Postmortem Planning Consideration for the Family Business Owner:
A Review of Income, Gift, and Estate Tax Planning Issues

By

Steve R. Akers
Bessemer Trust Company
Dallas, Texas

Copyright © 2009 by Bessemer Trust Company, N.A. All Rights Reserved.
TABLE OF CONTENTS

Postmortem Planning Considerations For the Family Business Owner: A Review of Income, Gift, and Estate Tax Planning Issues

Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
(214) 981 9407
akers@bessemer.com

Page

I. INTRODUCTION .................................................................................................................................... 1

II. INCOME TAX PLANNING...................................................................................................................... 1

A. Decedent's Final Return ......................................................................................................................... 1
   1. File Decedent's Final Income Tax Return ......................................................................................... 1
   2. Consider Filing Joint Return ............................................................................................................. 1
   3. Determine How to Report Series E Bond Interest ........................................................................... 2
   4. Treatment of Deductions on Final Return ..................................................................................... 3
   5. Partnership and S Corporation Income ............................................................................................ 3
   6. Net Operating Losses, Charitable Deduction and Capital Loss Carryovers ................................ 4
   7. Installment Sale in Year of Death .................................................................................................... 4
   8. Treatment of Final Paycheck .......................................................................................................... 4
   9. Dependency Exemptions .................................................................................................................. 4
  10. Executor's Liability for Decedent's Unpaid Income (as well as Gift or Estate) Taxes .................. 4
  11. Inspection Right over Intestate Decedent's Final Income Tax Return ........................................... 7
  12. Place for Filing Final Form 1040 .................................................................................................... 7
B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041 ............................... 7
   1. Consider Fiscal Year .......................................................................................................................... 7
   2. Administrative Expense Deductions ................................................................................................ 7
   3. Effect of Two Percent Floor Under §67 on Miscellaneous Itemized Deductions ........................... 9
   4. Take Advantage of Double Deduction Items ................................................................................. 15
   5. Plan on Paying Substantial Administration Expenses in Last Year to Pass Deductions to
      Beneficiaries .................................................................................................................................. 15
   6. Pay Estate Income Tax Liabilities ................................................................................................... 16
   7. Election Under §645 to Treat Revocable Trust as Part of Grantor's Estate .................................... 16
   8. Consider Utilization of Depreciation and Depletion Deductions (By Estates or Trusts) and
      Establishment of Depreciation or Depletion Reserve (By Trusts Only) ........................................ 22
   9. Material Participation by Estate or Trust for Purposes of Passive Activity Losses ....................... 22
  10. Reporting of Qualified Dividends and Capital Gains Subject to 5-15% Tax ................................. 23
C. Funding and Distribution Planning .................................................................................................... 23
      a. General Rules ............................................................................................................................... 23
      b. Exceptions: Specific Bequest Exception and Separate Share Rule .......................................... 25
      c. Income in Respect of a Decedent ............................................................................................... 31
      d. Distribution of Appreciated Property in Satisfaction of Pecuniary Bequest ............................ 32
      e. Distribution of IRD to Satisfy Pecuniary Bequest Accelerates Recognition of IRD ............... 33
      f. Distribution of IRA in Satisfaction of Pecuniary Bequest .......................................................... 34
      g. Deemed Holding Period of Inherited Property ......................................................................... 34
      h. Beneficiaries Must Report Inconsistencies with Fiduciary Return ........................................... 34
      i. Undistributed Property When Beneficiary Dies ....................................................................... 34
      j. Uncertainty of Beneficiaries ....................................................................................................... 35
GIFT TAX PLANNING .......................................................................................................................... 48

A. Filing Requirement .......................................................................................................................... 48

B. Consider Splitting Gifts With Surviving Spouse ........................................................................ 48

1. Gift-Splitting of Decedent’s Gifts ............................................................................................. 48

2. Gift-Splitting of Decedent’s Spouse’s Gifts ............................................................................. 48

3. Debt Deduction for Gift Tax ....................................................................................................... 48

IV. ESTATE TAX PLANNING .............................................................................................................. 48

A. Alternate Valuation Date ............................................................................................................. 49

1. General Rule ........................................................................................................................... 49

2. Mechanical Requirements for Making Alternate Valuation Election ..................................... 49

3. Make Alternate Valuation Election if it Produces Lower Estate Tax .................................... 50

4. Consider Making Sufficient Disclaimers to Cause a Small Amount of Tax to be Payable .... 50

5. Consider Effects of Sales and Distributions on Alternate Values ........................................... 52

B. Special Use Valuation ................................................................................................................ 53

1. General Effect of Special Use Valuation ...................................................................................... 53

2. Qualification Requirements ........................................................................................................ 54

3. Special Use Value ....................................................................................................................... 58

4. Consider Whether to Make Special Use Valuation Election .................................................... 58

5. Carefully Consider Estate Tax Apportionment if Special Use Valuation Election is Made .... 59

6. Minority Interest Discount With Special Use Valuation ........................................................... 59

7. Planning Considerations to Leverage Benefit of Special Use Valuation .................................. 59

C. General Valuation Considerations ........................................................................................... 60
1. Penalty Considerations ................................................................. 60
2. Mechanical Valuation Requirements .............................................. 63
3. Make Appropriate Valuation Adjustment ......................................... 64
4. No Necessity of Aggregating With QTIP Assets for Valuation Purposes ...................................................... 83
5. Valuation of S Corporation Stock; Whether to “Tax Affect” S Corp Earnings in Determining Value Based on Capitalization of Earnings Approach ......................................................... 85
6. No Discount for Potential Income Taxes on Retirement Account .................................................. 87
7. Effect of Post-Transfer Events .......................................................... 87
8. Reduced Value By Applying String Provisions to Depreciated Assets ................................................................. 88
9. Reduced Value by Excluding Income From Assets Brought Back Into the Estate Under §2035 or String Provisions ...................................................... 89
10. Reduction in Amount of Life Insurance Proceeds Brought Back Into Estate Under §2035 if Transferee Pays Some Premiums ...................................................... 89

D. Administration Expense and Debt Deductions ........................................ 89
1. Decide Whether to Claim Administrative Expense Deductions for Estate or Income Tax Purpose ...................................................... 89
2. Deductibility of Post-Death Interest Expenses ........................................ 89
3. Allocating Post-Death Interest Expenses Against Estate Income ...................................................... 100
4. Possibility of Allocating Administrative Expenses (Other Than Post-Death Interest) Against Estate Income ...................................................... 101
5. Deduction of Administrative Expenses Attributable to QTIP Trust or Other Non-Probate Assets ...................................................... 101
6. Sales Expenses Deducted Even If Sufficient Non-Probate Assets to Pay Administration Expenses ...................................................... 102
7. Residence Maintenance Expenses .................................................... 102
8. Maintenance Expenses of Ongoing Business ......................................... 103
9. Valuation of Disputed Claims Against Estate ........................................ 103
10. No Deduction For Income Taxes on Distribution to Estate From IRA to Pay Estate Taxes ...................................................... 111
11. Gift and Estate Tax Effects of Executor Elections on the Executor Personally ...................................................... 113

E. Marital Deduction Planning ............................................................... 113
1. QTIP Planning Considerations .................................................... 113
2. Funding Issues ................................................................. 123
3. Consider Rights of Election Against Will to Increase Marital Deduction ...................................................... 129
4. Planning Considerations for Non-Citizen Surviving Spouse ...................................................... 129

F. Charitable Deduction Planning .......................................................... 136
1. Consider Deductibility of Charitable Bequests ........................................ 136
2. Consider Statutory Reformation of Split-Interest Trust ...................................................... 138
3. Consider Judicial Proceeding to Compromise the Interest of Non-Charitable Beneficiaries to Obtain Charitable Deduction ...................................................... 139
4. Consider Disclaimers of Non-Charitable Interests in Non-Deductible Split-Interest Bequests ...................................................... 140

G. Qualified Family-Owned Business Interest Deduction ...................................................... 140

H. Filing of Estate Tax Return and Payment of Estate Tax ...................................................... 141
1. General Filing and Payment Requirements Extension of Time to Pay Tax ...................................................... 145
2. Extension of Time to Pay Tax Attributable to Closely-Held Business Under §6166 ...................................................... 141
3. Discharge of Personal Liability of Executor for Estate Tax ...................................................... 162
4. Transferee Liability of Beneficiaries .................................................... 162
5. Special Automatic Estate Tax Lien, §6324(a) ...................................................... 163

V. DISCLAIMER PLANNING ............................................................... 165

A. General Requirements ............................................................... 166
B. Nine Months Time Limit Requirement ...................................................... 166
1. Date of Taxable Transfer .................................................... 166
2. Time Limit Strictly Enforced .................................................... 167
3. Under Age Twenty-One Rules .................................................... 167
4. Joint Tenancy Property ........................................................................................................ 167
5. Application of Time Limit to Transfers Preceding Adoption of Gift Tax ...................... 167
6. No “Substantial Compliance” Approach; Person Dies Before Signing Disclaimer ........... 168
7. Income Tax Effect of Disclaimers ...................................................................................... 168
C. Planning Flexibilities with Partial Disclaimers ................................................................. 168
1. Regulation §25.2518-3 ........................................................................................................ 168
2. Separate Interests .............................................................................................................. 168
3. Cannot Disclaim for Certain Number of Years ............................................................... 168
4. Severable Property ........................................................................................................... 168
5. Power of Appointment is Treated as a Separate Interest ............................................... 169
6. Can Disclaim Specific Assets From Trust ...................................................................... 169
7. Disclaimer of Specific Pecuniary Amount Allowed ....................................................... 169
8. Formula Disclaimers are Permitted .............................................................................. 169
9. Partial Disclaimers With Executor Having Authority to “Pick and Choose” .............. 174
D. Passing Without Any Direction By Disclaimant ................................................................. 174
1. Splintering of Interests in Will .......................................................................................... 174
2. Disclaimant as Fiduciary .................................................................................................. 174
3. Disclaimant Cannot Hold Power of Appointment ......................................................... 174
4. Disclaimant as Director of Foundation Receiving Disclaimed Assets ......................... 175
E. Disclaim to Avoid Inclusion in Beneficiary's Estate .......................................................... 175
F. Disclaim to Avoid Creditor's Claims ................................................................................ 176
G. Disclaimer Opportunities Involving Surviving Spouse ................................................... 177
1. Disclaim Outright Disposition Into QTIP Trust ......................................................... 177
2. Consider Partial Disclaimer to QTIP Trust .................................................................... 177
3. Disclaimers to Allow QTIP Treatment; Disclaimers on Behalf of Minors .................... 177
4. Disclaimer by Trustee of Power to Make Distributions to Beneficiaries Other Than Spouse — But May Be Questionable Unless Beneficiary Consents .................. 179
5. Disclaimer of All Interests Under Will, so Property Passes by Intestacy to Spouse ....... 180
6. Disclaimer of Insurance on Surviving Spouse's Life ..................................................... 180
7. Disclaimer of Property Passing by Intestacy to Persons Other Than Spouse ............... 180
8. Disclaimer of Qualified Plan Benefits Having QTIP Trust as Beneficiary, so Benefits Pass Outright to Spouse to Get Benefit of Rollover IRA ........................................ 180
9. Disclaimer Before End of Period To Determine “Designated Beneficiary” ................... 180
H. Partial Disclaimer After Some Benefits Have Been Accepted; Expectation of Future Benefit as Acceptance ................................................................. 181
1. General Rule .................................................................................................................. 181
2. Community Property .................................................................................................... 182
3. Other Jointly Owned Assets ........................................................................................... 183
4. Expectation of Future Benefit as Acceptance ................................................................ 184
5. Disclaimer of Qualified Plan Benefit After Receiving Minimum Required Distribution for Year of Participant’s Death ........................................................................ 186
I. Disclaimers of Joint-Tenancy Property ............................................................................ 186
1. Overview ......................................................................................................................... 186
2. Bank Accounts, Brokerage Accounts, or Other Similar Interests ................................ 187
3. Joint Tenancies of Other Property .................................................................................. 188
J. Disclaimers for Generation Skipping Transfer Tax Purposes .......................................... 189
1. Disclaim to Utilize First Spouse’s Million Dollar Exemption Amount ......................... 189
2. Disclaim to Create Direct Skips ..................................................................................... 189
3. Disclaim Right to be Reimbursed for Estate Taxes from QTIP Trust ............................ 190
4. Disclaim by Children to Utilize Decedent’s Exemption Amount .................................. 190
5. Disclaim to Limit Generation-Skipping Transfer to Exemption Amount ...................... 190
K. Effects Upon Disclaimer of Non-Ascertainable Standard For Distribution Power Held By Disclaimant ...................................................................................... 190
1. Disclaimer to Avoid Having General Power of Appointment ....................................... 190
2. Requirement that any Retained Power to Direct Enjoyment of Disclaimed Interest be Limited by an Ascertainable Standard ......................................................... 190
VI. GENERATION-SKIPPING TRANSFER TAX - BRIEF SUMMARY
OF PLANNING OPPORTUNITIES

A. Disclaimer Planning Opportunities ................................................................. 192

B. Effects Upon Disclaimer of Non-Ascertainable Standard For Distribution Power
   Held By Disclaimant .......................................................................................... 192
   1. Disclaimer to Avoid Having General Power of Appointment ....................... 192
   2. Disclaim to Utilize GST Exemption Amount By Creating Direct Skips ......... 192

C. GST Exemption Allocation ............................................................................ 192
   1. General Rules .............................................................................................. 192
   2. Consider Allocating GST Exemption to Lifetime Transfers That May Result in
      Generation-Skipping Transfers .................................................................... 193
   3. Consider Allocating GST Exemption to Testamentary Transfers Likely to Result in
      Generation-Skipping Transfers .................................................................... 193
   4. Consider Retroactive Allocation of GST Exemption If Children-Beneficiaries Predecease
      Grandchildren-Beneficiaries and Original Transferor ..................................... 193

D. Funding Considerations ................................................................................ 194
   1. General Rule-Use Estate Tax Values ............................................................. 194
   2. Exception for Allocating GST Exemption to Pecuniary Lead Gifts ............... 194
   3. Residual Transfers After Payment of Pecuniary Amount ................................. 195

E. Reverse QTIP Considerations ........................................................................ 195
   1. Make Reverse QTIP Election ....................................................................... 195
   2. Split QTIP Trust into Separate Trusts for Making Reverse QTIP Election ....... 195
   3. Consider Predeceased Ancestor Exception in Determining Whether to Make the
      Reverse QTIP Election .............................................................................. 195

VII. ALLOCATING ADMINISTRATION EXPENSES AGAINST INCOME — OR
     UNDER REGULATIONS, TREATMENT OF “ESTATE MANAGEMENT EXPENSES” ................ 196

A. Hubert-Supreme Court Decision .................................................................. 196
   1. Facts ........................................................................................................... 196
   2. Summary of Supreme Court Decision ........................................................ 196

B. Final Regulations ............................................................................................ 196
   1. Overview ................................................................................................... 197
   2. Estate Management Expenses ..................................................................... 197
   3. Estate Transmission Expenses ..................................................................... 197
   4. Reduction of Marital or Charitable Deduction for Estate Management Expenses
      Attributable to Property Passing to Beneficiaries Other Than Spouse or Charity . 197
   5. Special Rule Where Estate Management Expenses Are Deducted on the
      Estate Tax Return ....................................................................................... 197
   6. Effective Date of Regulation ....................................................................... 198
   7. Planning Considerations Under Final Regulations ....................................... 198

C. Retain Flexibility to Utilize Estate Tax Deduction Under Section 642(g) ........ 202