Post-Mortem Tax Planning

A Guide After the Client Has Passed

Part 2 of a 2-Part Series

by
Jordon N. Rosen, CPA, AEP®
Belfint, Lyons & Shuman, P.A.

While estate planners generally focus on helping their clients with their estate plan while the client is still alive, there are many elections and opportunities to consider after the client has passed.

In part 1 we discussed elections relating to the decedent's final income tax return, administrative elections and various tax elections available to the fiduciary. Part II continues with other relevant tax elections available to the fiduciary, including those when the decedent was a partner in a partnership or shareholder in an S corporation, the use of QSSTs and ESBTs, deferring estate taxes, the use of alternate valuations, special use valuation elections and GST planning. These issues were also the topic of a session at the recent 2017 Delaware Trust Conference.

- 65-Day Rule. Section 663(b) generally allows the fiduciary to elect to have any or all of an income distribution made within 65 days after the close of the estate or trust's yearend to be treated as if made on the last day of the preceding tax year of the estate or trust. The election must be made on a timely filed return, including extensions (although there may be Section 9100 relief if an amended return is filed within 6 months) and is irrevocable after that date. If no return is required to be filed, the election can be made on a statement filed with the IRS. The election can be a valuable tool to

assist executors/trustees to determine whether the income is best taxed to the trust or the beneficiary for the current or subsequent tax year, for both regular income tax and net investment income tax (Section 1411) purposes. It also is a great tool if the trustee forgot to make a distribution before the end of the estate/trust's tax year.

• Deducting Administrative Expenses. In general, amounts allowed under Sections 2053 relating to administrative expenses and 2054 relating to losses during administration which are used to reduce the taxable estate may not also be taken as deduction on the estate's income tax return. The executor/trustee can make an election, however, to claim such deductions on the income tax return and waive the deduction on Form 706. This especially makes sense if there is no taxable estate. The election and statement detailing the specific deductions and losses must be filed in duplicate with the return on which they are being claimed, including a statement that such deductions will not be claimed on the decedent's estate return. The election can cover all or a portion of the deductions and can be made up until the running of the statute of limitations for filing the income tax return. Taxes, interest and business deductions at the time of death which are claims against the estate can be deducted on BOTH the 706 and income tax return.

• Qualified disclaimers. Under Section 2518, a beneficiary can refuse to accept or have the power over property to which the individual is otherwise entitled. Valid uses of disclaimers include avoiding estate tax inclusion and overfunding a marital trust. The disclaimer must be irrevocable and unqualified, in writing and identify the property being disclaimed, signed by the disclaimant and delivered to the transferor not later than 9 months after the death creating the transfer occured, or if under age 21, within 9 months after turning age 21. In addition, with certain exceptions for surviving spouses and cases of joint tenancy which may be unilaterally severed, the property must pass without direction on the part of the disclaimant and the disclaimant must not have accepted the property or any of its benefits.

• Allocation of estimated taxes to beneficiaries. An allocation can be made by the executor/trustee to treat any portion of the estimated taxes paid by the estate or trust as a payment made by the beneficiary. The election (Section 643(g)) must be made on or before the 65th day after the close of the taxable year and in the case of an estate, is only available in the estate's final year. The estimated payments are treated as estimates made by the beneficiary on January 15th of the following year.

• Charitable contributions made in succeeding year. If a charitable contribution is paid after the close of a tax year, but before the close of the following tax year, the trust or estate can elect to treat the contribution as paid in the preceding tax year, but only with regard to amounts paid or permanently set aside for charitable purposes. The election, which is irrevocable, is made by filing a statement with the tax return for which the deduction is being claimed (Reg. Section 1.642(c)-1(b)(3)). The election can be made up until the due date, including extension, of the succeeding year's return and can be made on and amended return if filed within this time frame.

• Net operating losses. The executor may elect to forego the carryback of a net operating loss.

• Property distributions. The executor may elect to treat tier-two in-kind property distributions as a taxable event (Section 643(e)(3)) which, although the beneficiary would be picking up additional income, he or she would have a higher basis in the distributed property and the character of the estate's taxable income could change from ordinary to capital, resulting in lower taxes on the estate's income tax return.

Business Related Elections

The executor or administrator needs to be aware if the decedent, at the time of his or her death, was a partner in a partnership or a shareholder in an S corporation and of the elections available to the estate.

Partnerships

• If the decedent was a partner in a partnership, two elections need to be considered. The first is the Section 754 election. This election can only be made by the partnership and is made on a timely filed partnership return, including extensions. The election is attached to the partnership return for the year of the partner's death. Once made, the election is irrevocable and can only be revoked with the consent of the IRS and is effective for all subsequent years. The effect of the election is to allow for a step-up in basis to be assigned to the assets inside of the partnership which effectively reconciles the succeeding partner-in-interest's inside and outside basis in the partnership property and is most beneficial where the partnership owns depreciable or amortizable property. The downside to the election is that it is irrevocable and binding on all partners for all future years unless revoked, which could include a year where there is a "step-down" in basis.

• The second election to consider comes under Section 732(d), which is similar to Section 754, but made by the estate, rather than by the partnership, so it has no effect on the remaining partners. The election allows for a date-of-death basis step-up and applies to property distributed to the estate within 2 years of the partner's death. This may be an alternative if the partnership is unwilling to make the 754 election.

S Corporations

• An estate can own S corporate stock indefinitely, but only certain trusts can own S corporate stock. A testamentary trust can own S corporate stock for 2 years after the date of death, with the exception of a Qualified Subchapter S Trust (QSST). (Section 1361(d)). To qualify, the trust must meet all of the following requirements.

• The trust can only (and is required to) distribute all income annually to only one beneficiary, who must be a U.S. citizen or resident

• Only the income beneficiary can receive principal distributions

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- The income beneficiary's interest must terminate upon the earlier of the death of the income beneficiary or the termination of the trust
- Upon termination, all trust assets must go the income beneficiary
- The income beneficiary must elect to be treated as the owner of that portion of the trust consisting of the S corporation stock
- The QSST status will terminate at the time any of the above requirements are not satisfied

A separate election is required for each S corporation owned by the trust and must be made within 2½ months after the S corporate stock is transferred to the trust or from the time the S election is made. Once made, the QSST election is irrevocable and it covers all successive beneficiaries unless they affirmatively refuse to consent within 2½ months of becoming an income beneficiary. Since the estate is the owner, beneficiaries of the estate who may otherwise be ineligible S corporation shareholders, do not negate the S status. Furthermore, the estate can defer income to its beneficiaries if it is on a fiscal year.

Another type of trust that can have an estate as a beneficiary is an Electing Small Business Trust (ESBT). The election to be a small business trust must be made by the trustee within 2½ months of the later of the S stock being transferred to the trust or the beginning of the first tax year which the election is effective (Reg. Section 1.1361-1(m)(2)). Unlike a QSST, an ESBT may have more than one beneficiary, sprinkle income among various beneficiaries and accumulate income. The tax treatment is also different in that it has an S portion which consists solely of S corporate stock which is subject to the highest rate of tax and a portion consisting of other property. Although a ESBT can convert to a QSST and vise versa, a trustee will need to consider the stark differences between the QSST and ESBT, especially to cost/benefit of accumulating income in the ESBT when deciding how to structure the trust.

Elections Specific to Larger Estates

More than 99 percent of all estates will not be subject to the federal estate tax. For those estates in excess of the exclusion amount at the time of death ($5,490,000 in 2017) which are required to file a federal estate tax return, certain elections may be available that could reduce the overall taxable estate or defer the payment of estate taxes.

- Alternate valuation (Section 2032). The election to use the alternate value date which is 6 months after the date of death can only be used if the estate is subject to the estate tax, must lower the overall federal estate tax and must be used to value all assets in the estate other than those that were disposed of through sale or distribution within the six-month period. If qualified appraisals were obtained, a copy at the date of death and at the 6-month alternate valuation date must be attached to the estate return. Factors to consider before using the alternate valuation date include (1) whether the use of the marital deduction would render a better result, (2) the effect of a lower basis for depreciation in the hands of the beneficiary and (3) whether the beneficiaries plan to sell the assets in the immediate future.
- Special use valuation (Section 2032A). In general, property is valued for estate tax purposes at its highest and best use value. However, if certain criteria are met, an executor may elect under Section 2032A to value qualified real property based on the current use for which it qualifies. The aggregate reduction cannot exceed $1,120,000 in 2017, (indexed annually for inflation). The business must have been owned by the decedent for 5 out of the 8 years prior to death, disability or retirement of the decedent, transferred to qualified heirs and if sold to a third party within 10 years after death, the tax benefit could be lost. Furthermore the value of the real property must have been at least 50% of the decedent's gross estate and the business real property must have been at least 25% of the adjusted gross estate
- Estate tax deferral (Section 6166). In short, Section 6166 allows a qualifying estate to pay interest only on the estate tax liability for 5 years and then interest and principal in equal installments over the next 10 years. This allows the estate of a decedent who owned a closely held family businesses avoid having to sell-off assets to pay the federal estate tax. To qualify, there must be an active trade or business, sole proprietor or partnership/corporation with 45 or fewer owners or the decedent having at least a 20% capital interest or voting stock ownership, respectively, and the value of the business must generally be more than 35% of the adjusted gross estate. Payment may be accelerated if there are missed installment payments or if there is a disposition or withdrawal of 50% or more of the money or assets of the business. The interest rate if set by formula (2% on the first $596,000 in 2017 and then 45% of the IRS underpayment rate on the balance), but no deduction is permitted.
- GST planning. Although beyond the scope of this article and worthy of its own dissertation, a few points on the generation skipping transfer planning need to be mentioned.
  - o GST allocation. Can be allocated at any time up until the due date, including extension, of the federal estate tax return. The allocation can be made either by formula or by using the automatic allocation rules.
  - o Use of Reverse QTIP (Section 2652(a)(3)). If elected, the decedent is treated as transferor for GST purposes, allowing the use of the decedent's GST exemption. This could be advantageous if the decedent's unused GST exclusion amount would otherwise be wasted.

Author's Note: In Part 1, an incorrect reference to Form 706 (Federal Estate Tax Return) was made with regard to the filing of Form 4810 to request a prompt assessment of tax. The correct reference should have been to a fiduciary tax return, Form 1041.

Jordon Rosen, CPA, MST, AEP® is a Director at the Wilmington, DE CPA firm of Belfint, Lyons & Shuman, P.A. where he heads the firm's estate and trust section. He is a past president of the National Association of Estate Planners and Councils and is a member of the AICPA technical resource panel on trust, estate and gift taxes. He can be contacted at jrosen@belfint.com or at 302.573.3911.