II. FEDERAL ESTATE TAX

A. Introduction

The federal estate tax is an excise tax imposed on a decedent's privilege of being able to transfer his or her entire taxable estate at death. Internal Revenue Code ("IRC") § 2001(a). The federal estate tax is an indirect tax on the transfer of property rather than a direct tax on the property itself. Because of various exclusions, credits and deductions, only significant transfers of property are subject to the federal estate tax.

Minimizing taxes at death is an important goal for many clients seeking financial and estate planning advice. Although the tax rules applicable to transfers at death are complex, a basic understanding of these rules will help practitioners recognize potential issues and provide sound tax planning advice to such clients.

This Chapter discusses the following topics relating to the federal estate tax:

- Types of property and property interests subject to federal estate tax.
- Valuation for federal estate tax purposes.
- Federal estate tax deductions.
- Federal estate tax credits.
- Calculation of federal estate tax.
- Payment of federal estate tax.
- Income tax consequences of inherited property

B. Types of Property and Property Interests Subject to Federal Estate Tax

Generally, a decedent's "gross estate" includes the value of all property owned by the decedent at death and the value of all property in which the decedent had an interest at death. IRC §§ 2031(a) and 2033. This definition is very broad, and includes all kinds of property and property interests, both real and personal and tangible and intangible, wherever situated, to the extent of the interest beneficially owned by the decedent. Examples of such property and property interests include, but are not limited to, the following:

- Tangible personal property (*e.g.*, jewelry, furniture, furnishings, clothing, furs, collections of tangibles, automobiles, artwork, hobby equipment, video and audio equipment, cameras and camera equipment, computer equipment, sporting equipment, together with any assignable insurance policies on any such items).
- Cash on hand or on deposit (*e.g.*, checking accounts, savings accounts and certificates of deposit).
- Stocks, bonds and notes (*e.g.*, shares in a corporation, U.S. savings bonds, promissory notes of which the decedent was the lender).
- Business interests (*e.g.*, interest in a partnership or unincorporated business).
- Real property and interests in real property (*e.g.*, interest in principal

residence, vacation home, business real property).

- Annuities and retirement accounts (*e.g.*, IRAs, 401(k) accounts).
- Life insurance (*e.g.*, proceeds payable to the decedent's estate).
- Certain payments received after death (*e.g.*, compensation received after death, post-death employee benefits, tax refunds due to decedent) but not wrongful death proceeds. Rev. Rul. 55-87, 1955-1 C.B. 112.

The Internal Revenue Code also addresses the inclusion of specific types of property and property interests in a decedent's gross estate. These provisions are discussed below.

C. Property Owned by Decedent

1. Jointly-Owned Property

The general provisions of IRC §§ 2031(a) and 2033 govern the estate tax treatment of property owned by the decedent and another person as tenants in common. IRC § 2040 specifies the estate tax treatment of: (a) property owned by the decedent and another person as joint tenants with rights of survivorship; and (b) property owned by the decedent and his or her spouse as tenants by the entirety.

a. Property Owned as Tenants in Common. Generally, the value of property owned by the decedent and another person as tenants in common is included in the decedent's estate to the extent of the decedent's fractional interest in the property. IRC §§ 2031(a) and 2033.

> **EXAMPLE:** A and her sister B own a home as tenants in common. B dies first when the home is worth $150,000. At B's death, one-half of the value of the home ($75,000) will be included in B's estate.

b. Property Owned as Joint Tenants With Rights of Survivorship or as Tenants by the Entirety. Generally, the value of property owned by the decedent and another person in joint tenancy with rights of survivorship is included in the decedent's estate except to the extent that it can be shown that the other joint tenant contributed to the cost of the property. IRC § 2040(a).

➔ **Planning Point:** Practitioners should advise clients to keep track of contributions to such jointly-owned property for estate tax purposes and also for income tax purposes with respect to the step-up in basis at death.

> **EXAMPLE:** A and her sister B own a home as joint tenants with rights of survivorship. A contributed the entire purchase price of the home ($100,000). B contributed nothing. B dies first. At B's death, the full value of the home will be included in B's estate unless B's estate can show that B did not contribute to any of the cost of acquiring the home.

> **EXAMPLE:** A and her sister B own a home as joint tenants with rights of survivorship. A contributed $75,000 to the purchase price of the home. B contributed $25,000. A dies first. At A's death, the home is

worth $200,000, and A's share of the home, $150,000 (3/4 of $200,000), is included in A's estate.

(1) <u>Property Acquired by Gift, Bequest, Devise or Inheritance</u>. Where the decedent and the other joint tenant(s) acquired the property by gift, bequest, devise or inheritance, the decedent's fractional interest in the property is included in the decedent's gross estate. IRC § 2040(a).

<u>EXAMPLE</u>: X makes a gift of real property to his four children A, B, C and D. A dies first. At A's death, one-fourth of the property will be included in A's gross estate, and the property will pass by operation of law to B, C and D. If B dies next, one-third of the property will be included in B's gross estate, and the property will pass by operation of law to C and D, and so on.

(2) <u>Qualified Joint Interests</u>. A special rule applies to married joint tenants. If the joint tenants are married, then only one-half of the value of a qualified joint interest is included in the estate of the first spouse to die. This is true regardless of the amount each spouse contributed towards the property. A "qualified joint interest" is any interest in property held by the decedent and the decedent's spouse as tenants by the entirety or as joint tenants with rights of survivorship but only if they are the only joint tenants.

<u>EXAMPLE</u>: H and W own real estate as joint tenants with rights of survivorship. W paid the entire purchase price of $200,000. H dies first. At H's death, the property is worth $300,000, and $150,000 (one-half of the value of the property on the date of death) is included in H's estate even though W paid the entire purchase price of the property. If H and W had owned the real estate with a third party, then the general rule would apply because the property would not be a qualified joint interest.

2. Life Insurance

IRC § 2042 governs the estate tax treatment of life insurance proceeds.

a. <u>Proceeds Payable to Insured's Estate</u>. Life insurance proceeds payable to the insured's estate or the executor of the insured's estate will be included in the insured's gross estate, regardless of who owned the policy. IRC § 2042(1).

<u>EXAMPLE</u>: A owned a $100,000 policy of insurance on B's life. The insurance policy named B's estate as beneficiary of the proceeds. At B's death, $100,000 is included in B's gross estate even though A owned the policy.

b. <u>Proceeds Payable to Beneficiary Other Than Insured's Estate</u>. Life insurance proceeds will be included in the insured's estate if the proceeds are payable to another beneficiary or beneficiaries, but the insured possessed any incident of ownership in the policy, exercisable alone or in conjunction with another person. IRC § 2042(2). An "incident of ownership" is the ability to control any of the economic benefits of the property. It includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy. Treas. Reg. § 20.2042-1(c)(2).

> **EXAMPLE:** A owned a $100,000 policy of insurance on A's own life. The insurance policy named B as beneficiary. A assigned ownership of the policy to B in 1998 but retained the right to revoke the assignment. At A's death in 2009, $100,000 would still have been included in A's estate under IRC § 2042 because A's right to revoke the assignment was an incident of ownership in the policy.

> **EXAMPLE:** A owned a $100,000 policy of insurance on B's life. The insurance policy named A as beneficiary. At B's death, none of the proceeds will be included in B's estate because B did not have any incident of ownership in the policy and because the policy did not name B's estate as beneficiary.

c. Transfer of Ownership Within 3 Years of Death. If an insured transfers ownership of a policy within three years of the insured's death, the proceeds will be brought back into the insured's gross estate. IRC § 2035(a).

> **EXAMPLE:** A owned a $100,000 policy of insurance on A's own life. The insurance policy named B as beneficiary. In 2005, A transferred ownership of the policy to B. A died in 2007. Because A died within three years of transferring the policy to B, the $100,000 policy proceeds will be included in A's estate.

3. Certain Property for Which Marital Deduction Was Previously Allowed

IRC § 2044 provides that a decedent's gross estate includes the value of any property in which the decedent had a qualifying income interest for life if:

- An estate tax marital deduction (IRC § 2056) or gift tax marital deduction (IRC § 2523) was previously allowed with respect to the transfer of the property to the decedent; and
- The decedent did not make a taxable gift of the decedent's income interest in the property under IRC § 2519.

Property includible in a decedent's estate under IRC § 2044 is treated as property owned by and passing from the decedent rather than the decedent's predeceased spouse.

> **EXAMPLE:** At H's death, a trust was created for W's sole benefit. The trust qualified for the estate tax marital deduction in H's estate. W did not otherwise dispose of her income interest in the trust. The value of the trust at W's date of death will be included in W's estate, and the trust will be treated as owned by and passing from W.

4. Certain Property Transferred by Decedent During Decedent's Lifetime

a. **Transfers Within Three Years of Death**. Prior to 1982, all non-annual exclusion gifts made within three years of death were brought back into a decedent's estate as gifts made in contemplation of death. After 1982, only certain gifts made by a decedent within three years of death are brought back into the decedent's estate under IRC § 2035.

(1) **General Rule**. Outright gifts made by a decedent within three years of death are not includible in a decedent's estate. IRC § 2035(e) treats a gift by a decedent's revocable trust (a trust of which the decedent is treated as the owner under IRC § 676) as a gift by the decedent.

➔ **Planning Point:** One of the estate tax benefits of making lifetime gifts is the removal from the donor's gross estate of the value of the gifted property and any future appreciation in value of and income generated by the gifted property. Any gift tax paid on the gifted property also will be removed from the donor's estate (unless paid within three years of death under IRC § 2035(b)).

EXAMPLE: On October 18, 2004, D gave real property worth $700,000 to A. At D's death on July 3, 2007, the property was worth $1,000,000. Even though D made the gift within 3 years of D's death, the gifted property will not be included in D's estate because it was an outright gift. In addition, the appreciation on the property between the date of gift and D's date of death ($300,000) is removed from D's estate.

(2) **Transfers (or Releases of a Power) Under IRC §§ 2036, 2037, 2038 or 2042**. IRC § 2035(a) brings back into a decedent's gross estate certain interests transferred (or powers released) by the decedent within three years of the decedent's death that would have been included in the decedent's estate under one of the "string provisions" (IRC §§ 2036, 2037, 2038 and 2042) had they not been transferred (or released).

EXAMPLE: D contributed real property worth $100,000 to a revocable trust for the benefit of A. D retained the right to revoke the trust. D releases his right to revoke the trust on August 1, 2004 and then dies on January 31, 2007. The gifted trust property will be brought back into D's estate because it would have been includible in D's estate under IRC § 2038 had D not released the right to revoke.

(3) **Gift Taxes Paid Within Three Years of Death**. IRC § 2035(b) brings back into a decedent's estate gift taxes paid within three years of death.

➔ **Planning Point:** Note that even if the gift taxes are brought back into the decedent's estate, the decedent's estate still benefits from the removal of the gifted property and the future appreciation in value of and income generated by the gifted property.

EXAMPLE: D paid gift taxes on a gift to A of real property worth $500,000. D dies within three years of the gift when the property is worth $700,000. D's gift is not includible in D's estate under IRC § 2035(a) because it would not have been includible in D's estate under IRC §§ 2036, 2037, 2038 or 2042 had D not transferred the property. The gift taxes on D's gift, however, will be brought back into D's estate under IRC § 2035(b). D's estate still benefits from the removal of the appreciation in value of and income generated by the gifted property between the date of gift and D's date of death ($200,000).

b. Transfers With Retained Life Estate.

(1) General Rule. Generally, IRC § 2036 brings back into a decedent's gross estate the entire value of property gifted by the decedent if the decedent retained for life or for a period that does not in fact end before the decedent's death:

- the possession or enjoyment of the property;
- the right to the income from the property; or
- the right, either alone or in conjunction with another person, to determine who would possess or enjoy the property or the property's income.

EXAMPLE: D transferred $100,000 to a new trust for A but retained the right to the income of the trust for 5 years. If D dies 4 years after the trust was created, the value of the trust property will be included in D's estate because D's right to the income did not in fact end before D's death. If D had died 6 years after the trust was created, none of the trust property would be includible in D's estate because D no longer retained the right to the income.

EXAMPLE: D transferred $100,000 to a new trust for A but retained the right to change the beneficiaries of the trust to A's children. The entire trust property will be included in D's estate because D's right to change the beneficiary is a right to determine who will enjoy the trust property.

A decedent has a retained right under IRC § 2036 if the decedent's use, possession, right to the income or other enjoyment is applied towards the discharge of a legal obligation of the decedent (such as a legal obligation to support a dependent during the decedent's lifetime). Treas. Reg. § 20.2036-1(b)(2).

EXAMPLE: D transferred $100,000 to a new trust for A but retained the right to income to support D's minor child, B. Under state law, D is legally obligated to support B. Accordingly, the trust property will be included in D's estate.

(2) External Standard Exception. Any part of the gifted property subject to a power to distribute principal in favor of a beneficiary that is limited by an external standard will not be included in the decedent's gross estate under IRC § 2036. *Budlong, Milton Est.*, 7 T.C. 756 (1946), *acq.* 1947-1 C.B. 1, *aff'd & rev'd sub nom. Industrial Trust Co.*, 36

A.F.T.R. 502, 165 F.2d 142 (1st Cir. 1947), 48-1 U.S.T.C. ¶10593; *Frew, Walter Est.*, 8 T.C. 1240 (1947), *acq. Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

The following are examples of external standards that sufficiently limit a grantor-trustee's power of distribution to prevent inclusion of the trust property in the grantor-trustee's gross estate under IRC § 2036:

- For the beneficiary's support, maintenance and education.
- If the beneficiary's other sources of income are insufficient to provide for the proper care, support and medical attention of such beneficiary during any period of incapacity or illness.
- In the event of sickness, accident, misfortune or other emergency.

> **EXAMPLE:** D transferred $100,000 to a new trust for A but retained the right to the income of the trust for D's health and support. The value of the trust property will not be included in D's estate because D's right to the income was limited by an ascertainable external standard.

c. **Transfers Taking Effect at Death**. IRC § 2037 brings back into a decedent's gross estate the entire value of property gifted by the decedent if all three of the following requirements are met:

- Possession or enjoyment of the property can be obtained only by surviving the decedent;
- The decedent retained a "reversionary interest" (a possibility that the gifted property may return to the decedent or the decedent's estate or may be subject to a power of disposition by the decedent); and
- The value of the reversionary interest immediately before death exceeds 5% of the value of the gifted property.

> **EXAMPLE:** D contributed $100,000 to a trust that provided that the principal of the trust will be distributed to A in 5 years if D is not living at that time. Otherwise, the principal of the trust would revert to D. D dies 4 years later. The value of D's reversionary interest exceeds 5% of the value of the trust. The trust property will be included in D's gross estate because A can enjoy the property only if A survives D, and D retained a possibility that the trust property would revert to D if D had survived 5 years. If the trust had instead provided that the principal would be paid to A in 5 years if A had finished college, A's enjoyment of the trust property would not depend on surviving D, and the property would not be included in D's estate under IRC § 2037.

d. Transfers With Retained Right to Revoke.

(1) General Rule. IRC § 2038 brings back into a decedent's gross estate the entire value of property gifted where the decedent, either alone or in conjunction with someone else, retained a right or power to alter, amend, revoke or terminate the transfer.

> **EXAMPLE:** D transferred $500,000 to a trust for A's benefit but retained the right, in conjunction with A, to revoke the trust. At D's death, the entire value of the trust property is included in D's estate.

(2) External Standard Exception. The property will not be included in the decedent's gross estate under IRC § 2038 if the decedent's right or power is subject to an external standard. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

The following are examples of powers limited by an external standard that prevent inclusion of trust property in the gross estate:

- Reserved power to amend only to clarify, but not to change substance.
- Reserved power to increase trust principal.
- Reserved power as grantor-trustee to distribute principal to or for a beneficiary if the beneficiary is suffering a prolonged illness.

> **EXAMPLE:** D transferred $500,000 to a trust for the benefit of A and B but retained the power to amend the trust to clarify the trust terms only. None of the trust property will be includible in D's estate under IRC § 2038. Although D retained the power to amend the trust terms, D's power was limited by an external standard (to clarify the trust terms).

(3) Power to Remove Trustee.

(a) Power to Appoint Self as Trustee. IRC § 2038 applies if the decedent-grantor had the unrestricted power to remove or discharge a trustee and appoint himself as trustee. In that case, the decedent would be considered as having the discretionary powers of distribution of the trustee. Treas. Reg. § 20.2038-1(a)(3). If the trustee's powers are sufficiently limited by an external standard, however, the power of the decedent-grantor to appoint himself as trustee will not cause inclusion in the decedent-grantor's estate.

> **EXAMPLE:** D transferred $500,000 to a trust for the benefit of A and B but retained the power, as trustee, to remove the trustee and appoint himself as successor trustee. The entire value of the trust property is included in D's estate.

(b) Power to Appoint Unrelated and Nonsubordinate Trustee. IRC § 2038 does not apply, however, if the decedent-grantor had the unrestricted power to remove or discharge a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent (within the meaning of IRC § 672(c)). Such a power is not considered a reservation by the decedent of the trustee's discretionary powers of distribution over the property transferred by the decedent-grantor to the trust. Rev. Rul. 95-58, 1995-2 C.B. 191.

> **EXAMPLE:** D transferred $500,000 to a trust for the benefit of A and B but retained the power, as trustee, to remove the trustee and appoint an individual or corporate successor trustee that is not related or subordinate to D. The trust property is not includible in D's estate under IRC § 2038.

5. Property Controlled By Decedent — Powers of Appointment

a. What is a Power of Appointment? A "power of appointment" simply is the power to decide who will take the trust property next, and the time, terms, shares and conditions under which they will receive it. A power of appointment can be exercisable during the powerholder's lifetime (a "lifetime" power of appointment) or exercisable upon the powerholder's death by will (a "testamentary" power of appointment). Powers of appointment often are used in trusts to give the powerholder a degree of control over the disposition of trust property or to achieve certain tax planning goals.

> **EXAMPLE:** H creates a trust for W's benefit. The trust gives W a power to appoint the trust property at death by W's will in favor of any one or more of the descendants of H and W. The trust also provides that if W does not exercise this power, at W's death, the trust property will be divided equally between their children, A (who is financially independent) and B (who is less stable financially). If W wishes, W may exercise her power of appointment in W's will to leave a greater share of the trust property to B after W's death.

The term "power of appointment" includes any power that is in substance and effect a power of appointment.

> **EXAMPLE:** A decedent's power to remove or discharge a trustee and appoint himself as trustee may be a power of appointment. For example, if the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal. Treas. Reg. § 20.2041-1(b)(1).

b. Estate Tax Treatment of Powers of Appointment. IRC § 2041 addresses the estate tax treatment of certain powers of appointment.

(1) General Rule. Only the value of property over which a decedent held a general power of appointment is included in the decedent's estate. IRC § 2041(a). A "general power of appointment" is a power of appointment exercisable in favor of the holder, the holder's estate, the holder's creditors or the creditors of the holder's estate. IRC § 2041(b)(1).

> **EXAMPLE:** A trust provides that beneficiary A has a power to withdraw any or all principal for his own benefit. At A's death, the value of the trust property is included in A's gross estate for estate tax purposes because A's unlimited power to withdraw principal for his own benefit is a general power of appointment. The result is the same regardless of whether A actually withdrew the principal or not.

(2) **Exceptions**. There are several exceptions to the general rule that general powers of appointment are taxable for estate tax purposes.

(a) **Ascertainable Standard Exception**. First, the ascertainable standard exception provides that a holder's power to appoint the property to himself that is limited by an ascertainable standard relating to the holder's health, education, support or maintenance is not a general power of appointment. Certain other standards (such as "welfare" or "happiness") are not considered an ascertainable standard.

> **EXAMPLE:** A trust provides that the trustee has a power to withdraw any or all of the principal for his own health. None of the trust property is included in the trustee's estate because his power to withdraw principal for himself was limited to an ascertainable standard (health). If the trustee had the power to withdraw principal for his health and welfare, all of the trust property would be included in the trustee's estate because "welfare" is not an ascertainable standard.

(b) **Pre-October 22, 1942 General Powers of Appointment**. Property subject to a general power of appointment created before October 22, 1942 is not includible in the holder's gross estate unless the holder exercised the power either (1) by will, or (2) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's estate under IRC § 2035 (relating to transfers in contemplation of death), IRC § 2036 (relating to transfers with retained life estate), IRC § 2037 (relating to transfers taking effect at death) or IRC § 2038 (relating to revocable transfers).

> **EXAMPLE:** Beneficiary B has a general power of appointment over property in a trust created in 1939. B never exercised that power. At B's death, B's general power of appointment is not included in B's estate because B never exercised the power.

(c) **Power Exercisable Only With Consent or Joinder**. A power exercisable only with the consent or joinder of the creator of the power or a person having substantial adverse interest is not a general power of appointment. IRC § 2041(b)(1)(C).

(3) **Special Powers of Appointment**. A special power of appointment is a power of appointment that is *not* a general power of appointment (not exercisable in favor of the holder, the holder's estate, the holder's creditors or the creditors of the holder's estate). Special powers of appointment are not includible in the holder's gross estate. A special power of appointment often is used when the donor wants to give the holder the flexibility to control the disposition of trust property but still limit the group benefiting from the holder's exercise of the power.

> **EXAMPLE:** A trust gives beneficiary A power to appoint trust principal in favor of anyone other than A, A's estate or the creditors of either. None of the trust property will be included in A's estate because A's power is a special power of appointment.

> **EXAMPLE:** A trust gives beneficiary A a power to appoint trust principal in favor of A's descendants. A's power of appointment is a special limited power of appointment limited to the class of A's descendants. None of the trust property will be included in A's estate.

D. Valuation for Federal Estate Tax Purposes

1. General Rule

Generally, unless the executor elects the alternative valuation method (discussed below), property included in a decedent's gross estate is subject to estate tax based on its fair market value on the decedent's date of death. "Fair market value" is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. § 20.2031-1(b). The Regulations provide guidelines on the valuation of specific types of property for federal estate tax purposes:

- Treas. Reg. § 20.2031-2 (stocks and bonds).
- Treas. Reg. § 20.2031-3 (business interests).
- Treas. Reg. § 20.2031-4 (notes).
- Treas. Reg. § 20.2031-5 (cash on hand or on deposit).
- Treas. Reg. § 20.2031-6 (household and personal effects).
- Treas. Reg. § 20.2031-7 (annuities, interests for life or term of years, and remainder or reversionary interests).
- Treas. Reg. § 20.2031-8 (certain life insurance and annuity contracts).
- Treas. Reg. § 20.2031-9 (other property).

➔ **Planning Point:** Some documentation helpful in determining what assets the decedent owned at death and their value include the decedent's bank statements, brokerage account statements, and prior income tax returns.

The following discussion briefly summarizes the general rules as to the valuation of the above types of property.

a. **Stocks and Bonds**. The fair market value of a decedent's stocks and bonds is based on the mean between the highest and lowest selling prices on the date of death. If the date of death falls on a weekend or holiday, the value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the date of death.

> **<u>EXAMPLE</u>:** D died owning 100 shares of common stock of Company X, a publicly traded company. D died on a Friday, which was a holiday. The nearest trading date before D's date of death ("DOD") was Thursday (1 day before) when the mean sales price per share was $10. The nearest trading date after D's date of death was the following Monday (3 days later) when the mean sales price per share was $15. The value of D's 100 shares is $1,375. The value per share of $13.75 on D's date of death is calculated as follows:

$$\text{Value} = \frac{(1 \text{ day before} \times \$10) + (3 \text{ days after} \times \$15)}{4 \text{ days total}} = \$13.75/\text{share}$$

b. **<u>Business Interests</u>.** Generally, the fair market value of any interest of a decedent in a business is the net amount which a willing purchaser, whether an individual or corporation, would pay for the interest to a willing seller. The net value is determined on the basis of all relevant factors, including a fair appraisal of the business's assets and the business's demonstrated earning capacity.

c. **<u>Notes</u>.** Generally, the fair market value of a decedent's note, secured or unsecured, is the amount of unpaid principal, plus interest accrued to the date of death unless the executor establishes the value is lower or that the note is worthless.

d. **<u>Cash on Hand or on Deposit</u>**. Generally, the amount of cash belonging to the decedent at the date of his death, whether in his possession or in the possession of another, or deposited with a bank, is included in the decedent's estate.

e. **<u>Household and Personal Effects</u>**. Generally, the fair market value of a decedent's household and personal effects is the price which a willing buyer would pay to a willing seller. An appraisal is required for items of artistic or intrinsic value (*e.g.*, jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary, vases, oriental rugs, coin or stamp collections) having a total value in excess of $3,000.

f. **<u>Annuities, Interests for Life or Term of Years, and Remainder or Reversionary Interests</u>.** Generally, the fair market value of a decedent's annuities, life estates, terms of years, and remainder and reversionary interests is the present value of such interests. The Regulations provide tables with standard actuarial factors used to compute the present value of these interests.

g. **<u>Certain Life Insurance and Annuity Contracts</u>.** Generally, the fair market value of a decedent's life insurance and annuity contracts is established through the sale by the issuing company of comparable contracts.

h. **<u>Other Property</u>.** The valuation of any property not specifically described above is made in accordance with the general principles in the Regulations.

2. Alternate Valuation Date

As discussed above, property generally is valued as of the decedent's date of death for federal estate tax purposes. Subject to certain requirements, however, IRC § 2032 allows a decedent's personal representative to elect to value the gross estate as of the date that is six months after the decedent's date of death (the "alternate valuation date").

a. <u>Purpose of Alternate Valuation Date</u>. The main purpose of the alternate valuation date is to reduce the amount of estate tax that would otherwise be payable if the gross estate decreases in value during the six-month administration period following the decedent's date of death.

> **<u>EXAMPLE:</u>** D died on July 6, 2001. D's gross estate, consisting mostly of technology stock, was worth $2,000,000 on D's date of death. On January 6, 2002, the value of D's gross estate dropped to $1,500,000, which was caused by a drop in technology stock prices. D's executor can elect to value the estate as of January 6, 2002 on D's federal estate tax return.

b. <u>Requirements of Alternate Valuation.</u>

(1) <u>Reduce Gross Estate and Estate Taxes Due</u>. The alternate valuation election may be used only if the election will reduce the value of the gross estate and reduce the sum of the estate tax and generation-skipping transfer ("GST") tax liability (reduced by credits allowable against these taxes). IRC § 2032(c). The determination of whether there has been a decrease in the sum of the estate and GST tax liability (reduced by credits allowable against these taxes) is made with reference to the estate tax and GST tax payable by reason of the decedent's death with respect to the property actually included in the decedent's gross estate. Treas. Reg. § 20.2032-1(b)(1). This rule discourages certain estates, especially nontaxable estates, from using the alternate valuation date to obtain a higher step-up in basis for income tax purposes in order to reduce taxable gain. The step-up in basis rule is discussed later in this Chapter.

If an asset depreciates in value due to the mere passage of time, the alternate valuation date cannot be used with respect to such asset. IRC § 2032(a)(3). If an asset is sold or otherwise disposed of between the date of death and the alternate valuation date, the actual sale price will be the value of the asset for alternate valuation purposes.

(2) <u>Valuation Date Used</u>. If the alternate valuation date is used, all property still in the estate six months after the decedent's date of death is valued as of the alternate valuation date. Any property sold or otherwise disposed of prior to that date is valued as of its date of disposition. IRC § 2032(a).

(3) <u>Election</u>. The decedent's personal representative must make the election on the decedent's federal estate tax return. An estate cannot make the election on an estate tax return that is filed more than one year after the due date (including extensions) for filing the return. Once made, the election is irrevocable. IRC § 2032(d). No partial election is allowed; the election must be made for the decedent's entire estate.

Estates that fail to make the alternate valuation election on the last estate tax return filed before the due date or the first return filed after the due date could request an extension of time to make the election under Treas. Reg. §§ 301.9100-1 and 301.9100-3, which apply to all requests for an extension of time to make any election. However, the Internal Revenue Service ("IRS") will not grant any request for an extension of time if the return that is the subject of such request was filed more than one year after its due date (including extensions of time to file actually granted). Treas. Reg. 20.2032-1(b)(3).

The regulations provide guidance on making a protective election under IRC § 2032 on the estate tax return in cases where, based on the return as filed, use of the alternate valuation date does not result in a decrease in transfer tax and the value of the gross estate. If it is later determined that such a decrease would occur, the alternate valuation date would apply. The protective election is irrevocable as of the due date of the return (including extensions of time actually granted). Treas. Reg. § 20.2032-1(b)(2). The time limitations discussed in the previous paragraph also apply to protective elections.

E. Federal Estate Tax Deductions

1. Estate Tax Marital Deduction

IRC § 2056 allows an unlimited estate tax marital deduction for qualified interests that pass to a decedent's surviving spouse.

a. **Requirements**. An interest transferred to a surviving spouse must meet all of the following requirements in order to qualify for the estate tax marital deduction.

(1) **Interest Must be Includible in Decedent's Gross Estate**. It would not make sense to apply a deduction if the property against which the deduction is to apply were not included in the gross estate.

(2) **Decedent is Survived by a Surviving Spouse Who is a U.S. Citizen**. If the surviving spouse is not a U.S. citizen, the marital deduction is available only for transfers to a qualified domestic trust under IRC §§ 2056(d) and 2056A. See discussion below.

(3) **Interest Must "Pass" to the Surviving Spouse**. Under IRC § 2056(c), an interest in property "passes" to the surviving spouse if it passes to the surviving spouse by bequest or devise, inheritance, dower or curtesy, *inter vivos* transfer, joint tenancy with right of survivorship, the exercise or nonexercise of a power of appointment or life insurance.

(4) **Interest Must be Deductible (Not a Nondeductible Terminable Interest)**. See discussion below on terminable interests.

b. **Nondeductible Terminable Interests: The Terminable Interest Rule**. The terminable interest rule provides that the marital deduction is not available for interests that terminate or fail upon a lapse of time or the occurrence or nonoccurrence of an event if a person other than the surviving spouse receives the property after the termination of the surviving spouse's interest. IRC § 2056(b)(1).

<u>EXAMPLE</u>: H's will provides that $300,000 will pass to a trust for W's benefit for 10 years after H's death, at which time the trust will terminate and be distributed to H's children. H's estate is not entitled to a marital deduction for the $300,000 transferred to the trust for W because W's interest in the trust will terminate upon a lapse of time (10 years) and persons other than W (H's children) will receive the property from H.

<u>EXAMPLE</u>: H's will provides that $300,000 will pass to a trust for W. If W remarries or cohabits with another person, however, the trust will terminate and be distributed to H's children. H's estate is not entitled to a marital deduction for the $300,000 transferred to the trust for W because W's interest in the trust will terminate upon the occurrence of an event (W's remarriage or cohabitation with another person) and persons other than W (H's children) will receive the property from H.

c. <u>Deductible Terminable Interests: Exceptions to The Terminable Interest Rule</u>. Despite the terminable interest rule, certain terminable interests still qualify for the marital deduction. Some of these interests include the following:

(1) <u>Limited Survivorship Exception</u>. IRC § 2056(b)(3) provides that the marital deduction is available for transfers to a surviving spouse with a limited survivorship requirement. Specifically, a terminable interest is deductible if: (a) the only condition under which the interest will terminate is the death of the surviving spouse within six months after the decedent's death, or the surviving spouse's death as a result of a common disaster that also resulted in the decedent's death; and (b) the condition does not in fact occur. Treas. Reg. § 20.2056(b)-3(a).

<u>EXAMPLE</u>: H's will provides that $500,000 will pass to a trust for W. If W dies within 6 months of H's death or dies in a common disaster with H, however, the trust will terminate and be distributed to H's children. W survives H for at least 6 months. Therefore, H's estate would be entitled to a marital deduction for the $500,000 transferred to the trust for W. If W and H had died together in a plane crash, however, H's estate would not be entitled to the deduction.

(2) <u>General Power of Appointment Trust Exception</u>. Under IRC § 2056(b)(5), a marital deduction is allowed for an interest that passes to a surviving spouse in trust if all of the following requirements are met:

- The surviving spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
- The income payable to the surviving spouse must be payable at least annually.
- The surviving spouse must have the power to appoint the entire interest or the specific portion to either himself or herself or to his or her estate.

- The power must be exercisable by the surviving spouse alone and (whether by will or during life) must be exercisable in all events.
- The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

> **EXAMPLE:** H died, leaving $500,000 to a trust for W. All of the income of the trust was payable to W annually. W had a power to appoint the trust property at death by W's will in favor of W's estate. The trust qualifies for the estate tax marital deduction as a general power of appointment trust under IRC § 2056(b)(5). If the trust had also provided that W's child, C, had a power to appoint the trust property in favor of C's children, the trust would not have qualified for the estate tax marital deduction.

(3) Qualified Terminable Interest Property ("QTIP") Trust Exception. Under IRC § 2056(b)(7), a marital deduction is allowed for an interest that passes to a surviving spouse in trust if all of the following requirements are met:

- The surviving spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
- The income payable to the surviving spouse must be payable at least annually.
- The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.
- A QTIP election must be made on the decedent's federal estate tax return with respect to a specific portion or all of the trust.

➔ **Planning Point:** The QTIP trust exception is similar to the general power of appointment trust exception except that the surviving spouse need not have a power of appointment over a QTIP trust in order to qualify for the estate tax marital deduction.

> **EXAMPLE:** H died, leaving $500,000 to a trust for W. All of the income of the trust was payable to W annually. If H's executor makes a QTIP election on H's estate tax return, the trust will qualify for the estate tax marital deduction. If the trust had also provided that W's child, C, had a power to appoint the trust property in favor of C's children, the trust would not have qualified for the estate tax marital deduction under IRC § 2056(b)(7).

d. Estate Tax Marital Deduction for Non-U.S. Citizen Surviving Spouse. Generally, the estate tax marital deduction is not allowed for transfers to a non-U.S. citizen surviving spouse. IRC § 2056(d)(1). The rationale is to make sure that the property for which the marital deduction is allowed will later be subject to federal estate tax in the surviving spouse's estate. There are two exceptions to this rule:

(1) Resident Spouse Becomes Citizen Prior to Due Date of Estate Tax Return. The estate tax marital deduction is allowed if the non-U.S. citizen surviving spouse was a U.S. resident at all times after the decedent's date of death and before becoming a U.S. citizen, and if the surviving spouse becomes a U.S. citizen before the federal estate tax return is due (including extensions). IRC § 2056(d)(4).

EXAMPLE: H, a U.S. citizen, died leaving $500,000 to a trust for W, a Canadian citizen. H and W lived in the U.S. prior to and at H's death, and W continued to live in the U.S. If W becomes a U.S. citizen before the due date of H's federal estate tax return, H's estate will be entitled to a marital deduction under IRC § 2056(d)(4) even though W was not a U.S. citizen at H's date of death.

(2) Qualified Domestic Trust ("QDOT"). The estate tax marital deduction is allowed for property transferred to a QDOT for the non-U.S. citizen surviving spouse's benefit. IRC § 2056(d)(2).

(a) QDOT Requirements. IRC § 2056A(a) provides that a trust is a QDOT that qualifies for the estate tax marital deduction if all of the following requirements are met:

- At least one trustee is a U.S. citizen or a domestic corporation.
- No distribution (other than income) may be made from the trust unless the trustee who is a U.S. citizen or domestic corporation has the right to withhold from the distribution the tax imposed by IRC § 2056A on such distributions.
- The decedent's executor makes an irrevocable election to treat the trust as a QDOT on the decedent's federal estate tax return.
- The trust separately meets the requirements of IRC § 2056(b) (*e.g.*, a general power of appointment trust, QTIP trust).

(b) Tax on Distributions From QDOT. Under IRC § 2056A(b), certain distributions from a QDOT (other than income or hardship distributions) before the surviving spouse's date of death and any property remaining in the QDOT at the surviving spouse's death may be subject to estate tax at the rate described in IRC § 2056A(b)(2).

e. Use of Marital Deduction to Defer Estate Tax. The estate tax marital deduction essentially defers estate taxes until the death of the surviving spouse. All of the assets of the deceased spouse that are left outright or in a marital trust for the surviving spouse are potentially available for the needs of the surviving spouse and are not reduced by estate tax at the first death. Deferring the estate tax is advantageous because of the increasing estate tax exemption amount available to the surviving spouse, and because the surviving spouse, with careful planning, can reduce the size of his or her taxable estate.

EXAMPLE: H died in 2000 leaving $500,000 to a QTIP trust for W, all of which qualifies for the estate tax marital deduction in H's estate. No estate tax was due at H's death. W died in 2009 when the estate tax exemption amount was $3,500,000, and the QTIP trust was worth $600,000. Estate tax would have been payable by W's estate only if W's other assets exceeded $2,900,000.

2. Estate Tax Charitable Deduction

IRC § 2055(a) allows an estate tax charitable deduction for transfers to the following types of recipients:

- IRC § 501(c)(3) corporations operated exclusively for religious, charitable, scientific, literary or education purposes, which do not attempt to influence elections and are not substantially engaged in carrying on propaganda or influencing legislation.
- Federal government, state government or subdivisions thereof for exclusively public purposes.
- IRC § 501(c)(3) fraternal or veterans' organizations.
- Certain employee stock ownership plans if the transfer is an IRC § 664(g) qualified gratuitous transfer of qualified employer securities.

a. **Property Must Be Included in Estate**. None of the percentage and other limitations on the income tax charitable deduction under IRC § 170 apply to the estate tax charitable deduction. In this sense, the estate tax charitable deduction is "unlimited." Charitable deduction property, however, must be property that was included in the decedent's gross estate. Accordingly, the only ceiling on the estate tax charitable deduction is the value of the gross estate. IRC § 2055(d).

b. **Certain Conditional Gifts and Certain Gifts Subject to a Power Do Not Qualify For Charitable Deduction**. A transfer to a qualified charity that is conditional at the time of decedent's death will not qualify for the charitable deduction unless the likelihood that the charity will not receive the bequest is so remote as to be considered negligible. Further, if a legatee, devisee, donee or trustee has a power to divert a portion or all of the gifted property or interest, the charitable deduction will be limited to that portion which is exempt from an exercise of that power. Treas. Reg. § 20.2055-2(b).

EXAMPLE: D dies leaving an empty lot to a city government for as long as the lot is used by the city for a public park. If the city accepts the lot and if, on the date of D's death, the possibility that D will not use the land for a public park is so remote as to be negligible, a charitable deduction will be allowed.

c. **Split Interests**. A split interest is simply a gift in which a charitable beneficiary and a noncharitable beneficiary share interests.

(1) **Charitable Interest is Deductible**. The estate tax charitable deduction is limited to the charitable interest in a split interest. IRC § 2055(e)(2). The value of the charitable interest must be currently ascertainable (subject to a reasonably precise valuation). In addition, the split interest must be one of the deductible types specified in the Internal Revenue Code. Otherwise, no charitable deduction is allowed for any portion of a split interest gift.

(2) **Deductible Interests**. A charitable deduction is allowed for: (a) the remainder interest in a charitable remainder annuity trust ("CRAT"), a charitable remainder unitrust ("CRUT") or a pooled income fund; (b) the income interest in a charitable lead annuity trust ("CLAT"), a charitable lead unitrust ("CLUT"); and (c) the nontrust remainder interest in a personal residence or a farm.

d. **Death Taxes Payable Out of Charitable Bequest**. The charitable deduction is reduced by the amount of any estate, succession, legacy or inheritance tax payable out of the charitable bequest. IRC § 2055(c).

> **EXAMPLE:** D's will leaves $100,000 to a qualified charity. The $100,000 is subject to a state inheritance tax of $5,000 (payable out of the bequest per D's will). The estate tax charitable deduction is limited to $95,000.

➔ **Planning Point:** In addition to express directions in the decedent's estate planning documents, state law can determine the source of payment of such death taxes. In determining the correct charitable deduction amount, practitioners should be aware of applicable state law on the source of payment of death taxes.

e. **Charitable Deduction for Qualified Conservation Transfer**. IRC § 2055(f) allows an estate tax charitable deduction for any transfer of a "qualified real property interest" under Section 170(h) to a qualified charity for conservation purposes. A "qualified real property interest" includes the entire interest of the donor other than a qualified mineral interest, a remainder interest or a restriction (granted in perpetuity) on the use which may be made of the real property. IRC § 170(h)(2).

f. **Estate Tax Exclusion for Conservation Easements.** Subject to exclusion limitations, IRC § 2031(c) excludes from a decedent's gross estate a portion of land subject to a conservation easement if the land meets certain requirements.

3. Deduction for Expenses, Claims, Debts, Taxes and Losses

a. **Classes of Deductions**. IRC § 2053(a) allows an estate tax deduction for the following classes of expenses, indebtedness, taxes and losses:

(1) **Funeral Expenses.** In order to be deductible, funeral expenses must be actually expended and must be payable out of the decedent's estate under the laws of the local jurisdiction. Treas. Reg. § 20.2053-2. Funeral expenses include the casket, burial vault, funeral director's fee, flowers purchased by the estate, food for mourners, the cost of transporting the person bringing the body to the place of burial, tombstone, monument, mausoleum, burial lot, and the expense of landscaping the lot.

(2) **Administration Expenses**. An administration expense must be actually and necessarily incurred in the administration of the estate in order to be deductible. The administration expenses of an estate include the collection of assets, the payment of debts and the distribution of property to persons entitled to it. Administration expenses include executor's commissions, attorneys' fees and miscellaneous expenses. Expenditures that are not essential to the administration of the estate, but incurred for the individual benefit of an heir, legatee or devisee are not deductible. Treas. Reg. § 20.2053-3(a). For estates of decedents dying on or after December 3, 1999, certain administration expenses may or may not affect the marital deduction.

(a) **Estate Transmission Expenses**. Estate transmission expenses are expenses that would not have been incurred except for the decedent's death, such as the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property. Examples include executors' commissions, attorneys' fees, probate fees, appraisal fees, and expenses incurred in construction proceedings and defending against will contests. Executors' commissions and attorneys' fees that are related to the investment, preservation or maintenance of estate assets, however, would not be considered estate transmission expenses. Estate transmission expenses reduce the marital deduction on a dollar-for-dollar basis if they are paid from the income or principal of marital deduction property. Treas. Reg. § 20.2056(b)-4(d)(2).

(b) **Estate Management Expenses**. Estate management expenses are those expenses incurred with respect to the investment of estate assets and with their preservation and maintenance during a reasonable period of administration. Examples of estate management expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest. Generally, the marital deduction is not reduced by these expenses if they are paid from the income or principal of marital deduction property. Treas. Reg. § 20.2056(b)-4(d)(3). There are two exceptions to this rule: (1) if estate management expenses are deducted on the federal estate tax return as an IRC § 2053 deduction; or (2) if estate management expenses are incurred for non-marital deduction property. Treas. Reg. §§ 20.2056(b)-4(d)(3) and 20.2056(b)-4(d)(4).

➔ **Planning Point:** In drafting estate planning documents, practitioners should take advantage of these regulations by providing flexible language to charge administration expenses to either principal or income of the estate or trust.

(3) **Claims Against the Estate**. An estate can deduct claims which were personal obligations of the decedent that existed and were enforceable against the decedent at the time of the decedent's death, whether or not then matured, and interest thereon which had accrued at the time of death. Deductible claims include certain taxes (such as income taxes, gift taxes and property taxes) owed by the decedent before his death. Treas. Reg. § 20.2053-6. If a claim is founded on a promise or agreement, it is deductible if the claim is bona fide and contracted for full and adequate consideration in money or money's worth. Treas. Reg. § 20.2053-4.

> **EXAMPLE:** During D's lifetime, D promised to pay A $10,000 after D's death if A promised to release B from an obligation to pay A $10,000. D's estate would be entitled to a deduction for A's $10,000 claim against D's estate because the claim was created in good faith and

for adequate and full consideration.

(4) **<u>Unpaid Mortgages or Other Indebtedness</u>**. An estate may deduct the full amount of any unpaid mortgage on or other debt relating to property included in the decedent's gross estate. The liability must have been contracted in good faith for full and adequate consideration. Treas. Reg. § 20.2053-7.

(5) **<u>Losses</u>**. IRC § 2054 allows an estate tax deduction for losses incurred during the settlement of the estate arising from fires, storms, shipwrecks or other casualties, or from theft, when such losses are not compensated for by insurance or otherwise. The loss must have occurred during the settlement of the estate before the asset is distributed. Partial deductions are allowed for that portion not compensated for by insurance or otherwise.

> **<u>EXAMPLE</u>:** D's attorney embezzled funds from D's estate. The estate was partially reimbursed by a client security trust fund. The estate's theft loss deduction would be reduced by the amount of payment received by the fund.

b. **<u>Disallowance of Double Deduction</u>.** Amounts allowable as a deduction pursuant to IRC § 2053 or 2054 are not allowed as an income tax deduction unless the right to take such deduction for federal estate tax purposes is waived. IRC § 642(g).

c. **<u>Final Regulations Under IRC § 2053</u>**.

(1) **<u>Rules Applicable to All of IRC § 2053</u>**. The IRS issued proposed regulations in 2007 taking the general approach that unascertained or contingent claims are deductible under IRC § 2053 only if payments are actually made. However, there is an exception for estimated amounts that are ascertainable with reasonable certainty and will be paid. A protective claim for refund may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's right to claim a refund if the amount of a liability will not be ascertainable by the time of the expiration of the period of limitations for claims for refund. The IRS issued final regulations for deductions under IRC § 2053, effective for decedents dying after October 19, 2009. T.D. 9468, 74 FR 53652. The final regulations apply to all deductions under IRC § 2053 (not just claims against the estate) and generally maintain the concept set forth in the proposed regulations that deductions are limited to the total amount actually paid. Some of the changes in the final regulations include the following.

(2) **<u>Deductions for Expenses of Administering Estate</u>**

(a) **<u>Executor's Commissions</u>.** Treas. Reg. § 20.2053-3(b) provides that executor's commissions are deductible if they are within the usually accepted standard and practice for estates of similar size and character in the jurisdiction where the estate is being administered. Deviations from the usually accepted standard or range of amounts (permissible under applicable local law) must be justified to the Commissioner. A bequest in lieu of commission is not deductible. However, if the decedent's will sets forth the amount to be paid to the executor for services, then such amount is deductible to the extent it does not exceed the amount allowable by local law.

(b) **Attorney's Fees**. Treas. Reg. § 20.2053(c) provides that attorney's fees may not exceed a reasonable amount for services rendered, taking into account the size and character of the estate, the law and practice in the jurisdiction, and the skill and expertise of the attorney. A deduction for reasonable attorneys' fees in contesting an asserted deficiency or in prosecuting the claim for refund may be allowed even if not claimed on the estate tax return or in the claim for refund. Attorneys' fees incurred by a beneficiary incident to litigation are not deductible if the litigation is not essential to the settlement of the estate.

(c) **Miscellaneous Administration Expenses**. New Treas. Reg. § 20.2053-3(d)(3) provides that expenses incurred in defending the estate against claims" (a defined term) are deductible if "the expenses are incurred incident to the assertion of defenses to the claim available under the applicable law, even if the estate does not prevail."

(3) **Claims Against the Estate**. Treas. Reg. § 20.2053-4 deals with the deduction for claims against the estate and expands the former regulation. The new regulation begins by stating the general rule that "liabilities imposed by law or arising out of contracts or torts are deductible if they meet the requirements set forth in § 20.2053-1 and this section." To be deductible, a claim against a decedent's estate must be legitimate and bona fide and meet the following requirements: (1) the claim represents the personal obligations of the decedent existing at the time of the decedent's death; (2) the claim is enforceable against the decedent's estate at the time of payment; and (3) the claim is actually paid by the estate in settlement of the claim or the amount to be paid is ascertainable and will be paid. The new regulation specifically provides that "[e]vents occurring after the date of a decedent's death shall be considered when determining the amount deductible against a decedent's estate." The regulations also add an extensive discussion of "special rules" regarding claims against the estate.

(4) **Protective Claim for Refund**. Treas. Regs § 20.2053-1(d)(5) allows a protective claim for refund to be filed at any time within the period of limitations for filing a claim for refund under IRC § 6511(a) (the later of three years after the return was filed or two years after payment of the tax). The protective claim for refund must identify each claim or expense and describe the reasons and contingencies delaying the actual payment of the claim or expense. Action on the protective claim will proceed after the executor has notified the Commissioner within a reasonable period that the contingency has been resolved.

(5) **Effective Date**. The final regulations apply to the estate of any decedent dying after October 19, 2009.

4. Deduction for State Death Taxes

For estates of decedents dying after 2004, the state death tax credit under IRC § 2011 is repealed. Instead of the credit, there is a deduction for state death taxes actually paid with respect to property included in the decedent's gross estate. IRC § 2058. Under current law, IRC § 2058 itself is repealed after 2010, and IRC § 2011 is reinstated. Under IRC § 2058, a deduction for state death taxes will be allowed only for taxes actually paid and claimed as a deduction during the time period that ends before the later of: (a) four years after the filing of the estate tax return; (b) if a timely petition for redetermination of a deficiency has been filed with the Tax Court, 60 days after the Tax Court decision becomes final; (c) if an extension of time has been granted under IRC § 6161 or IRC § 6166 for payment of the tax, the expiration date of the extension period; or (d) if a timely claim for refund or credit of an overpayment of tax has been filed, the latest of:

- 60 days after the IRS mails to the taxpayer by certified or registered mail a notice of disallowance of any part of the claim,
- 60 days after a decision by a court of competent jurisdiction becomes final as to a timely suit started upon the claim, or
- two years after a notice of the waiver of disallowance is filed under IRC § 6532(a)(3).

Despite IRC § 6511 (time limits on filing refund claims) and IRC § 6512 (limitations on Tax Court petitions), a refund based on the state death tax deduction may be made if the refund claim is filed within the time period discussed above. Any refund will be made without interest.

F. Unified Credit

1. Allowance of Unified Credit

IRC § 2010(a) allows a tax credit of the applicable credit amount against a decedent's federal estate tax. The applicable credit amount often is also referred to as the "unified credit." The applicable credit amount is the amount of estate tax that would be generated on a transfer of property in the amount of the "applicable exclusion amount." The applicable exclusion amount often is referred to as a decedent's estate tax exemption. The following is a table of applicable credit amounts and applicable exclusion amounts.

YEAR OF DEATH	APPLICABLE CREDIT AMOUNT ("UNIFIED CREDIT")	APPLICABLE EXCLUSION AMOUNT ("ESTATE TAX EXEMPTION")
2021	$4,625,800	$11,700,000
2022	$4,769,800	$12,060,000

<u>EXAMPLE</u>: D died in 2022 with a $13,060,000 estate. Assuming D had not previously used any of his unified credit, $12,060,000 of D's estate would have been exempt from estate tax.

2. Consistent Planning

➔ **<u>Planning Point</u>:** In light of the adjustments to the estate tax exemption amount, practitioners should review clients' estate plans to make sure that: (a) the estate plan is taking advantage of the scheduled adjustments to the estate tax exemption amount; (b) the allocation between the marital and nonmarital share of the estate plan is appropriate; and (c) spouses are appropriately dividing assets between them so that each spouse can take advantage of the estate tax exemption amount, regardless of who dies first.

3. Adjustment to Credit for Certain Pre-1977 Gifts

The allowable applicable credit amount is reduced by an amount equal to 20% of the aggregate amount allowed as a specific exemption under IRC § 2521 with respect to gifts made by a decedent after September 8, 1976.

4. Limitations

There are certain limitations on the amount and use of the applicable credit amount.

a. Amount. The amount of the unified credit cannot exceed a decedent's federal estate tax liability. In other words, the decedent's federal estate tax exemption cannot exceed a decedent's taxable estate. IRC § 2010(d).

b. Nature. The applicable credit amount is a lifetime amount and has mandatory application. It is cumulative and does not renew annually. Therefore, it cannot be skipped during lifetime and saved for transfers at death.

> **EXAMPLE:** D made a gift in 2002 of $500,000. No gift tax was paid because $500,000 of D's applicable exclusion amount covered the gift. D died in 2009 with an estate of $3,500,000. Even though the applicable exclusion amount was $3,500,000 in 2009, D had used up $500,000 of his applicable exclusion amount. Therefore, $500,000 of D's estate would still have been subject to the estate tax.

G. Flexibility

Practitioners should design estate plans to provide maximum flexibility to determine the credit shelter amount and the extent of the QTIP election at the death of the first spouse. The executors could then make determinations based on the facts and circumstances at the time of the decedent's death, including the size of the estate, the size of the surviving spouse's estate and the provisions of both federal and state law.

H. Calculation of Federal Estate Tax

1. Computation of Federal Estate Tax

IRC § 2001(b) describes the computation of a decedent's federal estate tax liability.

a. Gross Estate. The first step is to determine what property of the decedent is subject to the estate tax. This property is called the decedent's "gross estate." IRC §§ 2031(a) and 2033 through 2044 describe the various types of property includible in a decedent's gross estate for federal estate tax purposes.

b. Estate Tax Deductions. The second step is to determine the total allowable estate tax deductions under IRC §§ 2053-2058.

c. Taxable Estate. Next, the decedent's "taxable estate" is determined by subtracting from the decedent's gross estate the total allowable deductions. IRC § 2051.

d. **<u>Tax Base</u>.** A decedent's tax base is the sum of the decedent's taxable estate and adjusted taxable gifts. A decedent's "adjusted taxable gifts" is the total amount of post-1976 taxable gifts made by the decedent that are not otherwise includible in the decedent's gross estate. IRC § 2001(b). Because the estate tax and the gift tax are part of a unified transfer tax system, the decedent's prior gifts are included in the decedent's estate tax computation.

e. **<u>Tentative Tax</u>.** A "tentative tax" is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's tax base. IRC § 2001(b)(1).

f. **<u>Reduction for Certain Gift Taxes</u>.** In order to avoid double taxation, the tentative tax is then reduced by gift taxes paid by the decedent on prior post-1976 gifts. IRC § 2001(b)(2).

g. **<u>Estate Tax Credits</u>.** The tentative tax is further reduced by applicable estate tax credits. IRC §§ 2010-2016 cover these credits, which include the unified credit against estate tax, the credit for gift taxes paid on pre-1977 gifts, the credit for tax on prior transfers, and the credit for foreign death taxes.

> **<u>EXAMPLE</u>:** D, a widow, died on January 1, 2009 owning the following property: a bank account worth \$500,000, real estate worth \$1,900,000, tangible personal property worth \$50,000 and a \$500,000 life insurance policy on D's own life. D was the beneficiary of a QTIP marital trust created at the death of D's predeceased spouse worth \$1,000,000. At death, D had debts of \$50,000, funeral expenses of \$10,000 and administration expenses of \$100,000. D's will left \$10,000 to a qualified charity. D's estate actually paid \$50,000 in state inheritance taxes. D's estate tax liability is calculated by taking her gross estate of \$3,950,000 and subtracting her total allowable deductions of \$220,000 to arrive at a taxable estate of \$3,730,000. D's tentative tax of \$1,559,300 is determined by applying the tax rate table to D's tax base of \$3,730,000. D's tentative tax is reduced by D's unified credit amount of \$1,455,800 for 2009 (which is equivalent to an applicable exclusion amount of \$3,500,000). Accordingly, D's federal estate tax liability is \$103,500 (\$1,559,300 - \$1,455,800).

I. Payment of Federal Estate Tax

1. General Rule

Generally, the federal estate tax and estate tax return are due nine months after the decedent's date of death. IRC §§ 6075(a) and 6151(a). Extensions of time to pay the estate tax are allowed under certain circumstances. IRC §§ 6161, 6163, 6165 and 6166 cover those circumstances.

2. Installment Payments of Federal Estate Tax Allowed for Certain Estates

One of the most important provisions relating to extending the time for payment of federal estate tax is IRC § 6166(a), which allows certain estates to pay some or all of their federal estate tax liability in installments.

a. **Requirements**. The estate must meet the following requirements to qualify for installment payments under IRC § 6166(a).

(1) **U.S. Citizen or Resident Decedent**. The decedent must have been a U.S. citizen or resident.

(2) **Interest in a Closely Held Business Exceeds 35% of Estate**. The decedent's gross estate must have included an interest in a closely held business which exceeded 35% of the decedent's adjusted gross estate.

(a) **Interest in Closely Held Business**. IRC § 6166(b)(1) defines "interest in closely held business" as:

- an interest in a proprietorship in a trade or business carried on as a proprietorship;
- an interest as a partner in a partnership carrying on a trade or business, if (1) 20% or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or (2) such partnership had 45 or fewer partners; or
- stock in a corporation carrying on a trade or business if (1) 20% or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or (2) such corporation had 45 or fewer shareholders.

(b) **Adjusted Gross Estate**. IRC § 6166(b)(6) defines "adjusted gross estate" as the value of the gross estate reduced by the sum of the amounts allowable as a deduction under IRC § 2053 or IRC § 2054. Such sum will be determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the federal estate tax return (or, if earlier, the date the return is filed).

(3) **Up to 10 Installments**. The executor may elect to pay part or all of the federal estate tax in two or more (but not exceeding 10) equal annual installments.

(4) **Amount Limitation**. The maximum amount of federal estate tax that can be paid in installments is an amount that bears the same ratio to the total estate tax as the ratio of the closely held business interest to the adjusted gross estate.

(5) **Election**. The executor must make an IRC § 6166 election on the decedent's federal estate tax return. IRC § 6166(d).

b. **Rationale.** The rationale for IRC § 6166 is to relieve the estate from the hardship of having to sell a portion or all of the decedent's closely held business interest in order to pay federal estate taxes, which might otherwise interrupt or cease business operations.

c. **Deferral.** If the estate elects to pay federal estate taxes in installments, the executor can defer the first installment for up to 5 years after the original due date. Each succeeding installment payment must be made one year after the date of the first payment. IRC § 6166(a)(3).

> **EXAMPLE:** D died on April 4, 2006. D's estate tax liability was $3,500,000. D's estate included a closely held business which comprised 75% of his adjusted gross estate. If D's estate makes an IRC § 6166 election on D's federal estate tax return, D's estate may pay up to $2,625,000 (75% of the federal estate tax liability) in up to 10 annual installments. D's estate may defer the first installment until January 4, 2013 (five years after the due date on January 4, 2008).

d. **2% Interest Rate.** Generally, if the estate elects to pay federal estate taxes in installments, then a 2% interest rate applies to a portion of the tax. IRC §§ 6601(j) and 6166.

e. **Acceleration of Payments.** Under certain circumstances, the IRS will accelerate the estate's installment payments. IRC § 6166(g). For example, the disposition of the business interest can trigger the acceleration because the rationale for the installment payments is no longer applicable. IRC § 6166(g)(1). Certain late payments or the nonpayment of principal or interest also can trigger acceleration. IRC § 6166(g)(3).

J. Income Tax Consequences of Inherited Property

1. Step-Up in Basis

Basis is the amount used to calculate income tax gain or loss on the sale of property. It usually is the cost of acquiring the asset. Before January 1, 2010 and after December 31, 2010, the basis of property inherited from a decedent usually is the federal estate tax value of the property in the decedent's gross estate. IRC § 1014. If the value at the date of death is lower than the basis of the property, the basis takes a step down to the value on the decedent's date of death. Because property generally appreciates over time, however, there usually is a step-up in basis at death.

> **EXAMPLE:** D's gross estate included 100 shares of ABC company stock, which D's will left to B. The price per share on D's date of death was $100. Therefore, the value of the stock on D's date of death was $10,000. D originally purchased the 100 shares for $50 per share ($5,000). B's basis in the shares becomes $10,000 ($100/share), eliminating the $5,000 of gain that would have been taxed if D had sold the stock immediately before his death.