decedent (IRD) under § 691 to the extent of any unrecognized gain? And finally, what are the basis of the note in the hands of the decedent (or his successor) and the basis of the property in the hands of the trust?

No single authority answers all these questions. Some commentators maintain that the termination of grantor trust status upon the grantor's death is taxable to the extent that the unpaid note exceeds the grantor's basis in the property.[220] Consequently they advise paying off the note before the grantor dies to avoid gain recognition. Other commentators concede that a conversion with an outstanding note during the grantor's lifetime is a taxable event, but maintain that there is a general "no gain at death" rule for transfers of property at death.[221] But the authorities cited for this proposition hold only that transfers from a decedent to his estate do not constitute a

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[217] Reg. § 1.1001-2(c), Ex. 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222, TAM 200011005; GCM 37228.

[218] Reg. § 1.1001-2(c), Ex. 5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; GCM 37228 (Aug. 23, 1977).

[219] Reg. § 1.1001-1(e), Ex. 1 (income recognized on a part-sale-part-gift); TAM 200011005; Diedrich v. Comm'r, 457 U.S. 191 (1982) (grantor was taxable to the extent the donee paid the donor's gift tax liability in a net gift arrangement.)

[220] Carol A. Cantrell, "Gain is Realized at Death," Trusts & Estates (February 2010), p. 20; Deborah V. Dunn & David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," J. Tax'n. (July 2001), p. 49.

[221] Jonathan G. Blattmachr & Mitchell M. Gans, "No Gain at Death," Trusts & Estates (February 2010), p. 34; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," J. Tax'n. (Sept. 2002).

taxable sale, exchange, or other disposition.[222] They do not hold that transfers of property in trust for consideration are nontaxable.

Moreover, IRC § 1022(g) suggests that gain can be realized at death when property is transferred from the decedent to the estate. Section 1022(g) prevents gain recognition for 2010 decedents. One wonders why the need for such an anti-gain provision in § 1022(g) if such transfers of encumbered property were not taxable in the first place. It is also incorrect to say that tax policy in general weighs against acceleration of income at death. When a self-cancelling installment note (SCIN) is cancelled at the holder's death, the cancellation is taxable to the decedent's estate as a satisfaction of the note at face value.[223] A Roth IRA owner who dies during the 2-year deferral period under § 408A(d)(3) must accelerate the remainder of the Roth income on his or her final income tax return.[224] A business owner who elected to defer income on advance payments for certain goods or services under § 451 and dies before the end of the deferral period accelerates the remaining income on his or her final return.[225] Therefore, income acceleration at death is not uncommon or against tax policy.

B. Income in Respect of a Decedent

The question of whether the decedent or his successor should report the deferred installment gain on conversion of a grantor to a nongrantor trust while the note is still outstanding depends on whether the transfer to the trust on death qualifies as an "installment sale" eligible for deferred gain reporting. If it does not qualify for installment reporting, the gain should be reported on the decedent's final income tax return because the deemed transfer to trust for income tax purposes occurs on death, and all income received on the date of death is taxable on the decedent's final income tax return.[226] If the deemed transfer qualifies for installment sale reporting, then the estate or other successor should report the gain as payments are collected.

Revenue Ruling 85-13 holds that the transfer of property to a grantor trust in exchange for a note is "not a sale for federal income tax purposes."[227] However, the exchange is recognized for income tax purposes at the moment the trust converts to a nongrantor trust. The grantor recognizes a taxable gain to the extent any consideration exceeds the donor's basis in the property transferred as discussed above. If the consideration (the note) qualifies for installment sale reporting, the deferred gain is income in respect of a decedent (IRD) and taxed to the recipient as the note payments are collected.[228]

An installment sale is defined as a "disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[229] Installment

[222] Campbell v. Protho, 209 F.2d 331 (5th Cir. 1954); International Freighting Corp., 135 F.2d 310 (2nd Cir. 1943); Rev. Rul. 73-183; Ltr. Rul. 8616029.

[223] IRC §§ 691(a)(5), 453B(f).

[224] IRC § 408A(d)(3)(E)(ii).

[225] Reg. § 1.451-5(f).

[226] Reg. § 1.451-1.

[227] Rev. Rul. 85-13, 1985-1 CB 184.

[228] IRC § 453B(c) (death is not a disposition of an installment obligation that causes gain or loss to be recognized); Reg. § 1.451-1(b)(2) (If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation.)

[229] IRC § 453(b)(1).

reporting is mandatory unless the taxpayer affirmatively elects out of it or the method is statutorily precluded.[230] For example, gains from the sale of marketable securities, certain dealer property, and property under s revolving credit plan are precluded from installment sale treatment.[231] The IRS also permits installment reporting in partial nonrecognition transactions, such as bargain sales to charity, tax-free exchanges, and transfers in exchange for stock under § 351.[232] Therefore, a transfer to trust for a note should qualify for installment reporting. As such, the deferred gain should constitute IRD to be reported by the estate or successor to the note.

C. Basis in the Installment Note

And finally, there is the question of basis in the installment note and the trust property. The note should be entitled to a stepped-up basis under § 1014(a) because it was required to be included in the decedent's estate tax return as property.[233] However, to the extent the deferred gain constitutes IRD, the note is not entitled to a stepped-up basis.[234] Therefore, the basis of the note turns on whether it qualifies for installment reporting and who is required to report the deferred gain. If the decedent is required to report the deferred gain on his final income tax return, the gain is added to the basis of the note and there is no IRD because all the gain has been reported. In that case, the basis of the note is its face value, which is presumably market value. On the other hand, if the deferred gain is properly reported by the estate or successor, and thus constitutes IRD, the basis of the note is not stepped-up.[235]

D. Basis in the Property

The property owned by the trust is not entitled to an adjusted basis under § 1014 because it was not included in the decedent's taxable estate.[236] Its basis is the greater of the amount paid by the trust (the note balance) or the grantor's adjusted basis at the time of the deemed transfer for income tax purposes.[237] If the note balance exceeds the grantor's basis, the trust's basis in the property is equal to the unpaid note and its holding period starts on the date the grantor trust status ceases.[238] On the other hand, if the unpaid note is less than the grantor's basis on termination of grantor status, the trust's basis in the property is equal to the grantor's basis and therefore it may tack the grantor's holding period.[239]

EXAMPLE

> Joe Brown sold a partnership interest on the installment basis to an IDGT for $60,000 in 2005. The trust is a grantor trust. Thus the sale is ignored for federal income tax purposes. Joe died in 2009 when the unpaid note balance was $30,000

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[230] IRC § 453(a), (d).

[231] IRC § 453(k), (l).

[232] Reg. § 1.453-1(f) (installment sale reporting allowed for nonpermitted property received in partial recognition exchanges such as tax-free exchanges under Section 1031, 351, etc; Ltr. Rul. 7933009 (bargain sale to charity with an installment note qualified for installment sale reporting).

[233] IRC § 1014(b)(9).

[234] IRC § 1014(c).

[235] IRC § 453B(b); IRC § 1014(c).

[236] CCA 200937028 (Sept. 11, 2009).

[237] Reg. § 1.1015-4(a).

[238] Ltr. Rul. 7752001; Reg. § 1.1015-4.

[239] *Id.*

> and the basis of the partnership interest was $20,000. Joe realizes a $10,000 gain on the transfer – the excess of the note balance ($30,000) over the basis of the property ($20,000).[240] If the transfer qualifies for installment reporting, Joe's estate reflects $10,000 of IRD, which the successors report as they collect the note payments. If the transaction does not qualify for installment sale treatment, Joe reports $10,000 of gain on his final Form 1040. The trust's basis in the partnership interest is $30,000, which is the amount paid for the partnership. The estate's basis in the note is $30,000, its market value under § 1014.

Perhaps the IRS will someday clarify the income tax treatment of death of the grantor of a grantor trust with an outstanding installment note. Based on their current published guidance, the Service is not likely to find that it is tax-free. But keep in mind that any potential gain is mitigated to the extent it can be added to the basis of the trust's property and recovered on sale.

VI. Administration Expenses and Claims

Section 2053 allows the estate to deduct funeral expenses, administration expenses, claims against the estate, and unpaid mortgages or indebtedness on property included in the decedent's gross estate.[241] The amount that an estate may deduct for these expenses and claims has been a highly litigious issue, as described in the preamble to the proposed regulations under § 2053.[242] The controversy stems from the fact that unlike § 2031, § 2053 does not expressly require that the value of a claim be measured at the time of the decedent's death. Rather, § 2053 covers many post-death transactions such as funeral and administration expenses, which are only determinable after the decedent's death. As such, courts have differed about whether and how to consider post-death events in valuing expenses and claims on the estate tax return.

To clarify the rules and provide consistency, the IRS published final regulations under § 2053 on October 20, 2009. The regulations set forth the general rules for deductibility and then describe special rules that apply to various types of expenditures. These special rules clarify which items may be deducted on Form 706 even though not yet paid by the filing date. And for those that are not deductible on Form 706 because they are not paid, the regulations suggest filing a protective claim. These general and special rules are described in more detail below.

A. Rules Applicable to All Claims and Expenses

The general rule for decedents dying after October 20, 2009 is that claims and expenses must be bona fide and *be paid* in order to be deductible.[243] The regulations enumerate several factors that may be considered in determining whether payments are bona fide. This is a vast improvement from the proposed regulations, which contained a rebuttable presumption that claims by family members, related entities, and beneficiaries were not legitimate or bona fide.

1. Claims Must Be Enforceable

No deduction is allowed for an unenforceable claim.[244] Claims that become unenforceable

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[240] Reg. § 1.1001-1(e).
[241] IRC § 2053(a).
[242] REG- 143316-03, 72 FR 20080 (April 23, 2007).
[243] Reg. § 20-2053-1(b) (bona fide) and § 20.2053-1(d) (paid).
[244] Reg. § 20.2053-4(d)(4).

during the administration of the estate are not deductible to the extent that they are paid (or will be paid) after they become unenforceable. For example if the decedent owes a debt (open account or promissory note) that is past the local law statute of limitations for collection, the debt may not be deductible on the 706 at any time, regardless of whether it is eventually paid. However, if the enforceability of a claim is the subject of a bona fide dispute, the claim will not be deemed unenforceable for purposes of § 2053. [245]

2. Related Party Claims and Expenses Must Be Bona Fide

Special scrutiny will be given to claims and expenses involving family members, related entities, and beneficiaries of the estate or revocable trust. These related party claims will be evaluated for their bona fide nature according to the following factors:

> (1) The transaction underlying the claim occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent.
> (2) The nature of the claim or expense is unrelated to an expectation or claim of inheritance.
> (3) The claim or expense originates under an agreement between the decedent and the family member, related entity, or beneficiary, and is substantiated with contemporaneous evidence.
> (4) Performance by the claimant is under the terms of an agreement between the decedent and the family member, related entity, or beneficiary, and the performance and the agreement can be substantiated.
> (5) All amounts paid in satisfaction or settlement of a claim or expense are properly reported by each party for federal income and employment tax purposes in a manner that is consistent with the reported nature of the claim or expense.[246]

The definition of family members is extremely broad. It includes the decedent's spouse, grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent's spouse, and the spouse and lineal descendants of any grandparent, parent, and sibling of the decedent or of the decedent's spouse. Family members include adopted individuals.

A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial ownership interest at the time of his death or within three years of his death. However, a related entity does *not* include (i) a publicly-traded entity, or (ii) a closely- held entity in which the combined beneficial interest, either direct or indirect, of the decedent and his family members, collectively, is less than 30 percent of the beneficial ownership interests (whether voting or non-voting and whether an interest in stock, capital and/or profits), as determined at the time a claim is being asserted. Regardless, an entity in which the decedent, directly or indirectly, had any managing interest (for example, as a general partner of a partnership or as a managing member of a limited liability company) at the time of his death is considered a related entity.[247]

A common related party claim might involve a claim by the spouse or children against the estate for failure to fund the bypass trust at the first spouse's death. The claim would probably pass the bona fide test if the trust legitimately should have been funded, but was neglected for

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[245] Reg. § 20.2053-1(b)(3)(iv).
[246] Reg. § 20.2053-1(b)(2)(ii).
[247] Reg. § 20.2053-1(b)(2)(iii).

some reason. Alternatively, the assets that should have been in the bypass trust could simply be excluded from the estate of the second to die as subject to a constructive trust. While this approach avoids the scrutiny of § 2053, the assets would not be included in the decedent's estate and hence would not acquire a stepped-up basis under § 1014 as would assets subject to a claim.

A recent district court case held that if a claim is not bona fide, the expenses to pursue or defend it will not be deductible under § 2053. In *Beat v. United States*, the U.S. District Court denied a deduction for legal fees incurred during an estate administration because there was a material question whether the common law marriage claim against the estate by the alleged 'surviving spouse' and executor was advanced in good faith and free from fraud.[248] The executor claimed a marital deduction based on a common law marriage. The estate sought to deduct $864,488 in legal fees incurred in establishing the common law marriage in state court and defending the matter before the IRS. The IRS disputed the common law marriage because the facts strongly indicated that no common law marriage existed. In addition, the IRS proposed the civil fraud penalty under § 6663, the negligence penalty for underpayment under § 6662 against the estate, and preparer penalties under § 6694 against the CPA who prepared the Form 706. The district court ultimately found that a common law marriage did exist, and thus allowed a deduction for the legal fees under § 2053 and voided the penalties.[249]

A similar issue arose in *Olivo v. Commissioner*, in which the Tax Court denied a $1.24 million deduction under § 2053 representing a claim by the decedent's son and executor for home care services rendered for his mother before she died.[250] The son had been a practicing attorney before he began to care for her. The only evidence he offered of his mother's intention to compensate him for his services was his own testimony, which the court did not consider credible within the meaning of § 7491(a). Despite his training as an attorney and the animosity between him and his other family members, he failed to document the alleged agreement or even offer some corroborating evidence beyond his self-serving testimony. Mr. Olivo also claimed that he should be entitled to some recovery under quantum meruit. However, under New Jersey law, services rendered to a family member living in the same household are presumed to be rendered gratuitously and Mr. Olivo offered no evidence to the contrary. Therefore, the Tax Court denied the deduction for lack of substantiation and incredibility under § 2053.

3. Court Decrees and Settlements

Court decrees and settlements can be relied upon to establish the legitimacy of an expense or claim. Under the pre-Oct. 20, 2009 law, amounts determined by court decrees and consent decrees were deductible regardless of whether paid.[251] However, the final regulations require that such amounts be paid in order to be deductible. A final court decree that approves claims or expenses may establish a deductible claim or expense, provided that the court actually passes upon the facts upon which deductibility depends. However, the result must be reasonable.[252] A consent decree may also be relied on to establish the amount of a claim or expense that is deductible, provided it resolves a bona fide issue in a genuine contest. Consent given by all parties having interests adverse to the claimant is presumed to resolve a bona fide issue in a

[248] Beat v. United States, 742 F. Supp. 2d 1227 (D. Kan. 2010).
[249] Beat v. United States, 2011 U.S. Dist. LEXIS 40501 (D. Kan. Apr. 11, 2011).
[250] Olivo v. Comm'r, T.C. Memo 2011-163 (July 11, 2011).
[251] Reg. § 20.2053-1(b)(2), before amendment by TD 9468, 10/16/2009.
[252] Reg. § 20.2053-1(b)(3)(i).

genuine contest.[253]

A settlement can be deducted provided it resolves a bona fide issue in a genuine contest and is the product of arm's-length negotiations by parties having adverse interests regarding the claim or expense. A deduction will not be denied if the estate can establish that the cost or delay of defending or contesting the dispute would impose a higher burden on the estate than paying to settle it.[254] No deduction will be allowed for amounts paid to settle an unenforceable claim. If a claim exceeds a limit under local law, it will be deemed to be unenforceable. However, if the enforceability of the claim is at issue in a bona fide dispute, the claim will not be deemed unenforceable for this purpose. Settlements meeting these requirements are deductible only to the extent they have been or will be paid.[255]

4. Certain Payments Not Required by 706 Due Date

Deductions under § 2053 are limited to the amount paid.[256] That generally means that expenses and claims must be paid by the time Form 706 is filed in order to deduct them. However, there are four exceptions to this rule – reasonably ascertainable estimates, claims with counterclaims, small claims under $500,000, and noncontingent recurring payments. These four categories may be deducted at the time of filing Form 706 regardless of whether paid.

a. Ascertainable With Reasonable Certainty

Certain claims and expenses may be deducted on Form 706 *even though not yet paid* if they are 1) ascertainable with reasonable certainty and 2) will be paid. In determining whether these two conditions are met, the IRS will take into account events occurring after the decedent's death. There is no specific time by which payments must be made. The estate must simply convince the IRS that they "will be paid." Thus, no deduction is allowed for a vague or uncertain estimate or contested or contingent claims.

Executor's commissions and attorney fees are generally ascertainable with reasonable certainty and will be paid. As such, they are deductible on Form 706 when filed.[257] Interest on a loan is deductible if the note prohibits prepayment.[258] Otherwise there is no guarantee that it will be paid. Similarly, real estate commissions should be deductible at the time of filing Form 706 if there is a firm contract between the estate and the buyer and the sale is necessary to pay the decedent's debts, expenses, or taxes, to preserve the estate, or to effect a distribution of the estate assets.[259] However, if there is only a listing agreement with no offer or contract, the commissions are not certain to be paid and may not be deducted at the time of filing the Form 706.

The Ninth Circuit recently upheld the California District Court's holding on the meaning of "ascertainable with reasonable certainty and will be paid" in *Naify v. Commissioner*, even

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[253] Reg. § 20.2053-1(b)(3)(iii).
[254] Reg. § 20.2053-1(b)(3)(iv).
[255] Reg. § 20.2053-1(b)(3)(iv).
[256] Reg. § 20.2053-1(d)(1).
[257] Reg. § 20-2053-1(d)(4)(i).
[258] Graegin v. Comm'r, TC Memo 1988-477 (Sept. 28, 1988).
[259] Reg. § 20.2053-3(d).

though the case was decided under the pre-2009 final regulations.[260] The Naify Estate deducted a $62 million debt on its Form 706 representing state income taxes owed by Mr. Naify to the California Franchise Tax Board. At the time the Form 706 was filed, the estate had just received a notice from the Franchise Tax Board that Mr. Naify's S corporation return was under audit. The estate ultimately settled with the California Franchise Tax Board for $26 million, which is what the IRS allowed as a deduction. But the estate subsequently filed a refund claim estimating the value of the potential liability at the time of filing the Form 706 to be $47 million.

The District Court held that no deduction was allowable in excess of the amount paid because the excess was not ascertainable with reasonable certainty. Too many post-death events would have to occur to fix the amount of the liability. A number of potential outcomes were possible, ranging anywhere from zero to $62 million. In addition, the Ninth Circuit had well established that post-death events must be considered in a disputed claim and the court refused to allow a deduction in excess of the amount ultimately paid.[261] The court also applied the doctrine of judicial estoppel to preclude Naify from obtaining a double benefit by taking inconsistent positions. That is, by structuring his affairs to avoid California income taxes, yet taking the opposite position with the IRS that his state income tax position was unsustainable, subjecting him to California income taxes.

In another recent case, *Foster v. Commissioner*, the Tax Court also denied a deduction under § 2053 for a claim against Mrs. Foster's estate by beneficiaries of an ESOP who claimed that Mrs. Foster's deceased husband had breached his fiduciary duty as trustee of the ESOP.[262] Because her taxable estate included property that was the subject of his alleged breach, the ESOP beneficiaries sought to impose a constructive trust on those assets. Mrs. Foster's executor deducted $14.7 million on Form 706, representing the value of the ESOP claim. Four months after Mrs. Foster died, however, the ESOP beneficiaries released their claims against her estate and the Marital Trusts. The Tax Court denied the $14.7 deduction because it found that the claim was not ascertainable with reasonable certainty on Mrs. Foster's death. The $8.1 discrepancy between the estate's expert and the IRS's expert was viewed as a "prima facie indication of the lack of reasonable certainty."

On the same day that *Foster* was decided, the Tax Court also decided *Saunders v. Commissioner*.[263] Mrs. Saunders died while a lawsuit was pending against her deceased husband, who was a lawyer. He had been sued by one of his clients for malpractice, breach of confidence, breach of duty of loyalty, and fraudulent concealment for allegedly informing the IRS that his client maintained a Swiss bank account. Her executors claimed a $90 million deduction under § 2053 for the compensatory and punitive damages claimed in the lawsuit. The jury ultimately found that the estate was not the legal cause of the client's damages and awarded costs of $289,000 to the estate. Before the trial the parties had exchanged settlement offers ranging from $250,000 to $2.6 million. During trial, the experts' reports suggested values ranging from $19.3 to $30 million. The Tax Court considered this wide range of values as "prima facie indications of the lack of reasonable certainty" under Reg. § 20.2053-1(b)(3). In addition, none of the experts

[260] Naify Revocable Trust v. United States, 106 AFTR 2d 2010-6236 (9/8/10), *aff'd* 109 AFTR 2d 2012-969 (9th Cir. 2012).
[261] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).
[262] Foster v. Comm'r, T.C. Memo 2011-95 (Apr. 28, 2011).
[263] Saunders v. Comm'r, 136 T.C. No. 18 (Apr. 28, 2011).

opined that any amount would ever be paid. Because neither expert's proof satisfied the legal standard, the Tax Court concluded that the claim was not deductible.

b. Claims and Counterclaims

To be deductible under § 2053, a claim against a decedent's estate must exist at the time of the decedent's death.[264] Amounts must be enforceable and actually paid or be ascertainable with reasonable certainty and will be paid. No deduction may be taken for a claim that is contested by the estate, except for claims with counterclaims and small claims totaling $500,000 or less.[265]

The regulations do not apply to claims against a closely held entity owned by the decedent. Nonetheless, such claims can significantly reduce the value of the entity included in the decedent's gross estate. For example, a lawsuit for employment discrimination against the decedent's wholly owned corporation would necessarily diminish the value of the closely held entity. Similarly, a claim for environmental contamination against a family investment partnership would diminish the value of the family partnership included in the decedent's estate, yet not be subject to the requirement that such claims be paid. The final regulations do not address such embedded claims.

To the extent the estate includes an asset involving a substantially related matter to the claim, the executor may deduct the claim, even though payment has not been made, provided that the claim is enforceable, there is a qualified appraisal, and the aggregate value of the related asset included in the decedent's gross estate exceeds 10 percent of the decedent's gross estate.[266] If a deduction is claimed on Form 706 and is not paid by the time of the final audit and is not ascertainable with reasonable certainty, the deduction may not exceed the current value of the claim taking into account post-death events.[267]

c. Claims Less Than $500,000

Enforceable claims existing at the date of death not exceeding $500,000 in the aggregate may be deducted on Form 706 even if contested and not paid, provided there is a qualified appraisal of the claim.[268] A claim is not eligible for this provision unless the entire amount of the claim is covered within this cap. For example, if the estate had three claims against it for $200,000 each, the executor may only deduct two of these claims because the aggregate value of all three would exceed $500,000.[269] If the claim is unpaid by the conclusion of the IRS audit, it either must be reasonably ascertainable and the IRS must be convinced that it will be paid, or the executor must obtain a current valuation of the claim.[270] If the claim is disallowed, the executor may file a protective claim for refund and notify the IRS when payment is finally made.

d. Recurring Payments

Recurring payments that are enforceable and noncontingent are deductible if the amount can be determined with reasonable certainty and will be paid. A recurring payment that is

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[264] Reg. § 20.2053-4(a)(1).
[265] Reg. § 20.2053-4(d)(2).
[266] Reg. § 20.2053-4(b)(1).
[267] Reg. § 20.2053-4(b)(3).
[268] Reg. § 20.2053-4(c)(1).
[269] Reg. § 20.2053-4(c)(3), Ex. 2.
[270] Reg. § 20.2053-4(b)(3).

contingent on the death or remarriage of the claimant will be deductible if measured according to actuarial principles and factors in the transfer tax regulations. An interest dependent upon marriage or remarriage cannot be valued under the regular mortality tables. However, IRS and the courts have approved use of the American Remarriage Table, which shows the probability of a widow's remarriage, for computing the value of future payments dependent upon remarriage. [271] If a special factor is required to value an interest, IRS will furnish the factor upon a request for a ruling along with all the relevant facts and documents.[272] From a practical standpoint, there may not be much difference in value between an annuity contingent on death or remarriage and one contingent only on death because a divorced person has little incentive to remarry if he or she is receiving a generous annuity.

In lieu of deducting the recurring payments, the estate may buy a commercial annuity to satisfy its obligation.[273] If the purchase is from an unrelated party the estate may deduct the amount paid for the annuity plus any additional amounts paid to the claimant.[274]

5. Potential and Contested Claims

Potential claims may not be deducted on Form 706 unless they are less than $500,000, are substantially related to a counterclaim, or may be estimated with reasonable certainty and will be paid.[275] When the claim matures, it may be deducted to the extent it otherwise qualifies if the executor files a protective claim for refund within three years of the extended due date of the Form 706. Contested claims may not be deducted unless they are less than $500,000 or are substantially related to a claim or asset included in the gross estate.[276] The executor should timely file a protective claim for contested claims that later mature.

6. Claims Against Multiple Parties

If the decedent's estate is one of several parties against whom the claim is being asserted, the estate may deduct only the portion of the claim due from and paid by the estate, reduced by any reimbursement from another party, insurance, or otherwise.[277] The estate's deduction is also reduced by any amount the estate could have collected from another party or an insurer, but which the estate declines or fails to attempt to collect.[278] However, the estate's deduction will not be reduced by a potential reimbursement if the estate provides a reasonable explanation of why the burden of collection efforts will outweigh the anticipated benefit from those efforts.

7. Claims Founded on a Promise

Claims founded on a promise or agreement are deductible only to the extent that the promise or agreement was bona fide and in exchange for "adequate and full consideration in money or money's worth."[279] This does not apply to charitable pledges or subscriptions.[280] The

[271] Reg. § 20.2053-4(d)(6).
[272] Reg. § 20.2053-4(d)(6)(i); Reg. § 20.2031-7T(d)(4).
[273] Reg. § 20.2053-4(d)(6)(iii).
[274] *Id.*
[275] Reg. § 20.2053-4(d)(1).
[276] Reg. § 20.2053-4(d)(2).
[277] Reg. § 20.2053-4(d)(3).
[278] Reg. § 20.2053-1(d)(3).
[279] IRC § 2053(c)(1)(A); Reg. § 20.2053-4(d)(5).

Ninth Circuit recently evaluated whether "love and affection" can be "adequate and full consideration" to support a contractual agreement in a palimony suit in *Estate of Shapiro v. United States*.[281] Cora Jane Chenchark sued Bernard Shapiro in Nevada district court claiming breach of express and implied contract after learning that her live-in companion of 22 years was involved with another woman. Shapiro died during the pendency of the suit. The jury found that no contract existed and Cora Jane appealed.

In the meantime, the estate paid Cora Jane $1 million to settle her claim and sued the IRS in federal district court for a $3.5 million estate tax refund based on an $8 million deduction for the estimated value of Cora's claim at the time of Shapiro's death.[282] The court ruled against the estate on the basis that love, support and management of Shapiro's household were not sufficient consideration to support a contractual agreement to support Cora the rest of her life and thus the money she sought was a gift. But on Appeal, the Ninth Circuit reversed the federal district court on the grounds that nonmarital cohabitation agreements had gained widespread social acceptance in California and Arizona, and thus the Nevada Supreme Court would likely uphold the contract for support. In any event, the value of the cohabitation services was a factual issue that precluded summary judgment. Thus the Court reversed and remanded the case to the district court for a determination of value and consideration of administrative expenses.

8. Reimbursements

For estates of decedents dying on or after October 20, 2009, new rules apply to reimbursements. An estate tax deduction is not allowed for a claim or expense to the extent that the claim or expense is, or could be, compensated for by insurance, or otherwise could be reimbursed. If the executor is able to establish that only a partial reimbursement could be collected, then only that portion of the potential reimbursement that reasonably could have been expected to be collected will reduce the deductible portion of the claim or expense.

An executor may certify on the estate's Form 706 that the executor neither knows, nor reasonably should have known, of any available reimbursement for a claim or expense. A potential reimbursement will not reduce the deductible amount of a claim or expense to the extent that the executor provides a reasonable explanation, on Form 706, that the cost of pursuing the reimbursement would outweigh the anticipated benefit from those efforts. Nevertheless, even if a reasonable explanation is provided, later events (including actual reimbursement) occurring within the 3-year statute of limitations will be considered in determining the amount of any deductible claim or expense.[283]

9. Protective Claims

If the IRS disallows a deduction because it was not paid by the conclusion of the Form 706 audit, the estate may file a protective refund claim. A protective claim preserves the estate's right to deduct a payment that is contingent on future events and may not be determinable until after the statute of limitations expires. A protective claim may be filed where an amount is not yet paid or when there is litigation pending that may impact the amount of a claim. If a pending

[280] Reg. § 20.2053-5(a)

[281] Estate of Shapiro v. United States, 634 F.3d 1055 (9th Cir 2011).

[282] Note that the regulations under § 2053 requiring payment of a claim before allowing a deduction were not yet in effect at this time.

[283] Reg. § 20.2053-1(d)(3).

claim is payable out of a share that is eligible for the charitable or marital deduction, neither the charitable nor the marital deduction will be reduced by the claim or expense until the amount is actually paid or otherwise meets the requirements for deducting expenses and claims on Form 706.[284] Without this rule, the estate would be required to reduce the marital or charitable deduction for the amount of the claim, which could cause the estate to incur an estate tax.

Alternatively, if the amount can be deducted on the estate's income tax return, Form 1041, that may be just as good since the income and estate tax rates are both 35 percent in 2010-2012. In addition, after 2012 the combined income and Medicare tax rates reach 43.4 percent (39.6 + 3.8), making it even better to deduct expenses on Form 1041, assuming the estate tax rates remain at 35 percent. Deducting expenses on Form 1041 that could be claimed on Form 706 requires a waiver to be attached to Form 1041 waiving the right to deduct the items on Form 706.[285] Keep in mind, however, that some estate administration expenses claimed on Form 1041 may be subject to the 2-percent floor on miscellaneous itemized deductions under § 67(e). Another factor that may favor a Form 706 deduction is that the IRS pays interest on refund claims. The current IRS interest rate on overpayments is 3 percent, calculated from the due date of Form 706 to 30 days before the refund check.[286]

A claim for refund must be filed before the statute of limitations on the return expires, which is generally three years from the due date (including extensions) of the Form 706. The claim need not specify a particular dollar amount. However, it must identify each claim or expense that would have been deductible if paid and describe the reasons and contingencies delaying the payment.[287] Where the deductions span several years, such as interest on a long term loan, the claim should identify each year that interest will be paid in order to properly put the IRS on notice.[288]

The Internal Revenue Manual describes the procedures for filing and processing protective refund claims.[289] They are the same as for filing a normal claim. The words "Protective Claim" may be written at the top of the form and a detailed description of the amounts and years involved should be attached. Protective claims for refunds of estate and gift taxes should be made on Form 843 filed with the IRS District in which the tax was paid.[290] The claim should always be hand delivered to the nearest IRS office or sent by certified mail. Courts have allowed taxpayers to file protective claims for refunds without using the proper form.[291] However, an amended Form 706, U.S. Estate Tax Return has been rejected as a valid protective claim where it failed to specify each future year that would be covered by the claim. [292] Claims should be filed within three years from the extended due date of Form 706.[293] This period cannot be extended.[294]

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[284] Reg. § 20.2053-1(d)(5)(ii).

[285] Reg. § 1.642(g)-1.

[286] Reg. § 301.6611-1(g); Rev. Rul. 2012-8, 2012-13 IRB 553 (Feb. 23, 2012).

[287] Reg. § 20-2053-1(d)(5).

[288] Axtell v. United States, 860 F. Supp. 795 (Dist. Ct. WY 1994).

[289] IRM 21.5.3.4.7.3 (10-01-2002); *see also* IRM 4.10.8.9.4.1 (8-11-2006); IRM 4.75.4.7.5 (2-01-2003); IRM 25.6.6.5.5 (5-17-2004).

[290] Reg. § 301.6402-2(c) (form to file); Reg. § 301.6402-2(a)(2) (where to file).

[291] U.S. v. Kales, 314 U.S. 186 (1941).

[292] Axtell v. United States, 860 F. Supp. 795 (D. WY 1994).

[293] IRC § 6511(a); Reg. § 20.2053-1(d)(5); Reg. § 301.6402-2(a).

The IRS recently published Rev. Proc. 2011-48 outlining how protective claims for refund under § 2053 should be handled.[295] The Service plans to publish new Schedule PC as part of the 2012 version of Form 706. A separate Schedule PC should be prepared for each claim. Decedents dying before January 1, 2012 must use Form 843 to file a protective claim. Estates of decedents dying on or after January 1, 2012 may use either Form 843 or Schedule PC. Whichever form is used, the executor should write at the top "Protective Claim for Refund under Section 2053." Sufficient detail should be attached to clearly identify the claim, including an explanation of the reason and contingencies delaying the actual payment.

Once the claim has "ripened" by payment of the claim, the estate should notify the IRS on a Supplemental Form 706 marked "Supplemental Information – Notification for Consideration of Section 2053 Protective Claim(s) for Refund Filed on [Date of Protective Claim]." The estate can also notify the IRS by filing Form 843 marked "Notification for Consideration of Section 2053 Protective Claim(s) for Refund Filed on [Date of Protective Claim]." The IRS may either accept, reject, or fail to act on the claim. If the IRS rejects the claim, the taxpayer may sue for a refund in district or claims court within two years of the mailing by the Secretary of the notice if disallowance of the claim.[296] If the IRS fails to act on the claim, the taxpayer may sue any time after 6 months from the date of filing the claim.[297]

The IRS has promised in Notice 2009-84 to limit its review of the Form 706 to the items covered by the protective claim rather than seek offsetting deductions for items not covered by the claim, unless there is fraud, malfeasance, collusion, concealment, or the misrepresentation of a material fact.[298] However, the promise may be illusory. The U.S. Supreme Court has held in *Lewis v. Reynolds* that "although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded."[299] Thus, the IRS has the authority to offset the claim with adjustments not covered by the protective claim. Even though the Tax Court requires the IRS to follow its own revenue rulings, this does not necessarily apply to IRS notices.[300] Therefore, a protective claim filed in reliance on Notice 2009-84 may not prevent the IRS from raising other issues on the estate tax return to reduce or eliminate the refund claim.

If after filing the protective claim, the executor changes his mind and decides to deduct the item on Form 1041 instead of Form 706, the executor must attach a statement to Form 1041 waiving the right to claim the deduction on the Form 706. Although this will necessarily defeat the protective claim, it may be just as beneficial to deduct the expenses on Form 1041 after 2012 when the combined Medicare and income tax rates for estates and trusts are 43.4 percent compared to perhaps 45 percent for estate taxes.

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[294] IRC § 6501(c)(4).

[295] Notice 2011-48, 2011-42 IRB 527 (Oct. 14, 2011).

[296] IRC § 6532(a); Reg. § 301.6532-1(a).

[297] *Id.*

[298] Notice 2009-84, 2009-44 I.R.B. 592 (October 16, 2009).

[299] Lewis v. Reynolds, 52 S. Ct. 145 (1932).

[300] Rauenhorst v. Comm'r, 119 T.C. 157 (Oct. 7, 2002).

B. Special Rules for Expenses of Administering the Estate

Administration expenses must be actually and necessarily incurred in the administration of the estate in order to be deductible.[301] That is, they must be incurred in the collection of assets, payment of debts, and distribution of property to persons entitled to it.[302] Expenses incurred in administering property not subject to claims (nonprobate property) are deductible only if paid before the expiration of the statute of limitations on the estate tax return.[303] "Property subject to claims" is not limited to probate property or property that passes under the will. Rather, it means property that is included in the taxable estate that would bear the burden of payment of administration expenses in the final adjudication and settlement of the estate.[304]

Included in administration expenses are executor's commissions, attorney fees, and miscellaneous expenses. Miscellaneous expenses include court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, and the cost of preserving and distributing the estate, including storing and maintaining the estate property.[305] They also include expenses for selling property and defending the estate against claims.[306] Expenses for selling property of the estate are deductible if the sale is necessary to pay the decedent's debts, administration expenses, or taxes, to preserve the estate, or to effect distribution.[307]

Interest accrued after death, except for interest deferred under IRC § 6166, may be deductible either as an estate tax administration expense under § 2053 or as an income tax deduction.[308] The estate must show that the interest is actually and necessarily incurred because it lacks liquidity and a sale of illiquid assets would result in significant losses.[309] Interest paid to related parties is subject to closer scrutiny.[310] Loans must also generally preclude prepayment because prepayment would render any estimate of future interest vague and uncertain.[311] In *Stick v. Commissioner* the Tax Court found that interest on a 10-year loan from the Stick Foundation was not deductible because the estate had sufficient liquidity on the face of its Form 706 to pay its estate taxes and all of its other debts without borrowing the money.[312] The record showed that the estate had $1,953,617 in liquid assets and $1,723,799 of debts, excluding the interest expense. Because its liquid assets exceeded its debts by $229,818, it was not entitled to deduct its interest expense under § 2053.

Contrast *Keller v. United States* in which the Texas District Court allowed a $52,018,200 interest expense deduction under § 2053 because the loan was "a necessary measure to preserve

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[301] Reg. § 20.2053-3(a).
[302] *Id.*
[303] IRC § 2053(b); Reg. § 20.2053-8(a).
[304] IRC § 2053(c)(2); Keller v. United States, 106 AFTR 2d 2010-6309 (Sept. 14, 2010).
[305] Reg. § 20.2053-3(d)(1).
[306] Reg. § 20.2053-3(d)(2), (3).
[307] Reg. § 20.2053-3(d)(2).
[308] IRC § 2052(c)(D); Reg. § 20.2053-4(e)(2).
[309] Keller v. United States, 106 AFTR 2d 2010-6309 (Sept. 14, 2010), *aff'g* 104 AFTR 2d 2009-6-15 (D.C. Tex. 2009) and 96 AFTR 2d 2005-6736 (D.C. Tex. 2005).
[310] Graegin v. Comm'r, 56 T.C.M. 387 (1988); TAM 200513028; Rev. Rul. 84-75, 1984-1 CB 193.
[311] *Id.*
[312] Stick v. Comm'r, T.C. Memo 2010-192 (Sept. 1, 2010).

the liquidity of the estate."[313] The executors had liquidated bonds to pay the estate taxes, but then issued a note to the partnership when they realized that the bonds were partnership property. The government argued that the loan was unnecessary because the assets were already liquidated before the loan was executed. A similar result was reached in *Murphy v. United States* where the District Court upheld the estate's interest deduction under § 2053(a).[314] The IRS argued that the interest and underlying loan were unnecessary because they arose out of the estate's tax-avoidance transfer to the family partnership that lacked a legitimate non-tax reason. However, the court found that the interest was deductible because the estate tax deficiency that it was incurred to pay was caused not by the decedent's wealth depletion transfers, but by the changing values of various assets inside and outside the partnership. The court, therefore, upheld the interest deduction as a necessary administration expense under § 2053.

Another recent taxpayer victory on interest deductions was *Duncan v. Commissioner*.[315] The decedent had used a revocable trust for his estate planning. When he died, he exercised a power of appointment over a trust created by his father to place assets into irrevocable trusts that were nearly identical to his revocable living trust. The revocable and irrevocable trusts had the same trustees and same beneficiaries, etc. Because the assets in the revocable trust were illiquid, consisting of oil and gas businesses, it borrowed $6.5 million from the irrevocable trusts to pay the estate tax. The loan was a 15 year balloon note that prohibited prepayment. When the estate deducted 15 years worth of interest ($10.7 million) on the estate tax return, the IRS objected on the basis that the loan would probably be prepaid, there being no incentive for the irrevocable trust to enforce the prepayment penalty. However, the IRS upheld the interest deduction on the basis that the two trusts were separate entities under state law with separate fiduciary duties that had to be respected. The illiquid revocable trust should not be expected to sell its assets at a discount to the liquid irrevocable trust.

Interest on a pecuniary bequest is generally not deductible under § 2053 unless the delay was reasonable and necessary. In the *Estate of Turner,* according to the will, the executor could not distribute the estate until it had confirmed the beneficiary's status as a qualified organization under § 2055.[316] Therefore, the two and a half year delay was actually and necessarily incurred in the administration of the estate and the interest was deductible under § 2053. Letter Ruling 9604002 held to the contrary and denied a deduction for interest paid on a delayed pecuniary bequest because interest under Pennsylvania law was intended to compensate the beneficiaries for administrative delays, not as an expense of administering the estate. The Service maintains that interest on pecuniary bequests is nondeductible personal interest for income tax purposes.[317]

A controversy exists over the deductibility of interest on loans acquired by the decedent before his death. The Tax Court has ruled that such interest is deductible if it was actually and necessarily incurred and allowable under local law.[318] The IRS, however, views interest paid after a decedent's death on debt incurred by him before death as nondeductible if the debt was

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[313] Keller v. United States, 106 AFTR 2d 2010-6309 (Sept. 14, 2010), *aff'g* 104 AFTR 2d 2009-6-15 (D.C. Tex. 2009) and 96 AFTR 2d 2005-6736 (D.C. Tex. 2005).

[314] Murphy v. United States, 104 AFTR 2d 2009-7703 (D.C. AR).

[315] Duncan v. Comm'r, T.C. Memo 2011-255.

[316] Turner v. United States, 306 F Supp 2d 668 (Jan. 30, 2004).

[317] Reg. § 1.663(c)-5, Ex. 7.

[318] Webster v. Comm'r, 65 TC 968 (Feb. 12, 1976).

not necessary to the estate administration.[319] In Revenue Ruling 77-461, the IRS argued that the interest would have been incurred if the decedent had continued to live and, therefore, it was not necessary to the estate administration. However, the IRS noted that if the executor had modified the terms of the debt (obtained an extension of the repayment, etc.) any *additional* interest incurred as a result of modification would have been deductible if allowable under local law.

Interest paid to the government on late filed estate tax returns and estate tax deficiencies is also deductible as an administration expense.[320] Interest paid on a fraud penalty for willful failure to disclose assets on the estate tax return was held to be deductible for the amounts actually paid or accrued, provided it was deductible under local law and the expense was incurred for the benefit of the estate.[321] However, penalties are not deductible.[322] Nor is interest on deferred estate tax attributable to a closely held business under § 6166 for decedents dying after December 31, 1997.[323] Instead, a special reduced rate applies to the deferred estate tax.

C. Charitable Pledges

Charitable pledges are deductible under § 2053 if they are enforceable under local law and would have been allowed as a deduction under § 2055 if it had been a bequest.[324] Therefore it is important to check local law to determine the enforceability of the pledge. Nonetheless, the pledge must be paid by the conclusion of the IRS audit of Form 706 or it will be disallowed.

VII. Executor Liability

A. Notice of Fiduciary Responsibility - Form 56

Executors should routinely file Form 56, Notice Concerning Fiduciary Relationship, with the IRS. This form puts the IRS on notice to send all tax due notices concerning the decedent to the executor so that the executor does not unwittingly distribute estate assets before the tax liabilities are paid. Form 56 is also used to notify the IRS that the fiduciary relationship has ended. The executor should attach proof of his authority, such as letters testamentary, to Form 56. The new revised version of Form 56 (Dec. 2011) states that Form 56 is not necessary if the fiduciary is also the authorized representative of the estate. Instead, Form 2848, Power of Attorney and Declaration of Representative should be used. Previously the IRS would reject a Form 2848 Power of Attorney unless it was accompanied by a Form 56.

B. Failure to File or Pay Estate Tax - § 6018 and § 6651

Section 6018(a) requires the executor to file a return containing specific information about property of decedents. The return is due 9 months after the date of death.[325] The IRS will grant an automatic 6-month extension if requested by the due date on Form 4768.[326] The IRS may also grant an extension even if the estate did not file an automatic extension request on Form 4768 by

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[319] Rev. Rul. 77-461, 1977-2 CB 324.

[320] Rev. Rul. 81-154, 1981-1 C.B. 470; Rev. Rul. 79-252, 1979-2 C.B. 333; Rev. Rul. 69-402, 1969-2 C.B. 176.

[321] FSA 199910003.

[322] Rev. Rul. 81-154, 1981-1 C.B. 470.

[323] IRC § 2053(c)(1)(D).

[324] Reg. § 20.2053-5(a).

[325] IRC § 6075(a).

[326] Reg. § 20.6081-1(b).

the due date if the estate shows good and sufficient cause.[327] Note that this does not allow additional extensions for those who have received an automatic extension.[328]

When an estate does not file a required return by the due date (including extensions), § 6651(a)(1) imposes a penalty of 5 percent of the *net tax due* for each month or part thereof that the return is late, up to a maximum of 25 percent. The *net tax due* is the tax liability shown on the return less any tax paid on or before the due date for payment, and less any credits allowed.[329] Thus, a deficiency assessed after the return is filed is subject to the late filing penalty.[330]

The extension of time to file does not extend the time to pay. An extension of time to pay all or part of the estate tax may be granted for a reasonable period of time, not to exceed 12 months, if the facts and circumstances indicate there is reasonable cause for the extension.[331] The failure to pay penalty is ½ of 1 percent per month. An estate that both files late and pays late can be subject to both penalties. For any month in which both penalties apply, the failure to file penalty is reduced by the failure to pay penalty. The combined penalty cannot exceed 5 percent per month or 47 ½ percent of the net tax shown on the return.[332] However, both the failure to file and accuracy-related penalties can apply to the same return.[333] The accuracy-related penalty only applies if the return is actually filed.

The penalty can be waived if the executor can show that his late filing was due to reasonable cause and not willful neglect. The regulations provide that, to demonstrate reasonable cause a taxpayer must show that it "exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time ..."[334] Examples of reasonable cause might include error by the postal service, death or serious illness of the taxpayer or a member of his family, and destruction of the taxpayer's business records or place of business by fire or other casualty. However, in *United States v. Boyle*, the Supreme Court held that a taxpayer's failure to file a timely return or the proper form, in reliance upon an attorney's advice was not "reasonable cause" under § 6651(a)(1).[335] Establishing a bright line rule, the Supreme Court held that the taxpayer's duty to file a timely return is nondelegable and consequently, reliance on an agent is no excuse.

Citing *Boyle*, the District Court of Pennsylvania recently upheld the failure to file (but not the failure to pay) penalty against the executor in *Freeman v. United States.* Here the executor had relied on an attorney to file the return. But the attorney failed to do so because of serious physical and mental ailments. He also embezzled money from the estate.[336] The court held that the attorney's disability might explain why the return was not filed on time, but it did not excuse

[327] Reg. § 20.6081-1(c).
[328] Dickow v. United States, 654 F. 3d 144 (1st Cir. 2011), *cert. denied* 2012 WL 33359 (Jan. 9, 2012).
[329] IRC § 6651(b)
[330] Reg. § 301.6651-1(a)(3).
[331] IRC §6161(a(2); Reg. § 20.6161-1(a)(1).
[332] Gerdes v. United States, 46 AFTR 2d 80-6188 (Aug. 20, 1980).
[333] Reg. § 1.6662-2(a).
[334] Reg. § 301.6651-1(c)(1).
[335] United States v. Boyle, 105 S.Ct. 687, 693-94 (2005).
[336] Freeman v. United States, 109 AFTR 2d 2012-723 (Oct. 2011); *see also* Baccei v. United States, 107 AFTR 2d 2011-898 (9th Cir. 2011).

the executor's failure to file. Further, it is reasonable to rely on an attorney's legal advice, but not on his advice about ordinary matters such as the due date of the return.

C. Early Determination and Release of Personal Liability for Estate Tax - § 2204

The IRS normally has 3 years after an estate tax return is filed to assess the tax and demand payment.[337] The 3 year period applies even after receipt of a closing letter. The executor is personally liable for the decedent's estate tax and so is any person in possession of the decedent's property up to the value of the property under his control. The executor may request a determination of the amount of tax and discharge from personal liability by attaching Form 5495 to the Form 706 or filing it separately within the 3 year statute of limitations. The executor may also use his own format as long as it contains the information required on Form 5495.[338] The IRS will notify the executor of the amount of tax due within 9 months from the later of the application date or the due date of the Form 706.[339] If a fiduciary other than the executor files the application, the time period is reduced to 6 months.[340] Upon payment of the amount so notified (except for amounts deferred under §§ 6161, 6163, or 6166), the fiduciary is discharged from personal liability for any estate tax deficiency later found to be due.

The executor's personal liability for estate taxes is not dischargeable in bankruptcy.[341] A debtor is not relieved "from any debt-- . . . for fraud or defalcation while acting in a fiduciary capacity."[342] An executor has been held to have a fiduciary duty under common law to pay the estate's federal estate taxes.[343] However, courts have absolved the executor from personal liability where the executor paid administrative expenses and made distributions before paying the estate taxes. In *U.S. v. McLendon* the government failed to establish that the executor knew or should have known that the estate assets would be insufficient to pay the estate taxes when he made the payments. In addition, the IRS had failed to perfect its tax liens in a timely manner and thus they were inferior to other debts that the executor paid.[344]

D. Personal Liability of Trustee for QDOT Tax - § 2056A(b)(6)

Each trustee (and not solely the United States trustee) of a QDOT is personally liable for the deferred estate tax.[345] For multiple QDOTs with respect to the same decedent, the trustee of each trust is personally liable for the amount of the deferred estate tax imposed on any taxable event with respect to that trustee's QDOT, but is not personally liable for tax imposed with respect to taxable events involving QDOTs of which that person is not a trustee. However, the assets of any QDOT are subject to collection by the IRS for any tax resulting from a taxable event with respect to any other QDOT established with respect to the same decedent.

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337 IRC § 6501(a).
338 Instructions to Form 5495 (rev. 12-2008).
339 IRC § 2204(a).
340 IRC § 2204(b).
341 Carroll v. U.S. 2009-2 USTC ¶60,577 (N.D. Ala. 2009).
342 11 U.S.C. § 523(a)(4) (2005).
343 United States v. Tomlin, 88 A.F.T.R.2d ¶ 2001-5334 (N.D. Tex. 2001).
344 United States v. McLendon, 84 AFTR 2d 99-5714 (N.D. Tex 1999).
345 IRC § 2056A(b)(6); Reg. § 20.2056A-11(d).

E. Prompt Assessment of Decedent's Income and Gift Tax Liability - § 6501(d)

The executor may request a prompt assessment of any tax for which the decedent or his estate was required to file a return.[346] This includes income, gift, employment, or excise taxes. However, the prompt assessment under § 6501(d) does not apply to estate taxes or in the case of fraud, willful attempt to evade tax, failure to file a return, gifts omitted from a return, or omissions of more than 25 percent of the gross estate or amount required to be shown on a gift tax return.

The executor may use Form 4810 to request prompt assessment or he may use his own format.[347] But he may not file a request until the returns for which he is seeking prompt assessment are filed. In other words, he cannot request a prompt assessment in the case where no return is filed. Upon the representative's request for prompt assessment, the IRS will assess the tax within 18 months. This gives the executor an idea of the potential taxes so that he does not over distribute the estate causing himself personal liability under § 6905. It is this author's experience that a request for prompt assessment of the decedent's income taxes does not trigger an IRS audit.

The executor can also order a transcript or a copy of the decedent's prior income and gift tax returns by filing a Form 4506-T or Form 4506, Request for Copy of Tax Form. If the IRS has not advised the executor of any action with respect to unpaid taxes within 18 months of the executor's request for prompt assessment under § 6501(d), the executor may distribute the estate assets without personal liability for any unpaid taxes unless he has personal knowledge of the debt or knowledge that would put a reasonably prudent man on inquiry.[348]

F. 6-Year Statute of Limitations - § 6501(e)

The basic statute of limitations for the IRS to assess an income, estate or gift tax deficiency is three years from the later of the due date of the return or the date on which it was filed.[349] While this period can be extended by agreement between the taxpayer and the IRS for income and gift taxes, it cannot be extended for estate taxes.[350] However, if the return contains "substantial omissions," the limitations period is six years from the date of filing. There is a substantial omission in the case of income tax if the taxpayer omits from gross income an amount in excess of 25 percent of the amount stated on the return.[351] In the case of omitted income attributable to foreign financial assets required to be reported under § 6038D, there is a 6-year statute of limitations for an omission of $5,000 or more of income.[352]

There is substantial omission in the case of estate and gift taxes if the taxpayer omits from the gross estate, or from the total amount of gifts made during the period, more than 25 percent of the gross estate or the total amount of gifts stated on the return.[353] It doesn't take much to exceed this 25 percent limit if the executor claims aggressive discounts. Thus an executor can be

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[346] IRC § 6501(d).
[347] Instructions to Form 4810 (rev. 2-2009).
[348] Rev. Rul. 66-43, 1966-1 C.B. 291.
[349] IRC § 6501(a).
[350] IRC § 6501(c)(4).
[351] IRC § 6501(e)(1)(A).
[352] IRC § 6501(e)(1)(A)(ii).
[353] IRC § 6501(e)(1), (2).

liable for unpaid taxes for as long as 6 years or more from the date of filing the decedent or the estate's various tax forms.

G. Fiduciary and Transferee Liability for Unpaid Income, Estate, and Gift Taxes - § 6901

If an executor or trustee pays a debt of the decedent or the estate before paying a claim of the U.S. Government, the fiduciary is liable to the extent of the payment for unpaid claims of the Government.[354] Thus, the executor may be personally liable for the decedent's unpaid income, estate, and gift taxes, interest, and penalties, even if the liability had not been assessed at the time of death, if the executor makes a distribution that causes the estate to be unable to pay the decedent's tax obligations.[355] The executor does not need actual knowledge of the tax liability before personal liability can be imposed. It is sufficient that the executor has "such knowledge as would put a reasonably prudent man on inquiry."[356] However, if he has neither personal knowledge of an unpaid tax liability of decedent nor has such knowledge as would put a reasonably prudent man on inquiry, he cannot be held personally liable.[357]

Transferees of a decedent's property can also be personally liable for the decedent's unpaid income, estate, and gift taxes up to the value of probate and non-probate assets they receive.[358] Transferee liability also extends to the donee of a gift within three years of the decedent's death even though the gifted asset itself is not brought back into the decedent's estate under § 2035.[359] The transferee is also liable for interest on unpaid estate taxes. However, the cases have not been consistent on whether the limit on transferee liability is the value of property at the time of the decedent's death or the value plus interest accrued on tax deficiency.[360]

The IRS has one year after the statute of limitations expires on the estate tax return to assess a liability on the transferee.[361] However, if there are no transfers to beneficiaries within the 3 year statute of limitations for assessment of the estate tax, they can have no transferee liability.[362]

Considering all the possible penalties in the Code, the executor could potentially be liable for a significant amount. For example, he could be liable for the decedent's failure to report foreign bank accounts and foreign financial assets, failure to file Forms 3520 and 3520-A with respect to foreign trusts, failure to file all required Forms 1099, failure to pay taxes on domestic employees, and failure to file regular income tax returns. In CCA 201208028 the IRS held that the executor "stepped into the decedent's shoes" and assumed the penalty for the decedent's

[354] IRC § 6901; 37 U.S.C.A. § 3713(b).

[355] Rev. Rul. 79-310, 1979-2 C.B. 404 (the executor of an insolvent estate is personally liable under § 6901 if he satisfies the decedent's state income taxes, debts to general creditors, and mortgage payments before paying the decedent's federal income taxes.)

[356] United States v. Tyler and Ruch, (2012, DC PA) 109 AFTR 2d; Rev. Rul. 66-43, 1966-1 C.B. 291.

[357] *Id.*

[358] IRC §§ 6901(a)(1); 6324(a)(2).

[359] Armstrong v. Comm'r, 114 T.C. 94 (2000).

[360] Richard M. Baptiste v. Comm'r, 29 F.3d 1533 (11th Cir. 1994); Gabriel Baptiste, Jr. v. Comm'r, 29 F.3d 433 (8th Cir. 1994), *cert. denied*, 513 U.S. 1190; Hahn, The Scope of Transferee Liability in Estate and Gift Tax Cases, 74 TAXES 72 (1996).

[361] IRC § 6901(c)(1).

[362] Illinois Masonic Home v. Comm'r, 93 T.C. 145 (1989).

failure to file Forms 3520 during his lifetime.[363] The CCA stated that if the foreign trust was only recently discovered and a prompt filing would have required some forensic accounting, there could be reasonable cause for excusing the penalty. Therefore, the executor should thoroughly examine his exposure for these items and document any reasonable defenses.

H. Discharge of Executor's Personal Liability for Decedent's Income and Gift Tax - § 6905

The executor may request a discharge from personal liability for the decedent's income or gift taxes by filing Form 5495, "Request for Discharge From Personal Liability Under IRC Section 2204 or 6905." The IRS then has nine months to notify the executor of any amount due.[364] After the nine-month period has run, the executor cannot be held personally liable for any additional income or gift taxes of the decedent. However, the 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.

I. Request for Release of Estate Tax Lien - §§ 6324 and 6325

If an estate tax liability remains unpaid, an automatic estate tax lien arises under § 6324(a)(1) on all property includible in the decedent's estate for 10 years from the date of death or until the estate tax is paid in full, whichever is sooner. This lien need not be recorded. The automatic lien does not apply to property that is designated as collateral for the deferred payment of estate tax under § 6166.[365] A separate lien applies to this property. The lien will not apply to estate property used for payment of administrative expenses and charges against the estate, including taxes.[366] The courts will apply a strict tracing requirement to determine whether the proceeds were used to pay administrative expenses and charges against the estate before releasing any lien.[367]

If probate assets are sold or transferred, they are still subject to the lien in the transferee's possession. However, if the executor has been discharged from personal liability for estate tax under § 2204, the lien attaches to the consideration received by the estate.[368] A purchaser of probate property should request either proof that the executor has been discharged from personal liability under § 2204 or that the IRS has no liens on the property. A copy of the IRS closing letter usually suffices to show a purchaser that the estate taxes have been paid and any liens have been released. However, a more cautious purchaser may request a certificate of release from the IRS. The IRS may release the lien entirely or discharge specific assets.[369]

The executor can request a discharge of specific property by filing Form 4422 if he satisfies any one of the following conditions:

(1) the remaining property in the estate is double the value owed the IRS

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[363] CCA 201208028 (3/8/12).

[364] IRC § 6905; Reg. § 301.6905-1.

[365] IRC § 6324A.

[366] IRC § 6324(a)(1).

[367] First American Title Insurance Company v. United States, 520 F.3d 1051 (9th Cir. 2008); Northington v. United States, 475 F.,2d 720 (5th Cir. 1973).

[368] IRC § 6324(a)(3).

[369] IRC § 6325(a).

(2) payment is made to the IRS equal to the value of the property being discharged

(3) the government does not have a valuable interest in the specific property, or

(4) sale proceeds are to be substituted for the discharged property.[370]

Nonprobate property is treated differently than probate property with respect to the government's liens. Nonprobate property is divested of the lien after it is transferred to a purchaser for full value or to a holder of a security interest.[371] However a substitute lien attaches to all of the transferor's other property.[372] Thus property owned by the decedent's revocable trust or in other entities can be sold or distributed after the decedent's death with less trouble than probate property. The Sixth Circuit has held that the estate tax lien did not attach to property distributed by a partnership to the estate and from the estate to the beneficiaries because the land was owned by the partnership, not the estate.[373]

J. Accuracy-Related Penalty on Underpayments - § 6662

A 20 percent penalty is imposed on an underpayment of tax attributable to a substantial estate or gift tax valuation understatement.[374] A substantial valuation understatement exists where the value of any property claimed on an estate, gift, or GST tax return is 65 percent or less of the amount ultimately determined to be the correct value.[375] For example, if the value of a share of stock claimed on the estate tax return is $65 and the ultimately determined correct value is $100, the executor may be liable for the substantial valuation understatement penalty. However, no penalty will be imposed unless the underpayment exceeds $5,000.[376]

The accuracy-related penalty also applies to any understatement of tax due to negligence.[377] This includes overstated deductions as well as valuation understatements. The penalty will not apply if the taxpayer had reasonable cause for taking the position that caused the underpayment, and acted in good faith.[378] The reasonable cause/good faith rule is applied on a case-by-case (i.e., facts and circumstances) basis. Examples of reasonable cause include an honest misunderstanding of fact or law that is reasonable in light of all facts and circumstances including the experience, knowledge, and education of the taxpayer, an isolated computation or transcription error, reliance on professional advice (i.e., an attorney, accountant, appraiser, etc.), and other situations where the taxpayer acted reasonably and in good faith.[379]

K. Other Liability Concerns

In addition to the specific statutory liabilities described above, there are numerous other ways that an executor or trustee can be liable.

[370] IRC § 6325(b).
[371] IRC § 6324(a)(2); § 6323(h)(1) (security interest defined); § 6323(h)(6) (purchaser defined).
[372] *Id*.; Rev. Rul. 56-144, 1956-1 C.B. 563.
[373] Beaty v. U.S, 937 F.2d 288 (6^{th} Cir. 1991).
[374] IRC § 6662(a), (b)(5).
[375] IRC § 6662(g)(1).
[376] IRC § 6662(g)(2).
[377] IRC § 6662(b)(1).
[378] IRC § 6664(c)(1).
[379] Reg. § 1.6664-4(b)(1).

1. Failed Disclaimers

Although the requirements for making a qualified disclaimer are fairly straightforward, it is easy to overlook some small detail that results in a failed disclaimer. It is also easy to overlook opportunities to make a disclaimer that could have saved the estate or the family a significant amount of money. Therefore, great care should be taken when considering disclaimers.

Section 2518 determines whether a disclaimer is valid whereas state law controls how the property passes when a disclaimer is made. In *Estate of Tatum v. United States*, Tatum, Jr. disclaimed property from his father's estate that he thought would pass to his children.[380] As executor of his father's estate, he distributed the disclaimed property to his children. However, the court held that under Mississippi law at the time, disclaimed property passed under the laws of intestacy. Therefore the disclaimed property passed right back to Tatum, Jr. as the only living heir of the decedent. This disqualified the disclaimer and the IRS treated it as a gift, sending Tatum, Jr. a notice of deficiency for $737,313 in unpaid gift taxes and a 20 percent negligence penalty under § 6662(c).

The notice of deficiency was issued 11 years after the property was distributed to the children under the disclaimer. Because Tatum, Jr. had not filed a gift tax return, not thinking it was a gift, there was no statute of limitations within which the IRS had to act. If Tatum, Jr. had timely filed a gift tax return reporting the disclaimer as a "non-gift," the 6 year statute of limitations would have run, preventing the IRS from assessing the gift tax.[381] Therefore, it may be good policy to report transfers of property pursuant to a disclaimer as a non-gift on a timely filed gift tax return.

Tatum had a happy ending, however. In a very short opinion, the Fifth Circuit held that the general proposition that a lapsed bequest becomes intestate property was qualified by Mississippi's anti-lapse statute (Miss. Code Ann. § 91-5-7), which provides that when the deceased beneficiary is a child of the testator, the bequest does not lapse but passes as if the legatee had survived the testator and then died intestate. In that case, Tatum Jr.'s interest would have passed to his heirs without any direction on his part, thus meeting the Code's requirement for a qualified disclaimer.[382]

2. Failure to File or Pursue a Protective Refund Claim

When the estate incurs expenses and claims that were not deducted on the decedent's Form 706, the executor should either deduct those expenses on Form 1041, if possible, or file a claim for refund of estate taxes within three years of the extended due date of Form 706.[383] If neither action is taken, the deductions are disallowed and the executor could be liable for damages equal to the lost tax refund. A lack of attention to this matter could be considered negligence.

If the executor has already filed a protective claim for a refund for expenses or claims that were paid after filing Form 706, but not deducted on the return, he should follow up on that claim even if it is past three years from the filing date of the Form 706. If the IRS fails or refuses

[380] Tatum v. United States, (No. 2:09-cv-00048) (D. MS. Oct. 6, 2010), *rev'd and rem'd* No. 1060852 (5th Cir. 2011).

[381] *See* discussion at VII.F. of this outline.

[382] Tatum v. United States, No. 1060852 (5th Cir. 2011).

[383] *See* discussion at VI.A.9. of this outline.

to act on the claim, the executor may be forced to sue in district or claims court. He can sue anytime after 6 months from filing the claim.

3. Failed Tax Elections

It is easy to overlook valuable elections or to inadvertently make them when they should not be made. Moreover, many of these decisions are made by the tax return preparer without ever consulting the client. Although there is abundant relief for late elections, this is not so for *revoking* an election. Under the "doctrine of election," the general rule is that a taxpayer who makes a proper election may not later revoke or change that election and substitute another (albeit correct) method that is more advantageous without the consent of the Commissioner.[384] However, courts have been sympathetic to allow a revocation where there has been a material mistake of fact.[385] This does not mean mere "oversight, poor judgment, ignorance of the law, misunderstanding of the law, unawareness of the tax consequences of making an election, miscalculation, and unexpected subsequent events, which have all been held insufficient to mitigate the binding effect of elections made under a variety of Code provisions."[386] If an amended return is not available to correct the error, the client should consider filing a claim against the tax preparer if the damages are more than mere timing differences.[387]

4. Errors in Apportionment

Many wills simply provide that estate taxes are to be paid from the residuary estate. If the residuary estate is not sufficient to pay these, the taxes are borne by general and specific bequests on a prorata basis. Other wills call for apportionment among the assets that make up the taxable estate. Among these wills, apportionment can either be made against all assets, or only probate assets. Some apportionment clauses are complex due to ambiguity, or difficulty in coordinating the various apportionment clauses among the will, revocable trust, and other ancillary documents that contain apportionment clauses.

One of the toughest jobs an executor has is collecting tax due from persons in control of nonprobate assets that should bear a share of the estate tax. Sometimes the decedent's will directs a secondary source for payment of the taxes, but not always. Failure to seek reimbursement from nonprobate assets has generated a fair amount of litigation.[388]

The will should give the executor as many tools as possible to collect the tax. For example, it may give the fiduciary the express right to offset other amounts due the same beneficiary. The executor could also sell assets that would normally be distributed in-kind if the beneficiary will not contribute his or her required share of estate taxes. The executor can also delay distribution until reimbursement of the beneficiary's share of the taxes is secured, such as through the purchase of a bond. The fiduciary should be granted full authority to pursue its right to

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384 Hodel v. Comm'r, T.C. Memo. 1996-348; Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982); Keeler v. Comm'r, 180 F.2d 707, 710 (10 Cir. 1950).

385 Grynberg v. Comm'r, 83 T.C. 255 (1984).

386 Estate of Stamos v. Comm'r, 55 T.C. 468, 474 (1970).

387 Camico Services, Inc., Impact, "Five Most Frequent Tax Claims" Winter 2007 (listed the fifth most common tax malpractice claim as mishandled Section 754 elections).

388 Barbara A. Sloan, "Tax Apportionment – What Would the Testator Want?" ABA Fall 2010 Joint CLE Meeting, Toronto, Canada, September 24, 2010.

reimbursement of estate taxes. If the fiduciary cannot collect the tax, he or she must decide how to apportion the taxes among the remaining beneficiaries.

5. Failure to Report Prior Gifts

The consequences of unreported prior gifts of the decedent are that the assets are included in the decedent's taxable estate, which may use up all or part of the unified credit as well as cause gift taxes to be due.[389] There is no statute of limitations on undisclosed gifts.[390] The IRS may assess the tax at any time. And the executor may be personally liable for these taxes.[391]

In addition, undisclosed prior gifts may mean the difference between having a Form 706 filing requirement and not. A return is required to be filed for the estate of every U.S. citizen or resident whose gross estate plus adjusted taxable gifts, valued at the date of death, exceeds $5,120,000 for 2012.[392] Gross estate means the value of all property included under §§ 2031-2046.[393] Thus it is computed before reduction by the decedent's debts, expenses, and claims. Therefore, executors should make a serious effort to search for undisclosed gifts and file delinquent gift tax returns.

VIII. Clawback

Most practitioners are telling their clients that they should take advantage of the $5 million gift tax exclusion (as indexed) before 2013 in case the exclusion drops to $1 million. However, clients fear that gifts made in 2011 and 2012 between $1 and $5 million may cause them to incur an estate tax on those gifts if the estate tax exclusion drops to $1 million in 2013. This tax, popularly known as "clawback" tax, does not occur at the time the gift is made because gift taxes are calculated differently than estate taxes. Gift taxes are calculated on the current year gift using the highest marginal rate in effect when the gift is made.[394] Then the gift tax is reduced by any unused gift tax credit, which is zero if the donor has fully used the prior gift tax credit. So a reduction in the unified credit does not produce a clawback tax.

The estate tax calculation, on the other hand, starts by adding the decedent's lifetime gifts to the gross estate and calculating a "tentative tax" on that base. Then we subtract from the tentative tax any "[gift] tax which would have been payable" on the gifts included in that base. The gift tax payable is the gift tax less the unified credit.[395] However, it is a *hypothetical tax* figured using the rates in effect in the year of death rather than in the year the gifts were made.[396] Unfortunately, § 2001(b) does not tell us whether to use the unified credit in the year of death or in the year the gift was made in figuring the gift tax payable.

Earlier versions of the IRS Instructions to Form 706, however, instructed us to use the unified credit in the year the gift was made. But this was technically not precise. Section 2001(b)

[389] IRC § 2001(b); IRC § 2503(a).
[390] IRC § 6501(c)(3); Reg. § 301.6501(c)-1(f).
[391] IRC § 6905(a).
[392] IRC §§ 2010(c)(3); 6018(a).
[393] IRC § 2031(a).
[394] IRC §§ 2502(a), 2505(a).
[395] IRC § 2001(b).
[396] *Id.*

does not state whether we should use the unified credit in the year of the gift or the year of death in computing the credit for gift taxes payable. As long as the unified credit is rising, the decedent will get full credit for gift taxes payable on prior gifts. But when the unified credit declines, the decedent gets a smaller credit for prior gift taxes payable than he should, which causes clawback.

EXAMPLE

> Dana died in 2013 with $1 million after making $5 million of lifetime gifts. Adding the gifts to her $1 million estate gives a tentative tax base of $6 million and a tentative estate tax of $2,940,800 using the 2001 EGTRRA tax tables and rates. Dana gets no credit for prior gift tax payable on the $5 million of gifts because the tax is zero, using the unified credit in the year of the gift. Her $2,940,800 tentative estate tax is reduced by the $345,800 unified credit on a $1 million exclusion and she pays $2,595,000 of estate tax on her $1 million estate.

Tentative estate tax on $6m ($1m taxable estate plus $5m of adjusted taxable gifts using the 55% Table)		$2,940,800
Gift tax on $5m gifts (at 55%)	2,390,800	
Unified credit on $5m(at 55%)	-2,390,800	
Credit for prior gift taxes paid		-0
Gross estate tax before the unified credit		2,940,800
Less $1m unified credit		-345,800
Estate Tax on $1m Taxable Estate (at 55%)		$2,595,000

In the calculation above, Dana owes $2,595,000 on a $1 million estate. This is clawback. It occurs solely because we used the unified credit in the year the gifts were made instead of the unified credit in the year of death to calculate her credit for prior gift taxes payable.

A. Form 706 Instructions

Initial concerns about clawback arose primarily because the 2009 and later drafts of Form 706 Instructions stated that, in calculating the gift tax payable, we should “use the unified credit [] in effect for the year the gift was made.” While the instructions correctly recognized that “tax payable as used here is a hypothetical amount and does not necessarily reflect tax actually paid” they took liberties in stating that gift taxes payable on prior gifts were figured using the unified credit in effect in the year the gift was made.[397] This statement would have been correct if the unified credit in the year of death was greater than in prior years. But it would not necessarily be

[397] Instructions for 2009 Form 706 (rev. Sept 2009), p.5; see also draft Instructions to Form 706 (Aug. 5, 2011).

true if the unified credit in the year of death declined from prior years, as could happen in 2013. Perhaps to avoid confusion, the final version of the 2011 Instructions to Form 706 remove the blanket instruction to use the prior year unified credit and instead they supply a table showing the actual credit for 1977 to 2011.

B. Impact of Sunset on Clawback

Many commentators have concluded that the EGTRRA sunset cures the clawback problem because after sunset the hypothetical gift tax payable will be determined as if EGTRRA had never been enacted. Thus, a $5 million exclusion will never have existed. There would only have been a $1 million exclusion for determining the gift tax.[398] This makes the unified credit on prior transfers only $345,800, which is the credit that would have existed if EGTRRA and the 2010 Tax Relief Act had never been enacted. Thus the decedent is allowed a credit for gift taxes paid on prior gifts to the extent the hypothetical tax exceeds $345,800.

EXAMPLE

Assume the same facts as above where Dana died in 2013 with a $1 million estate after making $5 million of lifetime gifts. We recompute her credit for gift taxes paid on the $5 million of lifetime gifts using a $1 million unified credit because this is the only credit that existed once sunset occurs. Thus, Dana receives credit for gift taxes payable on $4 million of gifts and her estate tax is only $550,000, calculated as follows:

Tentative estate tax on $6m ($1m taxable estate plus $5m adjusted taxable gifts using the 55% Table)		$2,940,800
Gift tax on $5m gifts at 55%	2,390,800	
Unified credit on $1m at 55%	-345,800	
Credit for prior gift taxes paid		(2,045,000)
Gross estate tax before the unified credit		895,800
Less $1m unified credit		-345,800
Estate Tax on $1m Taxable Estate (at 55%)		$ 550,000

[398] Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16) § 901.

As we would expect, Dana owes $550,000 of estate tax on her $1 million estate using a 55 percent top tax rate. This is consistent with the legislative history of the unified estate and gift tax transfer system enacted in 1976, which was to include lifetime gifts in the calculation of the estate tax solely for the purpose of achieving the highest estate tax bracket at death.

C. Clawback With a $3.5 Million Exclusion

It is also possible that Congress will not allow sunset to occur, but will instead simply reduce the exclusion amount from $5 million to $3.5 million, or some other amount. If this happens, there could be a clawback on prior gifts after the donor dies, unless the IRS changes its Form 706 Instructions or Congress clarifies in § 2001(b) which unified credit to use in computing the credit for prior gift taxes payable under

EXAMPLE

Assume the same facts as the example immediately above where Dana dies with a $1 million estate after making lifetime gifts of $5 million. Now assume that Congress changes the estate and gift tax exclusion to $3.5 million and increases the top estate tax rate to 45 percent. It makes no other changes to § 2001. Following the Form 706 instructions, Dana's estate tax on her $1 million estate is $1,125,000 computed as follows:

Tentative estate tax on $6m ($1m taxable estate plus $5m of adjusted taxable gifts using the 45% Table)		$2,580,800
Gift tax on $5m gifts at 45%	2,130,800	
Unified credit on $5m at 45%	-2,130,800	
Credit for prior gift taxes paid		-0-
Estate tax before the unified credit		2,580,800
Less $3.5m unified credit at 45%		-1,455,800
Estate Tax on $1m Taxable Estate (at 45%)		$1,125,000

Because we calculated Dana's credit for prior gift taxes paid using the $5 million exclusion amount in effect in the year the gifts were made, rather than the $3.5 million exclusion amount in effect in the year of death, she owes a $1,125,000 estate tax on her $1 million estate.

But if we had used the $3.5 million exclusion amount in effect in the year of her death to calculate her credit for prior gift taxes paid, she would get credit for hypothetical gift taxes on her gifts over $3.5 million, which would not have been exempt from the gift tax. This credit would offset the estate tax on those gifts that we added back to her taxable estate and solve the clawback problem.

This illustrates the need for Congress (or the IRS) to clarify that the credit for hypothetical gift taxes payable on prior gifts under § 2001(b) is the *lesser* of the exclusion amount in effect in the year of death or the amount in effect in the year the gift taxes were payable. This simple fix has been introduced in the House Ways and Means Committee on November 17, 2011 by Representative Jim McDermott (D-WA) as H.R. 3467, The Sensible Estate Tax Act of 2011. He accomplishes this by amending IRC § 2001(g) to provide as follows:

> (g) Modifications to Gift Tax Calculation- For purposes of applying subsection (b)(2) with respect to 1 or more gifts--
>
> (1) MODIFICATIONS TO REFLECT DIFFERENT TAX RATES- The rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute--
>
> (A) the tax imposed by chapter 12 with respect to such gifts, and
>
> (B) the credit allowed against such tax under section 2505, including in computing-
>
> (i) the amount determined under section 2505(a)(1), and
>
> (ii) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).
>
> (2) MODIFICATION TO REFLECT REDUCED APPLICABLE CREDIT AMOUNTS- The amount determined under section 2505(a)(1) for each calendar year shall not exceed the estate's applicable credit amount under section 2010(c).

Another possible solution is for the IRS to issue regulations clarifying how to compute the credit for prior gift taxes payable. The American College of Trust and Estate Counsel (ACTEC) has proposed this in comments to the IRS on April 30, 2012, stating: “New regulations under section 2001 could provide that in computing the amount of gift tax payable on adjusted taxable gifts, the unified credit to be taken into account shall be the lesser of the unified credit in the year of death and, with respect to each gift, the credit in effect when the gift was actually made.”[399]

D. Who is Liable for Clawback Taxes?

In the unlikely event that clawback becomes a reality, it not at all clear how, or even whether, the IRS can collect the taxes from donees. Presumably the only time the IRS would even consider this is if the donor’s estate tax liability exceeded his entire testamentary estate. But collecting from the recipients of lifetime gifts may be difficult in the absence of state law supporting the IRS’s efforts. The executor is only required to pay federal estate taxes from the assets under his control.

A donee can, however, be liable for unpaid gift taxes, and for estate taxes where gifts are included in the decedent’s gross estate under §§ 2034 to 2042.[400] This is known as transferee

[399] “Recommendations for 2012-2013 Guidance Priority List (Notice 2012-25)”, American College of Trust and Estate Counsel, Comments submitted to the IRS April 30, 2012.

[400] IRC § 6901(a)(1); IRC § 6324(a)(2).

liability. But the donee does not appear to be liable for estate taxes attributable to gifts that are merely grossed up with the taxable estate in order to determine the rate of tax on the estate.

The IRS can, however, attach an estate tax lien under § 6324 to the donee's property if he received it by gift within three years of the decedent's death.[401] Therefore, if the decedent died within three years of a gift, and his estate was subject to clawback taxes, but insolvent, the IRS could satisfy its lien with the donee's property. But this is clearly inapplicable if the donor lives for more than three years after making the gift.

IX. Conclusion

It is dangerous to ignore the significant planning opportunities that exist after the decedent's death. Moreover, many of these opportunities have a limited time period in which to take advantage of them. The executor has an awesome responsibility to make decisions that have significant and long-lasting impact. Therefore, it is imperative that the executor document the basis for his decisions and seek the best advice available.

[401] IRC § 2035(c)(1)(C).