Postmortem Estate Planning and Fiduciary Income Tax Part One: Postmortem Estate Planning

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Goal

- Provide an overview of several postmortem estate planning concepts, highlighting the planning strategies and sources of law.

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Topics

- Topics:
  - Disclaimer (known as Renunciation in New York)
  - Paying Estate Tax in Installments under Internal Revenue Code (IRC) § 6166
  - Alternate Valuation Date
  - Recovering Estate Taxes Paid by the Surviving Spouse's Estate
  - Right of Election
- The best plan is to have a plan!
- Several of these planning strategies can be built into a plan made during a person's lifetime, or can be relied on after death in the absence of a plan.

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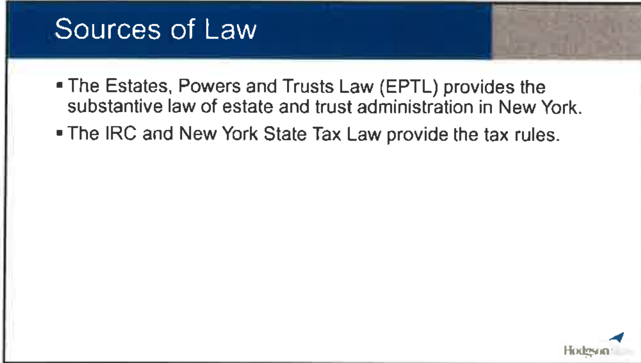

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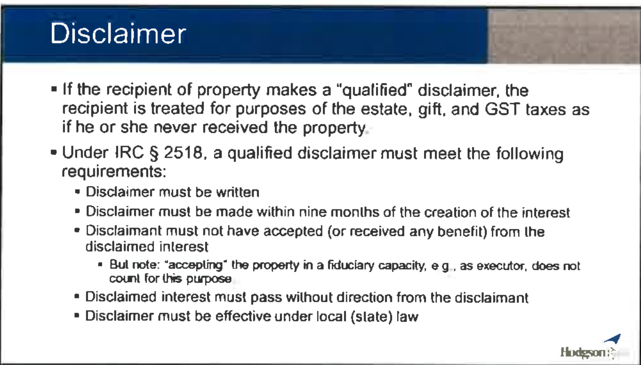

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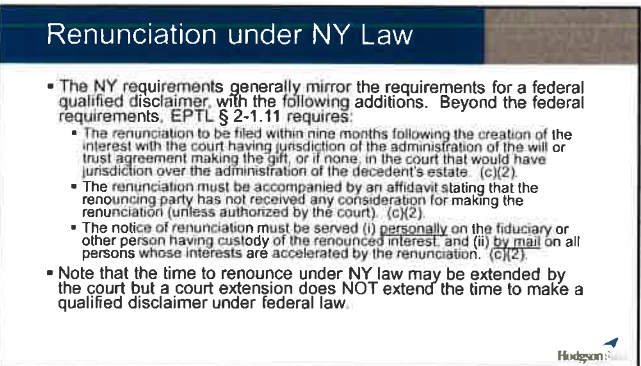

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Estate tax planning techniques utilizing disclaimer/renunciation

- For estate tax planning, disclaimer is commonly incorporated into an estate plan for married people when flexibility is desired.
- Current estate tax regime
  - The current federal estate tax exemption is $12.06 million per person, but is scheduled to "sunset" in 2026.
  - The exemption is "portable" between spouses and is adjusted annually for inflation.
  - The current NY estate tax exemption is $6.11 million per person.
  - The NY exemption is NOT "portable" between spouses but is adjusted annually for inflation like the federal exemption.
- Utilizing disclaimer trust for estate tax planning
  - The disclaimer regulations allow a surviving spouse to disclaim property into a trust for the spouse's own benefit. Reg §25.2518-2(e)(2).
  - The "disclaimer trust" is structured to utilize the decedent spouse's NY estate tax exemption, which would otherwise be wasted with an outright gift to the surviving spouse.

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Estate tax planning techniques utilizing disclaimer/renunciation (continued)

- Which assets should fund the disclaimer trust?
  - Ideally, the disclaimer trust should be funded with high growth, non-retirement assets.
  - Retirement assets *can* be used to fund the disclaimer trust, but that would result, at least for non-Roth retirement assets, in utilizing NY exemption to shield assets with a built in income tax liability. This is not ideal.
- Beyond the disclaimer trust, disclaimer can also be used for estate tax planning when there is no plan in place
  - If a spouse disclaims, and the disclaimed property passes other than to charity (e.g., to children), then the disclaimer would also utilize NY exemption.
  - But note: this plan only works if the surviving spouse does not need the assets for support!

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Other planning options for disclaimer

Beyond estate tax planning, disclaimer can also be used to:

- Pass unneeded assets from a wealthy disclaimant to less wealthy contingent beneficiaries, e.g., wealthy mother disclaims her inheritance to pass the inheritance to her own children.
- Avoid *some* creditors.
  - Disclaimer can generally be used to defeat rights of creditors. *Estate of Schiffman*, 105 Misc 2d 1025 (Surr. Ct., New York County 1980).
  - Disclaimer is not considered under a "fraudulent conveyance" analysis. *Estate of Oot*, 95 Misc 2d 702 (Surr. Ct., New York County 1978).
  - But some creditors are preferred, notably: the IRS and Medicaid.
    - The IRS may defeat a disclaimer.
    - A disclaimer may be treated as a "transfer" of assets for Medicaid purposes, and result in a period of ineligibility.

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Disclaimer: things to watch out for

- Irrevocable Trusts
  - When disclaiming an interest in an irrevocable trust, the disclaimer must generally be made within nine months after the trust was funded, even if the interest is a remainder interest that may not vest until many years after the initial transfer. Reg. § 25.2518-2(c)(3).
  - Beneficiary may not even know the trust was created before the time to disclaim expires
- Beneficiary Designation/TOD Assets
  - Consider who the contingent beneficiaries are
  - Sometimes the financial institution's terms will specify who the default beneficiary is in the absence of a contingent beneficiary being designated.
  - Results can be surprising, e.g., surviving spouse will take by the terms of the account instead of the deceased account owner's estate, which would ordinarily be the expectation in the absence of a designated beneficiary.
  - "Multiple" disclaimers may be required if the goal is to pass the asset through an estate to the contingent beneficiaries.
  - Also watch out for the beneficiary who claims the account and then seeks to disclaim—not possible even if no funds were actually withdrawn. The beneficiary has technically accepted the disclaimed interest.

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Estate Tax installments under IRC § 6166

- Payment of federal and NY estate taxes is generally due within nine months of a decedent's death.
- Many estates with illiquid assets, e.g., a closely held business, may be unable to pay all estate taxes owning by the due date without liquidating the business.
- With planning, estates can have liquidity to purchase business interests/pay estate tax with life insurance.
- But not all business owners will do this planning or be eligible for life insurance.
- To prevent businesses from being sold, IRC § 6166 allows for payment of estate tax in installments under some circumstances.

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Estate Tax installments under IRC § 6166 (continued)

- Under IRC § 6166, an estate may pay estate tax in installments if the following requirements are met:
  - The property must constitute "an interest in a closely held business";
  - The value of the closely held business must be includable in the gross estate;
  - The value of the closely held business must exceed 35 percent of the value of the adjusted gross estate; and
  - The decedent must be a U.S. citizen or resident at the date of death.
- If the requirements are met, then:
  - The estate tax can be paid in two or more (but not more than 10) installments of equal amounts, and
  - The maximum amount of tax that may be paid in installments is an amount that has the same ratio to the estate tax that the closely held business amount bears to the amount of the adjusted gross estate.

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Alternate Valuation Date

- Generally, estate taxes are calculated using the value of all assets as of date of death.
- However, IRC § 2032 allows the executor to calculate the estate tax based on the value of the assets six months after the decedent's death if that calculation results in less estate tax payable.
- The concept is simple, but the actual calculation can be complex because any asset "disposed of" before the six month date must be included in the estate tax calculation using the value as of the date of disposition. IRC § 2032(a)(1).

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Recovering estate taxes paid by the surviving spouse's estate

- In the current estate tax environment, payment of estate tax by estates is relatively rare. But when estate tax is payable, who pays becomes hugely relevant.
- The most common estate tax payment provision is to pay estate taxes from the residuary estate.
- Complications can arise on a surviving spouse's death when the surviving spouse was the beneficiary of a QTIP marital trust, which qualified for the marital deduction on the first spouse's death, and which is now included in the surviving spouse's estate on the surviving spouse's later death.

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Recovering estate taxes paid by the surviving spouse's estate (continued)

- Consider this scenario: husband and wife are each in their second marriage and each has children from their prior marriages. They have no shared children.
- Husband dies and his estate plan creates a QTIP trust for wife. No estate taxes are paid on the first death. On wife's death, the QTIP pays only to husband's children.
- Wife dies. Her estate plan pays to her children and directs all estate taxes to be paid from her residuary estate.
- The QTIP is included in her estate. Following the terms of her own estate plan, all estate taxes (even those payable as a result of the QTIP being included) are paid by wife's children.
- This could be a disaster for wife's children!

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Recovering estate taxes paid by the surviving spouse's estate (continued)

- IRC § 2207A saves the day, providing that:
  - If any part of the gross estate consists of property included in the gross estate because of a QTIP election, the surviving spouse's estate is entitled to recover the amount by which
    - The total tax paid exceeds
    - The total tax which would have been payable if the value of the QTIP property had not been included in the gross estate. IRC § 2207(A)(a)(1).
- This right of recovery exists unless the surviving spouse's estate plan *specifically* waives it. IRC § 2207(A)(a)(2).
- New York also follows this rule. EPTL § 2-1.8(d-1)(1)(A).

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Right of election

- Under NY law, a surviving spouse cannot be fully disinherited.
- EPTL § 5-1.1-A gives the surviving spouse the right to elect to receive a pecuniary amount, calculated under the statute, rather than what the spouse would receive under the will.
- The calculation can be complex, but generally the elective share amount is a sum equal to the greater of (i) $50,000 or (ii) one third of the "net estate." (EPTL § 5-1.1-A(a)(2)).
- The net estate generally includes all assets, not just probate assets, less estate administration expenses and creditor claims. (EPTL § 5-1.1-A(a)(2)).
- The surviving spouse must exercise the right of election within six months after the executor is appointed. (EPTL § 5-1.1-A(d)(1)).
- Note: in NY, assets received in trust do not satisfy the right of election.

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Conclusion

- Thank you!
- Any questions?

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Postmortem Planning Strategies for Trusts and Estates

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Overview of Topics

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- Select a fiscal year end for the estate
- Elect to include income earned in the decedent's trust on the estate's income tax return
- Manage distributions to minimize overall tax
- Prepare Form 1041 on the accrual basis
- Prepare a "first and final" return when possible

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Overview of Topics

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- Review allocation of estate administrative expenses between Form 1041 and Form 706
- Review payment of commissions
- Final income tax return (Form 1040) considerations

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Select a fiscal year for the estate

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- Using a fiscal year end can be a powerful tool to defer tax on income and allow beneficiaries time to plan for its inclusion in their personal returns. Any of the 12 month-end dates that follow the decedent's death can be the fiscal year-end date, but the year cannot exceed 12 months.
- For example, the maximum fiscal year for a decedent dying September 5th is through August 31st of the following year.
- The year can be shorter than 12 months, an effective choice if a large, income-producing transaction will occur in the months after the selected year end.

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Elect to include income earned in the decedent's trust on the estate's income tax return

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- Trusts are required to use a calendar year end. However, a tax adviser can elect to include the income from a decedent's qualified revocable trust on the estate fiduciary income tax return. Doing that provides an array of benefits not normally available to trusts, the most significant of which may be the ability to use the estate's fiscal year end for trust income.
- This election lasts two years beyond the decedent's date of death (longer if a Form 706 is required to be filed; consult the instructions to Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*).

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Manage distributions to minimize overall tax

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- Estate and trust income taxes reach the highest tax bracket of 37% at $13,451 of taxable income for 2022. If beneficiaries are in lower tax brackets, it will save tax for the family overall to distribute income out of the estate to them in a timely fashion.
- The fiduciary has until 65 days after the end of the tax year to make distributions for that tax year.
- Capital gains stay at the Form 1041 level and are taxed there, an exception is on a final fiduciary income tax return.

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Manage distributions to minimize overall tax

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For trusts and estates in 2022 there are three long-term capital gains brackets:

0%: $0 – $2,800
15%: $2,801 – $13,700
20%: $13,701 and higher

Note that the Net Investment Income Tax (NIIT) applies to a trust or estate's undistributed net investment income with a threshold of $13,450 of income.

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Prepare Form 1041 on the accrual basis

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- Excess deductions over income on an estate or trust Form 1041 do not carry over to the next year and therefore are wasted (except on a final return). If the fiduciary finds that the estate has paid large expenses without much income during the first year or, as is more often the case, the estate has ample income but will not pay related legal and administrative expenses until later, the fiduciary can prepare Form 1041 on the accrual basis and accrue the income or expenses into the current year.

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Prepare a "first and final" return when possible

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- Smaller estates often can be settled within a year plus 65 days. Then the fiduciary can file only one estate Form 1041 that is both an initial and a final return, saving the family money. Where possible, the fiduciary can make that happen by ensuring that timely distributions are made to beneficiaries and that any remaining assets are unlikely to generate the more than $600 of taxable gross receipts that would trigger an additional return filing requirement (by putting the remaining cash in a non–interest-bearing account, for example).

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Review allocation of estate administrative expenses between the Form 1041 and the Form 706

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- Most estate administration expenses can be claimed either as deductions for estate tax purposes or income tax purposes. Considerations in deciding where to claim the deduction include:
  - Relative tax savings
  - Timing of the payment of the expense

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Review allocation of estate administrative expenses between the Form 1041 and the Form 706

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- For estate tax purposes, a deduction can be claimed so long as the expense is ascertainable with reasonable certainty and it will be paid.
- For income tax purposes, the expense can be claimed only in the year in which it is paid.
- Ability to carry out the estate's final tax year expenses to beneficiaries
- A taxable estate resulting from claiming the expense on the income tax return

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Review payment of commissions

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- Consider whether it will be more tax efficient to take commissions—which will be subject to ordinary income tax for the fiduciary but will be deductible for the estate—or to waive commissions, which will increase the estate passing to the beneficiaries.

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Final 1040 income tax return issues

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Joint or separate income tax return. If the decedent was married at the time of his or her death, a joint return can be filed so long as the surviving spouse does not remarry before the end of the surviving spouse's tax year. Considerations in deciding whether to file a joint or separate return include: relative tax liability, availability of excess losses to offset spouse's gains, ability to use deductions—deductions for medical expenses can only be deducted for income tax purposes to the extent they exceed 7.5% of adjusted gross income. If the spouse has more income, the deduction might be more valuable on a separate return.

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Final 1040 income tax return issues

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Medical expenses considerations: Medical expenses paid within one year of death are treated as being paid by the decedent at the time incurred under IRC Section 213(c). As a result, such expenses can be claimed on either the decedent's final income tax return as a medical expense or on the estate tax return as a debt of the decedent. If the estate is not taxable, the expense should be claimed for income tax purposes so long as doing so will not generate a taxable estate. In addition to considering relative tax rates, remember the estate is not subject to the 7.5% floor mentioned above.

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