Fiduciary, Gift and Estate Tax Developments

Peter James Lingane

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This article introduces recent developments which have affected the preparation of fiduciary, gift and estate tax returns in the author's practice. The list is eclectic rather than comprehensive. While the discussion is abbreviated, references are included for further study.

FIDUCIARY TAX RETURN, Form 1041

1. **California has a new, more comprehensive Income and Principal Act as of January 1st, 2000. Probate Code Sections 16320 et seq. are history. While the new code is not yet on the ca.gov web site, the text of AB 846 can be found at www.sen.ca.gov/~newsen/legislation/legislation.htp.**

   Among other changes, the new Act clarifies the basis for allocating IRA distributions between the Income and Principal accounts. Absent contrary directions in the trust document, 10% of each distribution to a trust, and by assumption to individuals, is to be counted as income and 90% as principal.

   90% of each distribution therefore qualifies for the §691(c) deduction. This Schedule A miscellaneous deduction is the mechanism whereby beneficiaries recover estate tax paid on IRD. Since the §691(c) deduction is not limited by the 2% of AGI threshold, this deduction also reduces AMTI.

2. **A living trust is one in which the grantor - the person who creates the trust - retains the right to revoke the trust. Consequently, living trust assets are included in the gross estate.**

   Ordinarily, there is no need to file a fiduciary income tax return for a living trust but a fiduciary return is required for other trusts which are designed to be excluded from the estate.

   As discussed in IRS Regulation 1.671-4, income and deductions can be directly reported on the Form 1040 of the person who created the living trust so long as

   - **The grantor is one person or a married couple filing jointly**
   - **The income is reported under the grantor's TIN; and**
   - **The trustee provides a summary from which the grantor can prepare his/her personal Form 1040. No summary is required while the grantor is the trustee.**

   Alternatively, income can be reported under the TIN of the living trust if the trustee sends the IRS the appropriate Forms 1099. The Forms 1099 are in addition to providing the grantor a summary from which to prepare their personal tax return.

   Instead of filing 1099s, the trustee may attach a "grantor letter" to a blank Form 1041. The grantor letter is similar to a K-1 and summarizes the items of income and deduction by the TIN of the person receiving same.

Peter is licensed as a tax professional ("Enrolled Agent") and as a Certified Financial Planner. He is also a Fellow of the National Tax Practice Institute and a TCE volunteer. Peter earned degrees in chemistry from Harvard and Caltech and pursued an engineering career in the US and overseas before establishing Financial Security by Design in 1996. Peter limits his practice to retirement and estate planning and to tax compliance for individuals, trusts and estates. (925) 299-0472 or via http://www.lingane.com/tax.

The Forms 1099 or granter letter approaches must be used when the living trust is created by two or more unmarried individuals, two sisters perhaps.

The Form 1041/grantor letter approach must be used if any of the trust assets are located outside the US (Don't title your UK bank account in the name of your living trust!) or if any of the grantors are not US citizens or residents.

3. IRC §645(a) allows the executor and trustee to report the income from both the estate and the decedent's living trust on a single return for deaths after August 5, 1997. This means one less fiduciary return during the administrative period. In addition, the trustee can opt for a fiscal year and losses can be passed out of the combined estate/trust whereas losses can not be passed out of a trust alone.

   Revenue Procedure 98-13 is specific about how to report the income for the two entities on a single return. You need to secure EINs for both the estate and the living trust; the 1041 is filed using the estate's EIN; and the election reporting the trust's EIN is attached to the front of the 1041 each year.

   I'm not clear on how box 11, the closing month of the accounting year, is to be completed on the living trust's Form SS-4 and I've not been able to got an answer from the EIN unit in Fresno. So, I apply for a calendar year end even though the trust will file initially on a fiscal year, figuring that it should be easy to explain why no 1041 was filed for the first calendar year if the IRS computer should inquire.

   Funeral expenses are claimed on the estate tax return but expenses of the decedent's last illness can be claimed on the 706 or on the decedent's final 1040.

   Estate transmission expenses (e.g., appraisals, executor fees, costs to prepare the 706) and estate management expenses (e.g., investment and accounting fees) are deducted on the 706 but may be deducted on the 1041 if irrevocably elected pursuant to Reg. 1.642(g)-1. If these costs are charged to the marital share[1], the marital deduction is reduced by transmission expenses and estate taxes but is not affected by management expenses. (Prop. Reg. §20.2056(b)-4(e), Dec. 16, 1998.)

   Transmission expenses are usually taken on the estate tax return since deducting these costs on the fiduciary return increases the estate tax. On the other hand, it is often best to take management expenses on the 1041 since they may not provide any estate tax benefit if deducted on the 706.

   Be careful to not deduct expenses incurred on behalf of the beneficiaries. For example, real estate commissions are personal if the real estate is sold because the beneficiaries prefer to receive cash. On the other hand, commissions are deductible on the 706 or 1041 if the real estate is sold to pay estate taxes.

4. It can be a challenge to fund a trust to the applicable exclusion amount (currently $675,000) when part of the decedent's assets pass to the beneficiaries outside the trustee's or executor's control. Life insurance and IRAs are two examples.

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	Deduct on 706	Deduct on 1041	Deduct on 706	Deduct on 1041
Gross Estate	$ 1,400,000	$ 1,400,000	$ 1,400,000	$ 1,400,000
Transmission Expenses	<25,000>			
Management Expenses			<25,000>	
Marital Deduction	<700,000>	<685,317>	<725,000>	<725,000>
Taxable Estate	675,000	714,683	650,000	675,000
Tax	none	14,683	none	none

One solution is to name the trust as the contingent beneficiary in the expectation that the surviving spouse will disclaim (say "No, thank you" within nine months and before receiving any benefit from the disclaimed asset.) The disclaimed portion will flow to the by-pass trust. Remember that it is disadvantageous from an income tax perspective if the surviving spouse disclaims the decedent's IRA.

A married couple resident in California have another option if they own everything as community property. A living trust may say "Give my spouse enough to eliminate the estate tax and give the rest to my by-pass trust." If a couple own assets worth twice the applicable exclusion amount, there is no tax even if the decedent's entire $675,000 share is allocated to the by-pass trust.

Now suppose that the surviving spouse is the beneficiary of a one hundred thousand dollars of life insurance. This insurance is community property and the decedent's share is $50,000. Since the decedent's share passes directly to the surviving spouse, only $625,000 are available to fund the by-pass trust.

Suppose further that the living trust says something like "In making the allocation between the taxable and marital shares, the trustee shall consider community property passing both within and without the trust." This kind of language[2], authorizes the trustee to trade the decedent's community share of the life insurance proceeds for other assets of equivalent value owned by the living trust. Non pro rata allocation of community property makes it possible to increase the funding of the by-pass trust in this example.

There could be an income tax liability when the offsetting assets are IRD or carry unrealized gain. The IRS apparently argued, in several California cases five or ten years ago, that a non pro rata allocation was, in substance, a taxable exchange.

It is my understanding that California enacted Probate Code 100 specifically to address the income tax issue. Since January 1999, California couples have been able to agree a non pro rata allocation of community assets. Since this is an option allowed by state law, it is difficult for the IRS to claim income tax consequences.

Probate 100 is new legislation and every attorney I talk to has a different take of how this agreement is to be effected. My recommendation is to ask an attorney whether the documents and/or statute allow for a non pro rata allocation. Get the attorney's opinion in writing and attach this opinion to the 706.

5. **The executor of a probate estate must provide a periodic accounting to the Superior Count and recent legislation has changed the accounting format. You might want to suggest a voluntary accounting in a non probate situation when you know that the beneficiaries are fractious since an accounting which satisfies the statutory requirements limits the period during which the heirs can complain.**

GIFT TAXES, Form 709

1. **For gifts prior to 1997, the IRS could and still can challenge the valuation of a gift for estate tax purposes even if they had decided to accept the valuation for gift tax purposes a dozen years earlier. Since it is often impossible to validate valuations of old gifts, it is sometimes necessary to compromise with the IRS and to pay additional estate tax. There is now a three year statute of limitations with respect**

[2] This statement is solely for illustration. The author is not an attorney and this language may or may not achieve the desired result.

to all issues related to a gift after 1996, including the valuation for estate tax purposes, if the gift is "adequately" disclosed[3] on a 709.

Several commentators have suggested filing a 709 whenever there is a valuation issue, even if the return states that the gift is valued at less than the annual exclusion. I understand that 709 filings are up several fold.

I recommend that you make it a habit to discuss gifts as part of your annual review with your customers. It is also good practice to routinely extend the time for filing the gift tax return whenever extending the time for filing a personal return since a gift tax return might also be required.

2. **We are all aware of the $10,000 annual exclusion from Gift and Estate tax and that the exclusion also applies to gifts made in trust so long as the trust beneficiaries have an opportunity ("Crummey power") to withdraw the funds. Be sure that your customers retain the Crummey letters if they are making annual exclusion gifts in trust and attach the Crummey letters to any Forms 709 that are filed.**

   There is also a $10,000 annual exclusion from the Generation Skipping Tax (GST) so long as the gift is made directly or, <u>if the gift is in trust, so long as the only trust beneficiary is a direct skip</u>.

   Many gifts in trust do not qualify for the exclusion. The typical life insurance trust, for example, names the donor's children as beneficiaries with the donor's grandchildren as contingent beneficiaries. The premature death of a child results in a 55% GST tax on the share that passes to the grandchild, even though the annual gifts to the trust never exceeded $10,000.

   The solution is to file a gift tax return every time that you make a gift to a trust where a beneficiary or contingent beneficiary is one generation removed from the donor. The purpose of filing the 709 is to allocate part of the donor's lifetime $1,010,000 GST exclusion[4] to the gift. Once the GST allocation is made, all distributions will be free of GST tax no matter how much the trust appreciates.

ESTATE TAX RETURN, Form 706

The purpose of the federal estate tax return is to identify and value each asset owned by the decedent at the time of his or her death. Even though many returns show no estate tax liability, all returns have income tax consequences since the entries on the Form 706 determine the tax basis for subsequent sales.

All returns are reviewed by an estate tax attorney. Your goals as preparer are

- **First, to provide a complete an accurate return which is weighted in favor of the estate in those areas where the law or valuation is uncertain; and**
- **Second, to present the return in such a way that the examiner can easily confirm that the return is complete and substantially accurate.**

I have been told by IRS examiners that unclear and/or poorly documented returns are more likely to be chosen for examination.

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[3] Final regulations were issued December 3, 1999. "Adequate disclosure" is defined in §301.6501(c)-1(f).

[4] The million dollar GST exclusion has been indexed and is $1.010 million as of 2000. The $10,000 annual exclusion for gift and GST is also indexed but it will be another year or two before this changes.

1. **What did the decedent own? Watch for incomplete gifts, like a home deeded to children in which the decedent continues to reside or an UTMA account with the decedent as both donor and trustee.**

   The IRS wants copies of any trusts where the decedent was the donor, trustee or beneficiary since even a limited power of appointment may bring some or all of the trust assets into the gross estate.

   IRC §2040 says that half of the property held in joint tenancy is owned by each spouse whereas the entire value of joint tenancy property is included in the gross estate unless the contribution of the non spouse owner is demonstrated.

   The presumption in California is that everything acquired by a couple after marriage is community property. This is even true if the couple acquired the asset before becoming California residents. The distinction between separate and community property is important because community property receives a double step up in basis upon the death of either spouse and community property interests are reported on the 709 even if the decedent's name doesn't appear on the title.

   Of course, gifts have a carryover rather than stepped up basis.

   The community property presumption can be overcome by appropriate evidence. There are different standards in the Family and Probate Courts. In particular, statements as to what is community property which are written into revocable estate planning documents and wills are not considered in divorce proceedings.

   The manner in which title is registered may not be determinative. For example, if the bank account reads John Doe as separate property, it could be community property whereas if the deed reads John and Mary Doe, JTWROS it is probably not community property. Title has a larger import for real estate because of the extra documentation required for real estate transfers. But even real estate titles have their limitations. For example, the family residence is probably community property no matter what the deed says if purchased prior to 1984.

   Gifts and inherited property can be inadvertently converted to community property if the source of the funds can not be traced. Tracing is not for beginners.

   The recent Bonds decision, in which the court ruled that the prenuptial agreement was not valid because the future Mrs. Bond was not represented by independent counsel, has serious implications for both prenuptial agreements and property agreements generally. Be alert for a quirk in the ERISA legislation: only a spouse can give up his or her rights to qualified plan benefits and therefore qualified plan benefits CANNOT be waived in a prenuptial agreement.

   Life insurance, IRAs and annuity contracts are generally community property and the community share is reported on the 706 of the first spouse to die whether or not the decedent is listed as the owner.

   My recommendation is to seek legal advice on community property issues, to get this advice in writing and to attach this advice to the return. My observation is that all attorneys do not understand the community property rules in the same way and that it is possible to influence the result through your choice of counsel.

2. **What is the value? Publicly traded stocks and bonds are straight forward and a personal residence can be valued by comparison to the selling price of comparable homes. Contact the insurance companies to value life insurance as of the date of death and ask them for a Form 712 to attach to the return.**

If real estate is to be sold before filing the 706, the most credible valuation might be the actual sales price. You are going to need appraisals for works of art, jewelry, collections and other unusual and potentially valuable items, for commercial real estate, partnership interests and for closely held businesses.

The contribution of an asset to the gross estate is its value times an appropriate discount. Discounts come in a variety of flavors. While co-tenancy usually involves a discount, the Courts (e.g., Wayne-Chi Young 110 TC 24) have ruled that there are is no joint tenancy discount since the value is set by statute.

Taxpayers have argued that the decedent's share of a personal residence owned as community property is less than half since it is difficult to demand full price if the buyer has to share each and every room with the surviving spouse. The IRS fought the concept of community property discounts but the Ninth Circuit sided with the taxpayer in Propstra (1982.) Community property discounts are analogous to the discounts for co-tenancy.

The IRS soon realized that we were not preparing returns in a consistent manner. We tended to claim discounts in a taxable estate but to overlook these discounts in a non taxable estate. Two Bay Area examiners have told me that they will challenge the non taxable 706 of the first spouse to die[5] if there is no community property discount ascribed to a "substantial" personal residence.

Discounts in a non taxable estate do not affect estate taxes but do increase income tax when the asset is sold. So, discounts at the first death are usually an income rather than an estate tax issue. The §121 exclusion on the sale of personal residences makes the discount moot in many situations so long as the residence is allocated to the surviving spouse. (Perhaps this is why the examiners are willing to overlook the community property discount on modest residences.)

I suggest the following strategy if the intention is to allocate the personal residence to the by-pass trust. First, take an appropriate community property discount on the Form 706 and allocate the personal residence to the surviving spouse. Once the IRS has accepted the estate tax return, the surviving spouse sells the residence to the by-pass trust at the current FMV. Any gain on the sale is probably offset by the §121 exclusion. The IRS is happy because a discount was taken on the 706 and the client is happy because their home has a fully stepped-up basis.

3. **The largest opportunities for deep discounts are with partnerships and LLCs taxed as partnerships because the partner/shareholder cannot sue to partition as they can with a co-tenancy. You can save a lot of estate tax for your clients so long as you are not greedy. An egregious discount will be challenged but it is more difficult to challenge an aggressive valuation. So, the best way to wage the valuation battle may be to assert an aggressive discount on an aggressive valuation.**

   I had expected the burden of proof to shift to the IRS when there was a valuation disagreement. However, a recent series of Tax Court cases with Judge Laro presiding suggests that it is tough to convince at least one judge that the taxpayer's valuations are credible. See Kaufman, TC Memo 1999-119.

   It is not wrong to value assets aggressively. Indeed, the IRS will automatically lower valuations if they decide to challenge the return. While none of us want to

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[5] The unlimited marital deduction only applies if the surviving spouse is a US citizen or if the marital share flows to a Qualified Domestic Trust. See IRC §2056(d).

make a mistake that triggers an unnecessary audit, adopting conservative valuations so that your Forms 706 are never audited is leaving your clients' money, potentially large amounts of your clients' money, on the table.

As always, seek competent advice and be sure that the executor both understands that aggressive discounting increases audit risk and that he makes the decisions.

4. **It has been the law of some time that one does not aggregate stock owned by the by-pass trust and stock owned by the surviving spouse for purposes of determining whether a minority interest discount applies. For control reasons, it would be more attractive to split an asset between the QTIP trust and the surviving spouse but it had been unclear whether discounts also applied in this situation. The IRS recently acquiesced in the case of Mellinger (112 TC 4; AOD 1999-006) and agreed that minority interest discounts are appropriate for stock owned within a QTIP trust even if the surviving spouse owns stock in the same corporation. This opens up new possibilities for valuation discounts.**

5. **The value of what the decedent owned is offset by the decedent's debts. If a check does not clear the bank before death, the debt was not paid or the gift was not made before death. This differs from the income tax rule that a cash business pays a bill on the day that it mails the check.**

   David Gaw tells the story of a woman who decided to make annual exclusion gifts literally at death's door. There was not time to locate the addresses of all of the beneficiaries and one gift was wired to "John Doe, Fairbanks, Alaska." It would take the receiving bank a week to locate John Doe but the money was out of the woman's account when she died a few hours later.

   Real estate and California taxes can be deducted on more than one tax return. They qualify as unpaid debts on the 706 and as income tax deductions when paid. Real estate taxes assessed but not yet payable for the coming July - June fiscal year are an unpaid liability if death occurs in the preceding January - June period.

6. **Arranging to pay some tax at each death usually lowers the overall estate tax liability because the tax rates are graduated. The argument for paying tax at each death becomes unassailable if the surviving spouse dies soon after the decedent.**

   Therefore, it borders on malpractice to not request an extension of time to file, especially if the estate is substantial and the surviving spouse is in poor health, since an extension provides extra time to create a taxable first estate in the event of an early death of the surviving spouse.

   One can create a taxable estate at the first death by disclaiming assets which qualify for the marital deduction[6] or by not making the QTIP election. This disclaimer must be done within nine months whereas the QTIP election can be made up to the time of filing the 706.

   The surviving spouse has significant control over a QTIP trust and therefore the residual value of the QTIP is included in the estate of the surviving spouse. A QTIP trust is included in the estate plan in order to allocate the full million dollar GST exemption or when the decedent wants to defer estate tax at the first death but to control the ultimate beneficiaries.

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[6] Disclaiming part of an asset can create a minority interest discount for the remainder which passes to the surviving spouse. This discount decreases the marital deduction and increases the estate tax.

7. **The executor, or trustee if there is no executor, is personally liable for paying any income and estate taxes. Consequently, the executor is unlikely to close the estate until he or she is sure that the IRS is satisfied. To speed the process along, the executor can request a prompt assessment of the income tax liabilities under §6501(d), both for the decedent's personal return and for any fiduciary returns. This request is made on Form 4810 and shortens the tax assessment period to eighteen months. There is no effect on the statutes for fraud or underpayment.**

   The executor can also request a release of his personal liability for income, gift and estate taxes. Form 5495 requests release from income and gift tax liabilities; the release occurs when the assessment is paid or after nine months if the IRS does not assess a tax liability within nine months.

   There is no special form for requesting a release of personal liability for estate taxes but the request must refer to §2204. PPC's "706 Deskbook" has an illustration.

   Even though the executor is off the hook for estate taxes, the IRS can still go after the assets themselves for the tax. If the executor happens to be one of the beneficiaries, he might well be in for further discussions with the IRS.

8. **Form 56 "Notice Concerning Fiduciary Relationship" acts much like a power of attorney. It directs the IRS to send notices to the fiduciary rather than to the last known address of the decedent. Unless the Form 56 is filed, the ninety day period for appealing a statutory notice might run before the fiduciary becomes aware of it.**

REFERENCES

Classes provided by the California CPA Foundation, (800) 922-5272 and www.calcpaed.org.

"Hot Topics and Battlegrounds of the Estate Tax Return" by Keith Schiller with assistance from Joe Stemach, a Senior Estate Tax Attorney with the IRS in San Francisco.

"A Practical Workshop on Trust Administration of the Living Trust" by David Gaw, an attorney in Napa and Fairfield. See also www.gvmsmm.com

"When Clients Die: Post-Mortem Tax Returns and Tax Planning" by Jim McDaniel, an attorney in Los Angeles.

"Preparation of the 706." Text originally by Raymond Bolton.

"California Community Property" by Eileen Preville, a Family Law attorney in Alameda and Judge Pro Tem, Alameda and Contra Costa County Superior Courts.

"Practical Estate Tax Strategies: Effective Valuation Discount Planning" by Owen Fiore, an attorney and CPA in San Jose.

"Fiduciary Accounting for Estates and Trusts" by David Ostrove, an attorney and CPA and an Adjunct Professor at Southwestern University School of Law in Los Angeles.

"1041 Deskbook" and "706/709 Deskbook," Practitioner's Publishing Company, Fort Worth Texas. Updated annually.

"What to Do When Your Spouse Dies." This discussion is an overview of what needs to be done between the death of the first spouse and the final funding allocation of the by-pass trust and survivor's share. It can be found at www.lingane.com/tax/death.htm.

"Roth Might Mean Rethinking Your Estate Plan." This article discusses the use of disclaimers for funding the by-pass trust. It can be found at www.lingane.com/tax/roth/rethink.htm.