Key Principles

- Federal Estate Tax
  - *Assets – Liabilities = Net Worth*
  - Decrease the Value of Assets
  - ALSO Estate Tax decreases as Liabilities increase
- State Death Tax
  - Domicile controls Intangible Assets
  - Situs controls tangible assets = State Death Tax
- Income Tax
  - Unrealized Capital Gains disappear (Step-up in Basis)
    - **BUT** so do unrealized Capital Losses; Net Operating Losses (NOLs) and Unused Tax Credits
  - IRD – does not disappear
    - “Income in Respect of a Decedent” is taxable to recipient
    - Final 1040 year may be a “really” short year

Federal Estate Tax Planning

- Decreasing Assets (i.e., the Gross Estate)
  - Make annual exclusion gifts (early and often)
    - Make gifts early each year January 1st
  - Use annual exclusion gifts in lieu of bequests
  - Death bed gifts
    - Use Wire transfers & cashiers checks to assure that gifts are completed before death
  - Satisfy Charitable Giving with IRAs and deferred compensation in lieu of bequests under wills or gifts through trusts

Federal Estate Tax Planning

Tools and Techniques, if you have at least year to 18 months

- Decreasing Assets (Swap Included for Excluded)
  - Self Cancelling Installment Notes
  - Private Annuities
  - Purchase of Life Estate
  - Enhance Eligibility for Minority Interest Discounts
    - Resign as General Partner or Managing member
    - Recapitalize Corporations and Partnerships (voting and non-voting equity)
    - Transfer away voting control of family business

Federal Estate Tax Planning

Two minute drill – last minute strategies - when death is imminent

- Increase Liabilities to decrease the Net
  - Avoid Selling Appreciated Assets
    - *(Unless you have a Capital Loss Carryforward)*
  - Create debt instead of receiving income
    - Create Debt instead of income
    - Stop wages/borrow from family business instead
    - Borrow cash and appreciated assets from Grantor Trusts
    - Borrow cash from Family members
      - Pay (accrue) Highest possible interest rate
  - Final Year 1040 Income Tax = Estate Tax Deduction
    - Elect to accelerate installment sale gains
    - Elect Accrual method for US Savings Bond
    - Convert IRA to Roth IRA **(must be done during lifetime)**

ROTH IRA Conversions

NONDEDUCTIBLE CONTRIBUTIONS TO TRADITIONAL IRAs

You can make non-deductible IRA contributions, without any MAGI limitation, if you have earned income of at least the amount contributed. Similarly, there are MAGI limitations on the conversion of an traditional IRA to a ROTH IRA.

CONVERSIONS FROM TRADITIONAL TO ROTH

When converting a Traditional IRA to ROTH you must pay tax on the difference between the FMV of the account converted less the tax basis of amount converted. ***CAUTION: Your Basis in the converted account may be diluted if you have other IRAs or ROLLOVER IRAs.***

Final Year Income Tax vs IRD

Final Year Income Tax is an Estate Liability

- Take RMD Early and Convert balance of IRA to ROTH
  - If alive at year-end: (1) re-characterize ROTH back to Regular to postpone the tax (2) Wait thirty days and do it again
- Income Tax Payable is a deduction that saves Estate Tax
  - Income Tax liability saves 40% Federal Estate Tax
  - Income Tax liability saves 16% Illinois at top rate

Deduction In Respect of Decedent (DRD) not as good

- **Federal Estate Tax Paid is deductible as Income Tax itemized deduction**
  - Top income tax rate is 39.6%, but
  - Pease Amendment limits potential income tax deduction
- **State Estate Tax Paid is not deductible on income tax return**

General Death Bed Estate Planning

- State Death Tax
  - Domicile in locale with No Estate Tax
  - Identify vacation properties or real estate in taxable States
  - Convert tangible assets in states with Estate Tax into intangible assets
    - Irrevocable Trusts with Limited Power of Appointment
    - Partnerships and LLCs

  Warning: Single member LLC, revocable trusts and Land Trusts are disregarded

- Multi-State Probate and Non-tax Considerations
  - Fund living Trusts to avoid probate
  - Check beneficiaries on IRAs, Pensions, and Annuities
  - Asset protection considerations – leaving assets in Trust

Death Bed Income Tax Planning

Use Them or Lose Them

Utilize NOLs and Credits on Final Return

Identify and Realize - Accrued and Unrealized Income

- Convert IRAs and Qualified Plan Assets to ROTH-IRAs
- Take Annuity and Non-Qualified Deferred Compensation distributions early
- Elect to pay tax on Accrued Series E Bond Income
- Elect out of Installment Sale Gains

Utilize Capital Loss Carryforwards

Identify and Accelerate Gains that would not get "step-up"

- Elect to accelerate installment sale gains
- Distributed appreciated assets from S Corporations to Shareholder
  - Difference between FMV and Adjusted Basis will be taxed as a capital gain upon distribution. Gain will create AAA and avoid second tax

US Savings Bonds Election

ELECTION TO ACCRUE INTEREST ON U.S. SAVINGS BONDS

Taxpayer hereby elects under Internal Revenue Code Section 454 to currently recognize as income the increment in the periodic redemption price over original purchase price of U.S. savings bonds described in Treasury Regulation §1.454-1(a)(1) that were owned as of January 1, [Year] or that are acquired after that date.

Election Out of Installment Sale

To make this election , the sale is reported not on Form 6252 but is reported instead on Schedule D for the taxpayer's return or on Form 4797, whichever is appropriate.

This election must be made on or before the due date (including extensions) for filing the income tax return for the year in which the sale occurs.

Late elections are permitted only where IRS concludes that there was good cause for failure to timely elect .

An election-out can be revoked only if IRS consents.

Death Bed Planning

Enhancing Basis

- Decedent's Assets will get Step up in basis
  - Best assets for "old" to hold:
    - Low basis stock
    - Creator-Owned Copyrights, Trademarks, Patents and Artwork
      - Amortization and Depreciation deductions available to heirs
    - "Negative-Basis" Commercial Real Estate Property LPs
    - Artwork, Gold and Other "Collectibles"
  - Appreciated assets should be in hands of older/sicker spouse
    - Consider transfers between spouses
    - Sever Joint Tenancies
      - *CAUTION: Transferred assets must not pass back directly to Spouse. Safer if assets pass to Family Trust or Marital Trust.*

Death Bed Planning

Enhancing Basis

Plan for Step-ups in Basis

- Trade High basis assets for Low basis assets held by IDGT
- Distribute low basis assets to Trust beneficiary
- Change Domicile to Community Property Estate
  - Elect to treat low basis assets as community property assets
- For smaller estates have trust protector create a General Power of Appointment to force inclusion of exempt trusts

Avoid Step-Downs in Basis

- Unrealized Capital Losses disappear with Basis Adjustment
  - Sell loss property to daughter-in-law (not related IRC §267)
- Passive Loss Carryforwards absorbed by Basis Adjustments
- Exchange assets with Unrealized Losses to IDGTS/IDIOTS
- Convert to Income in Respect of a Decedent

Using IRD to Preserve Capital Losses

Avoiding Basis Loss

Income in Respect of a Decedent (IRD) is a door that swings both ways

Estate Planning Journal March 2013 "Income in Respect of a Decedent: the Tables have Turned" Yuhas and Radom.

- BAD IRD includes:
  - Uncollected wages and Income
  - Pensions and Individual Retirement Accounts
  - Gains on Installment Sales
- As a Result, If IRD then basis does not Change
- GOOD IRD can structured to Avoid Step-Downs in Basis:
  - A sells capital loss property to IDGT (IDIOT) on installment sale
  - Loss on Installment sale is not automatically triggered Rev Rul 85-13
  - Estate claims loss post death when grantor trust status terminates
  - Estate of Frane in reverse

Planning Ideas for Business Assets

- Partnerships
- Closely Held Businesses
- S Corporations
- Personal Holding Company

Partnership Planning

Partnership Considerations

During Life

- Position for Valuation Discounts
  - Redeem General Partnership and Manager interests
- Distribute appreciated assets in tax-free partial liquidation

After Death

- LPs with negative capital accounts
  - Negative capital will disappear and may remove phantom income
- IRC §754 Partnership Election
  - Step up basis of Partnership assets
- Dump the Dogs
  - "Dogs" = Real estate LPs with (COD) Cancellation of Debt issues or environmental clean-up issues
  - Easier to abandon partnership interest, if not part of trust, but probate asset

Closely-held Business Planning

- Valuation Discounts
  - Redeem or Remove Voting Control
  - Dilute % ownership
    - Exercise Stock Options
    - Issue Stock Bonus to Next Generation
- Death Benefits and Non-Qualified Deferred Comp
  - Create Liabilities on Books of Business
  - Provide income tax deductible benefit to key employee
    - NQDC = post-death Income Stream of non-working widow
    - Death Benefit Only (DBO) Plan is excluded from Gross Estate

Section 101 – Exclusion for Certain Death Benefits

- The IRC §101 death benefit exclusion from income tax only applies to benefits paid under a life insurance contract. Income Tax exclusion does not apply to self-funded Death Benefits (DBO Plans).

Death Benefit Only Plans (DBO Plans)

- However, a Death Benefit Only plan (also called "survivors benefit") can be structured to avoid federal estate tax.

IBM created a Death Benefit only Plan for key employees. The employees could make a beneficiary designation, but the designation once made was irrevocable. **Held**: Not subject to Estate Tax in the estate of the deceased employee.

Estate of Anthony F. DiMarco, 87 TC 653 (1986), 7 EBC 2239, acq. in result in part 1990-2 CB 1; Rev. Rul. 92-68, 1992-2 C.B. 257.

Death Benefit Only Plans (DBO Plans)

Income Tax Impact

Deductible to Business But Taxable to Recipient = Income Tax Neutral

- If S Corporation – Deduction will flow thru to shareholders
- Caveat - Reasonable Compensation Test
  - ***Past Service can Factor into "reasonable compensation"***

Payroll Taxes

- Not subject to payroll taxes since paid after death

Gift and Estate Taxes

Accrued Liability reduces value of the business in the Gross Estate

Death Benefit is excludable from the Taxable Estate of the Employee

- Provided employee has not:
  - retained right to change beneficiary
  - Received any other non-qualified deferred compensation benefit from the employer
- Best to pay as a benefit to second generation rather than to spouse

The "Great Estate Equalizer" (DBO Plans)

EXAMPLE: Rocky owns a business worth $8 million and has 2 kids: Kane and Toews. Rocky has worked in the business his whole life he has no pension or life insurance. Toews works in the business 70 hours per week. Kane is a "bad boy;" he is on the payroll but plays "Hookey", and rarely is seen after hours.

Currently, if Rocky leaves the business to the kids 50/50 he will have:

- A Taxable Estate (40% of excess over $5,430,000)
- Toews will need redeem Kane for 50% of FMV.

Alternative:

Since he has no pension or life insurance. Company can create a DBO for Rocky payable to Kane for $2.5 million and re-register the stock so that it Transfers on Death (TOD) to Toews.

- What is the value of the business immediately before death?
- How big could the DBO Plan be?
- How is the payment of the death benefit treated for income taxes?

NOTE: Toews could buy insurance on dad (outside of the business, if he was worried about ability for business to pay.

Considerations for S Corporations and Personal Holding Companies

Step up in Basis can avoid Double tax

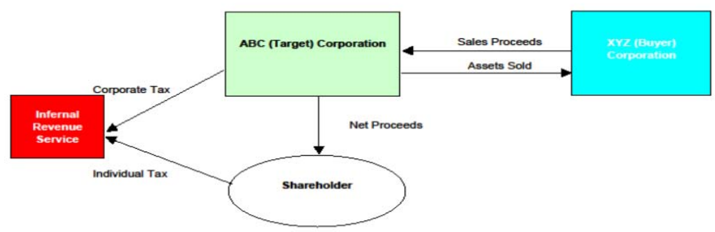
- Higher Basis could lead to Liquidation of S Corporation
- May be desirable for terminal spouse to hold 100% of stock
  - PHC could elect S and liquidate
- Stock Basis at death will permit deduction of Post death S Corporation Losses

Post mortem Holding Period for S Corporation Stock

- Revocable Trust can hold S Corporation for Maximum of 2 years
- Estate can hold for the entire period of administration

Personal Holding Company Dilemma

C Corporation Sale of Assets Followed by Liquidation



Lifetime - C Corporation Liquidation

ABC View	Basis	FMV	Income	Federal Tax	Illinois Tax
Cash, etc.	1,000,000	1,000,000	0		
Investments	50,000	100,000	50,000		
Land	50,000	100,000	50,000		
Building	400,000	500,000	100,000		
Accumulated Depreciation	(400,000)		400,000		
Goodwill	0	300,000	300,000		
Subtotal	1,100,000	2,000,000	900,000		
Gain on Sale of Assets			35%	315,000	
Shareholder View			**Tax Rate**	**Federal Tax**	**Total Tax**
Gross Sales Proceeds		2,000,000			
Less: C Corp Taxes paid		(315,000)			
Liquidation Proceeds		1,685,000			
Beginning Basis	10,000				
Gain on Liquidation		1,675,000	23.8%	398,650	
Total Tax					454,000

Lifetime - S Corporation Liquidation

ABC View	Basis	FMV	Income	Federal Tax	
Cash, etc.	1,000,000	1,000,000	0		
Investments	50,000	100,000	50,000		
Land	50,000	100,000	50,000		
Building	400,000	500,000	100,000		
Accumulated Depreciation	(400,000)		400,000		
Goodwill	0	300,000	300,000		
Subtotal	1,100,000	2,000,000	900,000	**No Entity Level Tax**	
Shareholder View		**NLTCG**	**Liquidation**	**Tax Rate**	**Federal Tax**
Liquidation Proceeds			2,000,000		
Beg Basis ($10k = AAA)	990,000				
Operating Income	0			39.6%	
Section 1245	50,000			39.6%	19,800
Section 1250	400,000	400,000		25%	100,000
Section 1231	350,000	350,000		20%	70,000
Ending Basis	1,890,000		(1,890,000)		
Gain on Liquidation			110,000	20%	22,000
Total Tax					211,800

Post Mortem – S Corp Liquidation

ABC View	Basis	FMV	Income	Federal Tax
Cash, etc.	1,000,000	1,000,000		
Investments	50,000	100,000	50,000	
Land	50,000	100,000	50,000	
Building	400,000	500,000	100,000	
Accumulated Depreciation	(400,000)		400,000	
Goodwill	0	300,000	300,000	
Subtotal	1,100,000	2,000,000	900,000	**No Entity Level Tax**
Shareholder View		**Net LTCG**	**Tax Rate**	**Federal Tax**
Liquidation Proceeds				2,000,000
FMV at Death	2,000,000			
Operating Income	0		39.6%	
Section 1245	50,000		39.6%	19,800
Section 1250	400,000	400,000		
Section 1231	350,000	300,000		
Ending Basis	2,900,000			
LTCL on Liquidation		(900,000)		Against other Gain?
Net LTCL		(200,000)	20%	(20,000)
Total Tax				200

Post Mortem Income Tax Elections

Decedent's Final Income Tax Return

- Married Filing Joint [IRC §6013(a)(3)]
- Medical Expenses paid after death may be deducted on final Form 1040 [IRC § 213(c)]
- Election to deduct unrecovered cost basis in a simple annuity [IRC Section §72(b)(3)]
  - ***A simple annuity has no death benefit or residual value. Unrecovered basis is deductible at death with proper election.***
- Election to use 50% of AGI limit (rather than 30% AGI limit on Charitable contributions of Capital Gain Property reduces deduction by removing gain from FMV [IRC170(b)(1)(C)(iii)]
- Request prompt assessment of income & gift tax returns - 18 months [IRC § 6501(d)]
- Request personal discharge of personal liability of income and gift tax [IRC §2204 & § 6905]
- Accelerating Income into Final 1040 Return ***[IRS has ruled that the full amount of decedent's income tax liability was deductible on IRS Form 706 as a claim against the estate PLR 9232006}.***
  - Election to include accrued interest income from US Savings Bonds [IRC § 454(a)].
  - Election to include unpaid balance of installment sale

Post Mortem Estate Tax Elections

- Disclaimers [IRC § 2518]
- Exclude 40% value of Qualified Conservation Easement [IRC 2031]
- Alternate Valuation Date [IRC § 2032]
- Special Use Valuation [IRC Section § 2032A]
- QTIP Marital Deduction [IRC § 2056(b)(7)]
- QDOT Marital Deduction [IRC § 2056A(a)(3)]
- Deduct Foreign Death Tax as a Charitable Contribution [IRC § 2053(d)]
- Transfer of decedent's unused exclusion to surviving spouse (DSUE)
- Generation Skipping Tax Exemption (Schedule R)
- Protective Claims (Form 706, Schedule PC)
- Waive right to deduct Administration expenses on Form 706

Post Mortem Fiduciary Income Tax Elections

- Consider Fiscal Year for Estate
- Elect to combine returns of Estate and Trust – IRC §645
- Consider filing income tax on a accrual rather than cash method
  - State income Taxes (especially with fluctuating income & AMT issues)
  - Trustee and Professional Fees (esp. closing estate and filing final returns)
  - Administration Expenses
- Consider 65 Day rule for timing of Estate and/or Trust Distributions
- Election to recognize gain on distribution of assets – IRC §643(e)(3)
  - Trust has Unused Capital Losses
  - Avoid unfairness where some heirs take in-kind while other receive cash

Administration Expenses

The law allows the estate to claim such expenses as either an estate tax deduction or an income tax deduction, but not both.

- Deduction can be taken on the estate tax return without any special action by the fiduciary, or
- Expenses can be claimed as an income tax deduction, instead of on Form 706. ***A formal election must be filed, waiving the item as an estate tax deduction.***
- The election should be filed in duplicate either (1) with the income tax return for the tax year for which the items are claimed as income tax deductions or (2) at any time before the statutory period for that tax year expires, by filing it with the district director of the district in which the income tax return for that year was filed and requesting its association with that return. See Treasury Regulation § 1.642(g)-1.

Sample Election to Claim Estate Expenses as Income Tax Deduction

Election to Treat Estate Expenses As an Income Tax Deduction

Estate of JANE SMITH, deceased Social Security Number (SSN) #123-45-6578

Form 1041 (U.S. Income Tax Return For Estates and Trusts) Ending December 31, [Year].

The undersigned administrator of the Estate of Jane Smith, deceased, hereby elects under Sec. 642(g) to claim the following expenses as a deduction from the gross income of the above-mentioned estate on the attached return:

Description	Amount
1. Legal and Accounting Fees	$ xx,xxx
2. Administrative Expenses	$ xx,xxx

The above-mentioned expenses have not been allowed as deductions in computing the decedent's taxable estate for estate tax purposes, and the undersigned hereby waives the right to have them on IRS Form 706 as estate tax deductions at any time.

____

Fiduciary, Estate of Jane Smith

Questions?

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