1984

Post-Mortem Estate Planning

Malcolm A. Moore

Repository Citation
http://scholarship.law.wm.edu/tax/542

Copyright © 1984 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
Knowledge of post-mortem estate planning has always been necessary for any advisor working in the trusts and estates area. In one respect, post-mortem estate planning is more satisfying than general estate planning because one is dealing with a fixed set of facts (when the client has died) and it is up to the post-mortem planner to be as creative as possible in saving income, gift and estate taxes within a given set of parameters. In the general estate planning area all possibilities must be considered and that can be frustrating, as well as challenging. With the removal from the transfer tax system of a large number of estates when the 1981 tax legislation was passed expanding the unified credit and introducing the unlimited marital deduction, post-mortem estate planning will become an increasingly significant part of every estate lawyer’s practice. Even those estates which no longer generate any estate tax are still prime candidates for effective post-mortem estate planning; significant reduction of income taxes during estate administration for such estates is still possible.

My focus in discussing post-mortem estate planning in this paper is on those aspects of post-mortem planning which are relatively new; some of these possibilities have come about through recent legislation and others are refinements on old techniques given recent legislative, case law, and ruling developments. The traditional post mortem planning techniques of using the estate as a separate tax paying entity, with the selection of a fiscal year, etc., while not highlighted in the paper, are discussed at its end.

I. Elections Available To Executor.

Alternate Valuation Election.

The Deficit-Reduction Act of 1984 (the “1984 Act”) permits the election of the alternate valuation for estate tax purposes only if the election would result in (a) a reduction in value of the decedent’s gross estate and (b) a smaller estate tax liability. Hence the election of a higher alternate value in a “no tax” situation (for example, by reason of the unlimited marital deduction) will not be allowed. The provision applies to estates of decedents dying after July 18, 1984. The Act also allows an alternate valuation election to be claimed on a late-filed estate tax return, but the return cannot be filed more than one year after the time prescribed by law (including extensions) for filing.

The prohibition against using the alternate valuation date in a zero tax estate is potentially disastrous when the will or revocable trust contains a pecuniary maximum marital deduction bequest (either outright or in trust) with the residue constituting the credit shelter and the estate has substantially depreciated during the six-month period. In such a situation, all of the
decrease in value will be allocated to the residue (credit shelter disposition) and none to the marital share, and the residue could be eliminated or reduced substantially. For example, if an estate was worth $6,000,000 at death, but declined by $600,000 in the first six months, and no alternate valuation date could be elected, the entire $600,000 reduction in value will reduce the exemption equivalent disposition to zero.

If some tax was payable, but would be reduced by use of the alternate valuation date, the alternate valuation date could be used. Hence, a partial QTIP election to pay some tax might seem sensible. However, if the decedent resided in a state whose estate tax is the amount of the federal state death tax credit, the entire death tax credit amount must be paid to the state. Presumably an executor would not want to incur payment of the entire state death tax credit merely to make the alternate valuation election available. However, in a jurisdiction which does not define its death tax in terms of the federal credit, paying a small amount of federal tax to enable use of the alternate valuation election should be explored.

"Discretionary" Valuations. Even if the alternate valuation date cannot be used (as in a no-tax situation) there is usually some latitude given an executor to opt for higher, as opposed to lower, valuations, when different to value assets (such as closely held stock) are involved. This would be desirable if a higher cost basis for income tax purposes could be achieved through the use of the higher date of death values. Of course, consideration must be given to I.R.C. § 6659 (providing for penalties for overvaluation of assets) which apparently could be used by the IRS to impose §6659 penalties on a taxpayer selling assets which had received too high a value (and hence basis) for estate tax purposes. See f.n.1 of Joint Jommittee General Explanation of ERTA (1900), p. 333.

If it is determined that there is latitude in valuation in a no-tax situation, and that Section 6659 will not be applicable or troublesome, consideration should be given to the following general principles:

1. In general, if no tax is payable at death of either spouse, choice of the highest reasonable values upon the first death in order to achieve an increased cost basis for capital gains, depreciation or cost depletion seems desirable.

2. If the credit shelter or exemption equivalent disposition is carved out by way of a pecuniary bequest, with the residue passing to or for the spouse's benefit, choice of higher values to achieve a greater income tax basis would also seem prudent. The legacy would be funded with assets at their distribution date values, and anything in excess of that would pass to the marital share. Regardless of the asset values, the credit shelter disposition receives only the dollar amount of the exemption equivalent, and the balance passes to the marital share.

3. If the instrument provides for a marital deduction pecuniary bequest, with the residue passing to others or to a "family" trust, choice of higher values could substantially increase the amount passing to the marital trust, which in turn will be subject to tax in the surviving spouse's estate. This is
undesirable. Under pre-1982 law, only one-half of any such increase in value was taxed at the surviving spouse’s death (since the marital deduction at the first death was limited to one-half of the estate), but a new cost basis was achieved with respect to the entire additional value. After 1982, however, all of such increase in value will be subject to tax at the surviving spouse’s death, because of the unlimited marital deduction. For example, assume an adjusted gross estate (as computed under prior law) where the range of possible asset values is between $1,800,000 and $2,100,000. The assets appreciate to $2,600,000 on date of distribution. The surviving spouse has $600,000 of separate assets and both deaths occur after 1987. If the lower value of $1,800,000 is used, the spouse receives $1,200,000. If the higher value of $2,100,000 is used, the spouse receives $1,500,000. This will mean that potentially $300,000 more will be subject to future estate tax in the surviving spouse’s estate to achieve $300,000 of additional basis. The additional estate tax at the surviving spouse’s death will be $139,000, assuming no further appreciation, versus a maximum capital gains tax saving of $60,000. Use of the higher values would not be warranted.

Undervaluation Penalties.

The 1984 Tax Act added Section 6660 which provides a penalty in case of asset undervaluation for gift and estate tax purposes. The presence of this penalty will require greater care and caution than in the past when nonfraudulent attempts to use low valuations only resulted in the additional tax and interest if a higher value was ultimately sustained. The new Section provides that if it is determined that the valuation claimed is 50% or more but not more than 66-2/3% of the true value, there is a penalty equal to 10% of the underpayment of tax; if the valuation is 40% or more but less than 50%, then the penalty is 20% of the underpayment; and if the valuation is less than 40% of the true value, then the penalty is 30% of the underpayment. There is a de minimis exception for underpayments of less than $1,000 and the IRS may waive all or any part of the addition to the tax on a showing by the taxpayer that there was a “reasonable basis” for the valuation claimed on the return and such claim was made in “good faith.” It remains to be seen what it will take to establish a “reasonable basis” for the reported value; presumably appraisals should be of help, although no regulations have yet been issued. The penalty would appear to apply even if the undervaluation is due to a mistaken assumption that Section 2032A would apply. Does reliance on the cases which have been favorable to the taxpayer in allowing for a minority and nonmarketable discounts on closely held stock constitute “a reasonable basis”? The answer should be “yes” but there is no guidance. The penalty applies for taxes payable on returns filed after December 31, 1984.

Deduction of Administration Expenses.

If no estate tax is payable, because either a decedent’s property falls below
exemption equivalent or the unlimited marital deduction is being used, or because of a combination of these, administration expenses such as executors' and attorneys' fees which are deducted on the estate tax return will not generate any tax savings, for the obvious reason that no estate tax is payable. This would lead one to conclude that in every such case they should be deducted on the estate's income tax return.

However, when such expenses, which are charged against principal, are used for income tax purposes, as opposed to estate tax purposes, a "Warms" type adjustment is often mandated, either by the governing instrument or by state law. In re Warms Estate, 140 N.Y.S.2d 169 (Surr. Ct., N.Y. Co. 1955); In re Bixby's Estate, 295 P.2d 68 (Cal. 1956). The income account is obligated to reimburse the principal account for the additional estate tax caused by the failure to use the deduction against the estate tax. However, when there is no estate tax, there has been no detriment to principal, and hence there would appear to be no adjustment required under the Warms rationale.

However, there still could be an argument for some kind of equitable adjustment. It could be argued that even if no estate tax is payable, had the expenses been deducted on the estate tax return and not on the income tax return, the nonmarital credit shelter disposition would not have been reduced by the amount of such expenses and, therefore, more property could have been excluded from the surviving spouse's estate. Foregoing an immediate income tax deduction could result in a possible future tax reduction. In the author's opinion, it is most unlikely that an executor (the spouse, child or a third party) could be criticized for not opting for the more immediate tax savings, even though it could arguably ultimately result in the diminution of principal by payment of additional estate taxes at the second death. Given this belief, the author also believes that no equitable adjustment should be contemplated.

On the other hand, if the administration expenses would ultimately be chargeable against the marital share (either because the unified credit had been used up during life and no other source existed for their payment, or the instrument's language did not require that administration expenses deducted on the income tax return by payable from the nonmarital share) perhaps it would be more prudent to deduct them for estate tax purposes, rather than for income tax purposes, even though there appears to be no immediate benefit. If they were deducted for income tax purposes, and taken out of the marital share, estate tax would have been created where none was intended because the marital deduction would be reduced.

If this happened, then arguably there would be a Warms-type equitable adjustment payable from income in the amount of the estate taxes caused by deducting administration expenses on the income tax return, as opposed to the estate tax return.

Could it be argued, however, that if state law imposed a Warms-type adjustment on the estate, that no taxes should be deemed payable from the marital share in the first place, and hence there should be no estate tax? This
theory has been suggested by some prominent commentators. Blattmachr & Lustgarten, "The New Estate Tax Marital Deduction: Many Questions and Some Answers," 121 Trusts & Estates No. 1, p. 18 (Jan. 1982). For this theory to work, however, there would have to be an actual Warns adjustment which reimbursed principal (and hence the marital share) for 100% of the estate taxes paid. If income from the QTIP trust is used to make the reimbursement (which under the Warns rationale would be the case), has the QTIP trust been disqualified because the spouse is no longer receiving all of the income? The answer should be no, based on the argument that if state law imposes a Warns adjustment, this by definition would reduce the income in the QTIP trust and the surviving spouse would still be receiving, under state law, all of the trust income. If there was a nonmarital trust disposition, there should be no qualification problem if income is taken from the nonmarital share to make the reimbursement. Usually, however, there will not be sufficient income in the nonmarital share to fully adjust for such estate taxes, and the QTIP or other marital disposition would have to be tapped.

**The QTIP Election.**

**In General.**

In determining whether to make a full or partial QTIP election, the executor is first governed by the governing instrument's language. For example, the Will may direct the executor to elect all qualifying property for QTIP treatment. The Will might direct the election unless the surviving spouse did not have a long life expectancy at the first spouse's death. The rationale for this would be that a full election in the first decedent's estate would generate no tax and none of the lower estate tax brackets would be utilized, whereas all the property would be taxable in the surviving spouse's estate at higher brackets.

If wide discretion is given the executor, the following factors are some which should be considered:

1. Size of respective estates of husband and wife.
2. Age and physical condition of surviving spouse.
3. Source of death tax payments for nonelective share; if a partial election is made which creates tax, the executor must know the source of that tax and whether it will be paid by the same beneficiaries as ultimately receive the QTIP trust remainder, or whether other beneficiaries will bear the burden.
4. Possibility of disclaimer by the surviving spouse which might preclude a partial or full election by the executor.
5. Potential availability of a Section 2013 property previously taxed credit to the surviving spouse's estate for a life estate subject to tax in the first estate; this could be relevant to whether the partial QTIP election or disclaimer route should be chosen.
Mechanics of Making the Election.

Proposed Regulation § 20.2056(b)-7(b) states that the QTIP election shall be made by the executor (as defined in Section 2203 and the Regulations) who is "in possession of" the qualified terminable interest property and shall be made by such executor on the estate tax return. The regulation goes on to define the estate tax return as the last estate tax return filed by the executor on or before the due date of the return, or if a timely return is not filed by the executor, on the first estate return filed by the executor. Hence the election can be made on a late filed estate tax return, which had been questionable before the regulations were issued. However, the election, once made, is irrevocable. Also, if the executor has made an election with respect to one or more properties, then no subsequent election may be made with respect to other properties in the executor's possession. The reference to property in the possession of the executor would prevent an appointed executor from making an election for property held by a trustee under a revocable trust because the executor does not have "possession" of that property. The regulation should make it clear that the executor can make the election for all property, whether or not possessed by the executor.

Recent private letter rulings have held that no QTIP election is available if an election is not made on the first return filed, although if the time for filing a timely return is still open, presumably an amended return can be filed claiming the election. Private Letter Rulings 8418005, 8427004, and 8427007. Neither of the returns as filed in the latter two rulings indicated in any manner a desire to claim QTIP treatment. However, on both returns, the property in question was listed on Schedule M as a deductible interest, but with no further explanation. In one ruling there was no box on the return to check, and in the other the box had been checked "no". The Rulings did not disallow QTIP treatment solely because the appropriate box was not checked; each ruling said that if there had been sufficient other indicia of interest on the return to claim QTIP treatment, the marital deduction would have been allowed.

Partial Elections.

Proposed Regulation § 20.2056(b)(7)(b) confirms the language of a previously issued temporary regulation that a partial election can be made relating to a fractional or percentile share of the property, and that it can be made by means of a formula. The provision then goes on to state that if a partial election is made, the trust may be divided into separate trusts to reflect a partial election that has been made or is to be made. If such a division occurs, the fiduciary must divide the trust according to the fair market value of the trust assets at the time of the division. The creation of separate trusts is usually the most advantageous manner in which to effect a partial election. The trustee can invest the two trusts differently, e.g., the elective trust could be invested in income-producing assets and the non-elective trust could be
invested in growth assets. Further, invasions could be made from the elective trust before the non-elective trust was depleted by such invasions. It is also clear that if separate trusts are not cleared, but a partial election is made with respect to a portion of a QTIP trust, then principal invasions can be made from the share for which a QTIP election has been made before invasions are made from the other share. Proposed Regulation § 20.2044-1(d), and (2). The examples in paragraph (e) illustrate that property included in the surviving spouse's estate when there has been a partial election is reduced by the invasions made from the qualified share, even though no invasions have been made from the nonqualified share.

_Election for Dispositions Made Under pre-September 11, 1981 Instruments._

If the disposition meets QTIP qualifications, an election is allowed. See, _e.g._, Private Letter Rulings 8308053, 8309030, 8343020, 8440037 and 8420074. Assuming that all of the decedent's property would pass under either a marital deduction formula clause or under an "old" trust for which QTIP treatment was elected, or both, the exemption equivalent in the decedent's estate could be saved and not wasted by a partial, not a full, election by the executor of the decedent's estate for assets passing into the residuary trust. Alternatively, there could be a partial formula-based disclaimer by the surviving spouse of a portion of property passing under either the maximum marital deduction clause or the residuary trust.

_Allocation of Assets Between Marital and Nonmarital Shares._

In general, growth assets should be allocated to the nonmarital share. However, if there is only a choice between growth assets on the one hand, and high yield assets on the other, a case can be made for allocating the growth assets to the marital share, and the high yield assets to the nonmarital share. At the surviving spouse's death the growth assets in the marital share will receive a new cost basis, eliminating any capital gains tax. If it is assumed that income received by the surviving spouse from the marital share will be taxed at 50%, allocation of the high yield assets to the nonmarital share would create the possibility that the income will be taxed in a lower bracket, such as a child's. Of course, if the surviving spouse receives all of the income from the nonmarital share, then this assumption is not accurate.

II. DISCLAIMERS

Post-1976 Transfers in General.

Section 2518, enacted as part of the Tax Reform Act of 1976, attempted (but failed) to "federalize" the law regarding disclaimers. In order to be a "qualified" disclaimer (so as to not be treated as a transfer by the disclaimant for estate, gift, and income tax purposes) Section 2518 provides that the disclaimer must be irrevocable and unqualified and must also have the following characteristics:

1. This disclaimer must be made within nine months after the day on which the transfer creating the interest is made (which means, according to the Congressional Committee Reports, a completed transfer for gift or estate tax purposes), or, if the disclaimant is under age 21, he or she has until age 21, whichever is later, to make the disclaimer, § 2518(b)(2);
2. The disclaimant may not have accepted any of the interest or its benefits, § 2518(b)(3);
3. As a result of the disclaimer, the interest must, except in the case of a spouse, pass to a person other than the person making the disclaimer, and there cannot be any direction on the part of the person making the disclaimer with respect to the disposition of the disclaimed property. § 2518(b)(4).

The statute goes on to specify that disclaimers can be made of "undivided portions" of an interest, § 2518(c)(1), and that a power with respect to property is regarded as an interest in such property for purposes of a disclaimer. § 2518(c)(2).

Proposed § 2518 Regulations.

Proposed regulations under § 2518 dealing with disclaimers were filed on July 21, 1980, and have not yet been made final. The following are the more noteworthy provisions:

1. Proposed Regulation § 25.2518-1(c) dealing with the effect of local law confirms the position taken in several private rulings that if a disclaimer is not made in a timely fashion under state disclaimer law, it will not qualify under § 2518.
2. Proposed Regulation § 25.2518-2(c) dealing with the nine-month time limit makes it clear that a person can disclaim upon attaining age 21 even though the disclaimant has received benefits from the property "without any action on his part but before attaining 21 years of age," such as a trustee exercising discretion for the minor's benefit. Paragraph (c)(2) of that section also makes it clear that in the case of a special power of appointment, the holder of the power, permissible appointees, or takers in default of appointment must disclaim within a nine-month period after the creation of the power. This is obviously impractical, since in the case of a "limited-unlimited" power of appointment exercisable in favor of anyone except the decedent, his estate or creditors of his estate, anyone else in the world is a permissible appointee.
3. With respect to the condition of § 2518 that no disclaimant may have accepted benefits in property attempted to be disclaimed, Proposed Regulation § 25.2518-2(d) states that the payment of property taxes on property subsequently disclaimed is an acceptance of the property, as is a request by the disclaimant to a fiduciary to sell property and give the proceeds to the disclaimant.

4. Proposed Regulation § 25.2518-2(d)(3) dealing with joint ownership specifies that any disclaimer of a joint tenancy must be made within nine months of the creation of the tenancy; this is consistent with the holding of a number of private letter rulings in the area.

5. Proposed Regulation § 25.2518-2(e), dealing with how much power can be retained by a disclaimant to direct beneficial enjoyment of the disclaimed property, provides that a power of appointment may be disclaimed if there is no direction on the part of the disclaimant with respect to the transfer of the property subject to the power. There have been some questions as to whether a power could ever be disclaimed because such a disclaimed power does not usually pass to someone other than the disclaimant, which is one of the requirements of § 2518.

6. Proposed Regulation § 25.2518-2(e)(2) dealing with disclaimers by surviving spouses and the examples relating thereto, states that a disclaimer of a portion of a marital deduction trust which passes to a nonmarital trust is a qualified disclaimer so long as there is no special power of appointment present. If there is such a special power present, the special power must also be disclaimed. However, the disclaimer of such an interest into a nonmarital trust where the surviving spouse can invade corpus for his or her “health or maintenance” is allowed.

7. Proposed Regulation § 25.2518-3 deals with disclaimers of less than an entire property interest. Paragraph (a)(1)(i) states that an income interest beneficially owned by a person shall be considered one interest and a beneficial interest in corpus shall be another interest. Therefore, a beneficiary who has a life interest and a remainder interest in the same trust can disclaim one, and keep the other. However, this section also states that if the applicable instrument divides the property in a manner that would permit the disclaimant “to avoid the limitations of § 2518, the separate interests created by the grantor are treated as one indivisible interest.” An example of this is contained in example (14) of paragraph (d) which recited the following fact situation: D was to receive one-third of the residuary estate, with any disclaimed property passing to E; D was to receive a second one-third of the residuary estate with any disclaimed property passing to F, and D was to receive the final third of the residuary estate with any disclaimed property passing to G. D disclaimed the first third of the residuary estate, but kept the other two. The example states that this disclaimer is not a qualified one.

This section also specified that if state law merges separate interests (such as remainder interests and income interests) transferred to a beneficiary, the beneficiary must disclaim the entire interest, and may not keep the income or
the principal interest, respectively. Example 13 of paragraph (d) involved the factual situation where A received a life estate in a farm, and was sole recipient of the residuary estate, which also received the remainder interest. Under state law, the beneficiary's interests merged to give him a free simple in the farm and all he disclaimed was the life estate. The example states that the disclaimer does not qualify.

Paragraph (a)(1)(ii) states that a partial disclaimer may be made of severable property, which “can be separated from other property to which it is joined and which, after severance, maintains a complete and independent existence.” There follows an example involving the disclaimer of some shares of a corporate stock, with the acceptance of others, resulting in a qualified disclaimer.

Paragraph (a)(2) deals with interests in trusts and states that a trust beneficiary must disclaim all interest in principal, or all interest in income, to have a qualified disclaimer. Thus, for example, a testamentary power of appointment over principal cannot be effectively disclaimed without disclaiming rights to receive discretionary distributions of principal (example 11 of paragraph (d)). A disclaimant can also not disclaim discretionary powers to pay himself principal for “happiness,” but retain the right to pay it for “health and maintenance.” Such a disclaimer would have been useful to convert an otherwise general power of appointment to a limited, nontaxable power of appointment.

In that same paragraph (a)(2), it is stated that income or remainder interests in particular trust assets may not be effectively disclaimed if interests in income or principal in other trust assets are retained.

Paragraph (b) of the proposed section makes it clear that a beneficiary who would otherwise have received a fee simple disposition may not “carve out” and disclaim the remainder interest, while keeping the life estate. This is not a disclaimer of “an undivided portion” which the paragraph states must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in such property and must extend over the entire term of the disclaimant’s interest in such property and in other property into which such property is converted.

Private Letter Rulings on Partial Disclaimers.

Partial Disclaimers of Partial Interests.

Private Letter Ruling 8332014 held unqualified the disclaimer by a trust beneficiary of the income from, and a general power of appointment over, specific trust assets. The Ruling held that such a disclaimer did not constitute the disclaimer of an undivided portion of an interest in property called for by I.R.C. § 2518(b). Proposed Regulation § 25.2518-3(c)(5) was cited as authority for this proposition.

In Private Letter Ruling 8406014, the IRS held that the disclaimer of individual assets from an estate (as opposed to a trust) constituted a qualified
disclaimer. The Ruling stated that although the items of the residue of the
estate are not initially identifiable, the residue, at the time of settlement and
distribution, consists of specific property items that are separate, complete
and of independent character. Consequently, a residuary beneficiary’s inter-
est, for purposes of Section 2518, is regarded as an interest in severable prop-
erty. It is only when disclaimers are attempted to be made in trusts that the
requirements of the private letter ruling explained in the above paragraph are
applicable because at that point the IRS regards principal and income as
different interests and one has to disclaim all of one, or a portion of one, in a
manner that qualifies the disclaimer as an undivided portion of an interest.

Acceptance.

In Private Letter Ruling 8405003, the IRS held unqualified the attempted
disclaimer by a widow of assets bequeathed to her from her husband. The
executor had written estate checks covering a number of the widow’s
expenses the effect of which were interest-free loans from the estate to the
widow. The “loans” were ultimately repaid. The Ruling held that the enjoy-
ment by the widow of the estate’s money, interest free, for a nine month
period was a benefit and constituted acceptance of the property attempted to
be disclaimed. The Ruling rejected the estate’s position that the widow was a
“debtor” rather than a beneficiary. Had the money actually been loaned to
the widow, who had then paid her own expenses, perhaps the argument
might have succeeded, although that too is questionable. Finally the Ruling
concluded that a person who disclaims has no interest in the disclaimed
property and, therefore, it would clearly be a breach of fiduciary duty for the
estate’s executor to make disbursements for the benefit of a person not an
estate beneficiary.

Disclaimers in Post Mortem Planning.

Avoiding “stacking.”

A common goal of disclaimer is to avoid “estate stacking” in a “second”
estate—e.g., the estate of a surviving spouse or where an intended beneficiary
under a will has inherited substantial property in the period following the
drawing of the will and desires to disclaim or reduce taxes in his or her estate.

Income tax savings.

Disclaimers can also be useful in saving income taxes on income which
would be generated in the future by the disclaimed property, where the dis-
claimant is in a high income tax bracket and the takers of the property by
reason of the disclaimer are in low brackets. Private Letter Ruling 7830022
states that no triggering of income in respect of a decedent occurs upon dis-
claimer of right to such income. A disclaimer could also be useful where
substantial capital gains attributable to an asset have been incurred since
death, and it is desired to spread those gains among several beneficiaries
either by distributing these gains to those beneficiaries on whose behalf they
have been incurred (such as gains on specifically devised real property), or by
making distributions from the estate to carry out distributable net income,
which (in addition to carrying out ordinary income) could be structured in
that particular year to contain such capital gains. Regulation § 1.643(a)-3(a).

Disclaimers and The Marital Deduction.

Disclaimers are extremely helpful in qualifying an otherwise unqualified
trust for QTIP election, in reducing the marital deduction where there is an
overqualification, and in increasing the marital deduction where there is an
underqualification. Recent private letter rulings provide helpful factual back-
grounds in evaluating the utility of disclaimer for marital deduction purposes.

1. Disclaimers to create a marital deduction qualification of a “family”
or “nonmarital” trust.

Private Letter Ruling 8331066 disallowed the marital deduction for a
sprinkling trust which benefited spouse and children. The children disclaimed
their rights to receive income and principal from the trust during the spouse’s
life and directed that the spouse receive all the trust’s income, but they did
not disclaim their right to receive the trust’s remainder on the spouse’s death.
The ruling concluded that the children’s disclaimers were not “qualified”
because (a) the disclaimers were for the spouse’s lifetime and, therefore, did
not qualify as partial disclaimers because they did not relate to an undivided
portion of the decedent’s property as expressed as a fraction or percentage of
each interest, and (2) they did not disclaim their rights to receive the
remainder interests, which the IRS interpreted to mean that they could enjoy
benefits from the disclaimed property. In addition, the children’s direction
that the spouse would receive all of the income following their disclaimers
clearly would be a proscribed direction with respect to the disposition of the
disclaimed property, another factor disqualifying the disclaimers.

Private Letter Ruling 8337069 involved a testamentary trust drawn after
1982, but which contained two “problematical” provisions. One provided
that all accrued but unpaid income would be paid to the remaindermen, not
to the spouse’s estate. The second provided that a daughter was a possible
principal beneficiary during the spouse’s life. The remaindermen (including
grandchildren through the actions of a guardian) disclaimed their interests in
any of the accrued but unpaid income (presumably under the state’s disclaim-
er laws such disclaimed property would pass to the surviving spouse’s estate)
and the daughter also disclaimed her rights to receive principal during the
spouse’s life. The daughter did not disclaim her right to receive the remainder
of the trust at the spouse’s death. Contrary to the conclusion reached in the
Private Letter Ruling discussed in the above paragraph, here the IRS con-
cluded that the disclaimer was qualified and that the daughter did not need to
disclaim her remainder interest at the spouse’s death because the remaining
trust property was deemed to have passed to her from the surviving
spouse and not the decedent. Since the daughter disclaimed all interests in property passing from the decedent, she did not have to disclaim at that same time an interest which she would receive at the spouse's death and which was deemed to pass from that spouse. The ruling cited the addition of subsection (c) to Section 2044 made by the Technical Corrections Act of 1982 to the effect that the property taxed in the surviving spouse's estate under Section 2044 is deemed to "pass" from that spouse for purposes, among other things, of a new income tax basis.

Private Letter Ruling 8429085 allowed a marital deduction for QTIP property where children were mistakenly given rights to discretionary distributions of principal during the spouse's life. The children disclaimed both rights to receive principal during the spouse's life and their remainder interests. Presumably they would not have had to disclaim the latter, on the theory of Private Letter Ruling 8337069. The children were trustees for the spouse but their powers of distribution were limited by ascertainable standards. Hence the ruling held that these rights as trustees did not amount to a right to direct the disposition of the disclaimed property which would have invalidated the disclaimer, and the trust qualified for QTIP treatment.

Private Letter Ruling 8309030 held that a residuary trust qualified for QTIP treatment after the disclaimer by the surviving spouse of a lifetime power of appointment and the rights to receive principal distributions. The spouse had to disclaim the lifetime power in order to qualify it as a QTIP (no lifetime powers of disposition may be held by anyone) and to meet the proposed disclaimer regulations (Proposed Regulation § 25.2518-3(a)(1)) requiring that any rights to receive principal must be disclaimed along with any powers of appointment.

Assuming that the only problem with a trust was that the income of the trust was not, by the trust's terms, payable currently to the spouse, can the trust be qualified as a QTIP disposition? For example, if children had been named as possible beneficiaries along with the spouse of either income or principal, and they had disclaimed all of their rights, the trust would be for the sole benefit of the spouse during his or her life, but income would not be currently payable. Could the trustee, through disclaimer of a power to accumulate income, render it all payable to the spouse and thus qualify the trust? Private Letter Ruling 8409024 held, in effect, no, because (a) the trustee had no power under state law to disclaim the right to withhold income during incompetency (this was the "bad" power rather than sprinkling) under local law and (b) even if he did, such a power would not disappear with such a disclaimer, but would have to be exercised by another fiduciary. Could the trustee commit, either through an agreement with the spouse or otherwise, to pay out all of the trust's income to the surviving spouse, thereby rendering the trust qualified?

2. Disclaimers to increase an underqualified marital deduction.

In Private Letter Ruling 8347001, the IRS held that a qualified disclaimer occurred, giving rise to an increased marital deduction, when two beneficiaries
other than the spouse disclaimed their interests in the decedent's residuary estate. The residuary estate had been left equally to three people, including the spouse, "share and share alike." The ruling concluded that a clear reading of the provision resulted in all the property passing to the surviving spouse by reason of the disclaimers and that there was no question about whether or not the disclaimed property passed instead of the disclaimant under the intestacy laws. There was no need under state law to determine anything further.

3. Disclaimers to reduce an overqualified marital deduction.

Private Letter Ruling 8240012 held invalid a disclaimer by a surviving spouse (who received more property than could be deducted under the marital deduction) of $195,000 from the residuary estate. Since the dollar amount disclaimed could be satisfied "in cash or in kind," the ruling stated that the spouse "... has not identified the assets that he wishes to disclaim, and thus the Executor of [the decedent's] estate (1) must choose which assets he believes the [surviving spouse] disclaimed in order to fund the marital deduction for [the decedent's] estate and (2) must also choose assets which the [surviving spouse] will accept as part of [the surviving spouse's] inheritance." The ruling, in essence, holds that the property disclaimed is not severable from the rest of the property because of the reasons stated.

Private Letter Ruling 8310893 approves a disclaimer by a surviving spouse of a portion of the marital trust by way of a formula. The terms of the formula provided that the surviving spouse would disclaim such amount of the decedent's property as was in excess of that deductible under the applicable marital deduction limitations.

4. Disclaimers to create a marital deduction by creating an intestacy.

If the surviving spouse and other persons were beneficiaries of a decedent's will containing a trust which either would not qualify for the marital deduction in the first place, or would not qualify even after disclaimers by the other beneficiaries (e.g., sprinkling or accumulation rather than direct payout of income) if under local law the spouse could disclaim property passing under the instrument, but still not be deemed to have predeceased for purposes of the intestacy laws, the beneficiaries other than the spouse could disclaim both their testate and intestate interests. If as a result of the disclaimer of testate property by the spouse and all interests by the other beneficiaries, the property passed outright to the surviving spouse under the intestacy laws, the spouse's intestate interest would qualify for the unlimited marital deduction. This presumes that disclaimers could be obtained for all of the beneficiaries (even minors and possible unborn beneficiaries) and that there was no "wipeout" clause which specified what disposition was to be made of the property if all family members died. Several private letter rulings confirm this planning possibility.

In Private Letter Ruling 8409089, each of three grandchildren disclaimed "all but $75,000" of each grandchild's intestate share. The disclaimer meant that the balance of the estate passed to the surviving spouse by intestacy and qualified for the marital deduction. There were three grandchildren and
$75,000 multiplied by three equals $225,000, the amount of the exemption equivalent in the year the decedent died.

In Private Letter Ruling 8402121, the surviving spouse and all children disclaimed their interest in a bypass trust which was to be funded by the decedent’s half of the community property. Those disclaimers resulted in an intestacy, resulting in the passing of the property to the surviving spouse outright, and hence qualified for the marital deduction.

In Private Letter Ruling 8439007, children and grandchildren disclaimed a fractional interest in stock in excess of a sufficient number of shares to use up the exemption equivalent. The ruling concluded that these disclaimers created an intestacy and, as a result, the surviving spouse received the disclaimed property which qualified for marital deduction.

IV. INCOME TAXATION OF ESTATES AND DISTRIBUTIONS FROM ESTATES.

Estates are separate taxpayers for income tax purposes, and an estate can elect a fiscal year which is not shorter than 30 days nor longer than 12 months. Use of the estate as a separate income tax-paying entity obviously produces another income taxpayer and reduces income taxes; selection of an appropriate fiscal year can result in the substantial deferral of income taxes. This is so because the beneficiary who receives a distribution from an estate which carries out estate income is taxed on that income only in his calendar year in which the estate’s fiscal year ends. Hence a distribution by an estate in March of a fiscal year that ends in January will not result in income taxation to the recipient of the distribution until the calendar year following the year of distribution.

Estates are generally taxed as complex trusts. Ordinarily income of an estate in administration is not required to be currently distributed. Hence both income and principal distributions of an estate fall into the “second tier”. I.R.C. §§ 661 and 662. Distributions to beneficiaries to the extent of distributable net income will be deemed to consist proportionately of the income of the estate.

The separate share rule does not apply to estates. Regulation § 1.663(c)-3(f). The absence of the separate share rule can cause difficulties for the executor of an estate since, for example, a distribution of property to one of three equal estate residual beneficiaries of the estate will result in tax on all of the estate’s distributable net income equal to or less than the amount of the distribution to that one beneficiary. Hence one beneficiary is taxed, and the other beneficiaries not. However, if one of the beneficiaries is in a much lower tax bracket than the other two beneficiaries, the absence of the separate share rule could be useful in terms of making distributions of estate income to the low bracket beneficiary, saving taxes for the high bracket beneficiaries. Some equitable adjustment should probably be made in such a case so that the lower bracket beneficiary will be reimbursed in part for his taxes. Disproportionate distributions resulting in tax to only one beneficiary because of
the absence of the separate share rule have been held to be valid notwithstanding claims of unconstitutionality. See Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972).

One advantage of an estate, as opposed to a revocable trust with post death provisions, is that income taxes may be paid in quarterly installments.

Distributions can also be made from estates to trusts, rather than individual beneficiaries, which have the effect of carrying out estate income. These are known as “trapping” distributions. They are distributions of principal which have the effect of carrying out estate income to the trust under IRC Sections 661 and 662. Whether the income is further carried out to individual trust beneficiaries depends upon whether the trust is simple or complex and whether income or principal is distributed. For more information, the article by Dave Cornfeld entitled “Trapping Distribution” contained in the 14th Miami Institute on Estate Planning at 1400 for 1980 should be consulted.

Some case law has required that estate income must reimburse the trust’s principal for the amount of the additional income tax payable by the trust which is attributable to the distribution. In re Estate of Holloway, 67 Misc. 2d 32, 323 N.Y.S. 2d 534 (Surr. Ct. 1971), modified 68 Misc. 2d 361, 327 N.Y.S. 2d 865 (Surr. Ct. 1972). The theory is that income taxes which would, and should, have been borne by the income beneficiaries of an estate have instead been borne by principal, even though there is an overall income tax saving. These adjustments have become especially relevant after the 1981 tax legislation and the advent of the QTIP trust, since in most cases the surviving spouse will have no power of appointment and certainly will not have a general power of appointment. In many cases the QTIP trust’s remaindermen will be different from the spouse’s own beneficiaries, and any reduction of trust principal by reason of benefits enjoyed by the income account should be addressed.

If the income interest of the QTIP is required to make a Holloway equitable adjustment, the trust should not be deemed to have violated the QTIP income payment requirement to the spouse. If the equitable adjustment is required by state law then all the income as defined by state law would still be deemed payable to the spouse, even though it is reduced by that equitable adjustment.

There is a limited exclusion from that rule that distributions to estate beneficiaries carry out estate income. This exclusion relates to certain bequests of principal and is provided for by § 663(a)(1) of the Internal Revenue Code. To qualify for the exception, the bequest must be of a specific sum or of specific property and must be payable in not more than three installments. The exclusion applies to trusts as well as to estates and has been narrowly construed by the Internal Revenue Service; thus a marital deduction formula clause based upon a fraction of the adjusted gross estate does not qualify for the exception. Regulation § 1.663(a)-1(b)(1). The bequest of such number of shares of stock as has a specified dollar value at the date of distribution does not qualify for the exceptions since the exact number of shares is undetermined

In Revenue Ruling 82-4, 1982-2 C.B. 99, the distribution by an executor of the entire residuary estate to one of two children (because the date of distribution value of the estate was less than the value of distributions made to another child during life) was held to be a distribution in satisfaction of a stated dollar amount, and since the property distributed was appreciated, gain was recognized. The Will contained an equalization clause stating that the amounts given to a child during life should be credited against his or her share. A Section 661 deduction was disallowed.

When real property which forms the part of a residuary estate is distributed, such a distribution does not carry out distributable net income on the theory that title to such realty vests in the residuary beneficiary on death. Revenue Ruling 68-49, 1968-1 C.B. 304; Private Letter Ruling 8147023.

V. DISTRIBUTION OF PROPERTY IN KIND.

There are special rules with respect to the tax consequence of distributions from estates and trusts of property in kind in satisfaction of a pecuniary legacy or other specific sum of money.

The 1984 Act amended I.R.C. § 643 by adding a new subsection (d) which provides that if a fiduciary of an estate or a trust makes a distribution of appreciated property to an estate or trust beneficiary, the beneficiary takes over the trust or estate's cost basis for purposes of future capital gain recognition, and, to the extent that the distribution carries out income from the estate or trust under I.R.C. §§661(a)(2) and 662(a)(2), the lesser of the property's basis or fair market value is deemed to be carried out by the distribution. However, if the fiduciary elects to recognize a gain or loss by reason of the distribution to the beneficiary, then the amount deemed carried out to the beneficiary will be the property's fair market value, as under current law. Distributions described in I.R.C. § 663(a) (payment of specific bequests or amounts in no more than three installments) are not affected by this section.

This new provision eliminates a significant planning opportunity which many fiduciaries and their advisors had used. Distributions of appreciated property would be made to estate and trust beneficiaries with the result that the distribution carried out the estate's or trust's distributable net income in the amount of the fair market value of the property distributed. The beneficiary would then be taxed on that carried out income in his individual income tax return, and the property would receive a new cost basis up to the amount of distributable net income carried out to the beneficiary by the distribution.

The new provision is made applicable to distributions after June 1, 1984, in taxable years ending after such date.

An election by the fiduciary to treat such a distribution of appreciated property as a sale or exchange resulting in capital gain would increase the tax payable by the trust or estate, and would also increase the tax paid by the
beneficiary, at least to the extent that the distribution carried out distributable net income. However, that increase in tax to the beneficiary would reduce the amount of income that otherwise would be taxed to the estate or trust. It would appear that in most cases the election would not be made so that there would be no capital gain at the estate or trust level, and only distributable net income in the amount of the asset's basis would be carried out to the beneficiary, leaving the beneficiary to recognize a capital gain when and if the beneficiary disposed of the asset.

The obvious effect of the new legislation is to eliminate what many had considered to be a "loophole" in allowing the unrealized appreciation assets distributed to beneficiaries of estates or trusts, which distribution in turn carried out income to them, to escape any capital gains taxation.