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NATIONAL BUSINESS INSTITUTE
Estate Administration Procedures: Why Each Step is Important

UNDERSTANDING TAX PROCEDURES TO AVOID PROBLEMS LATER

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I. Overview of Tax Compliance and Post-Mortem Planning: What You Need to Know

Numerous tax issues may come up in the context of administering a decedent's estate. The personal representative may need to file the decedent's final income tax return (and the return from the previous year if it is still open), the estate's income tax return, the income tax return for a related living trust, a gift tax return for the year of death and any open years, a federal estate tax return and a state estate tax return. Decisions regarding a tax-qualified disclaimer by one or more beneficiaries must be made within nine months after the decedent's death. There are deadlines regarding the distributions of IRAs to beneficiaries, including a trust, if stretch-out treatment or a spousal rollover is available. Certain income received after death (income in respect of a decedent or "IRD") may be subject to both income and estate tax. Calendaring key deadlines is of course critical, and staying in frequent contact with the estate's accountant should help in meeting deadlines and avoiding miscommunications. It is particularly useful to make sure each advisor knows which returns will be prepared by which advisor. Attorneys frequently prepare estate tax returns and sometimes gift tax returns, but may turn to the estate's accountant to prepare individual and fiduciary income tax returns.

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II. What You Need to Know to Prepare the Decedent's Final Income Tax Return

The decedent's tax year ends on midnight on the date of death. This is when the estate itself becomes a taxpaying entity. The personal representative should determine whether any returns are on extension, whether estimated tax payments were made for income earned in the year of death, and when the decedent last filed a return. Note that no estimated payments are required after death. Treas. Reg. § 1.6015(b)-1(c)(2).

If the decedent died very early in the year, the decedent may not be required to file a final return. For 2011, a single taxpayer over age 65 was required to file a return if his or her gross income reached $10,950. Commentators point out that by filing a return, the statute of limitations is triggered.

Normally, certain tax items are lost if not used before death. The estate does not succeed to the decedent's capital loss carryovers and net operating losses. This is consistent with the basis step-up regime. The basis in the decedent's assets is generally stepped up to the fair market value on the date of death, and therefore retaining losses is perceived as a "double dip." However, if the decedent's surviving spouse files a joint return, he or she may still be able to use those items. For example, if the surviving spouse incurs gains after the surviving spouse's death, this may absorb a potion of the deceased spouse's capital loss carry forwards. If the original loss was joint, only the decedent's one-half is lost.

The final return should report all income actually or constructively received before death, and all deductible expenses paid before death. The year for the decedent is not treated as a short year. The decedent is entitled to the full personal exemption and standard deduction on the final return. These are not prorated. Medical expenses incurred but not paid before death can be deducted on the federal estate tax return or on the decedent's final income tax return; the personal representative and advisors must determine which is more advisable.

If the decedent was married at the time of death, the final return will be filed as married filing separate or married filing jointly. This decision is made by the personal representative or the surviving spouse if there is no PR. The personal representative must sign "as personal representative," and the surviving spouse is instructed to sign "as surviving spouse." A joint return would pick up the couple's income and deductions until the date of death and the surviving spouse's for the balance of the year.

If necessary, file Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer. This is not necessary for a court-appointed personal representative or a surviving spouse, but tax preparers advise always filing it anyway. A personal representative must file Form 56, "Notice of Fiduciary Relationship."

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III. Estate's Income Tax Return/Distributions

A. Basic Rules

As of the date of death, the estate becomes a separate taxpayer. To simplify greatly: to the extent that an estate or trust retains income, any income tax attributable to the income is taxed to and paid by the estate. To the extent that the personal representative makes distributions to beneficiaries, the distributions generally "carry out" the income and it is taxed on the beneficiaries' returns.

The calculation of the estate's "distributable net income" determines how much income is carried out to the beneficiaries and taxed in their hands. The estate's "DNI" is:

- Total trust income (excluding tax-exempt income)
- Less deductions
- Less deductible expenses
- Plus tax-exempt interest reduced by expenses not allowed in the computation of taxable income and the portion used to make charitable contributions.

Capital gains are normally not part of DNI; as an accounting matter, gains are typically added to principal and benefit future beneficiaries. However, capital gains are added to DNI when (i) the gain is allocated to accounting income, (ii) gains allocated to principal are required to be distributed, or the personal representative consistently and repeatedly distributes the gain, or (iii) the gain is allocated to principal is paid to or permanently set aside for charity. Capital losses cannot be included in DNI unless capital gains are added to DNI; and losses can be included in the DNI calculation only to the extent of gains.

B. Distributions

Distributions carry out DNI to the beneficiaries in the year of the distribution. Under the "65 day rule," however, an estate can opt to treat distributions made within 65 days after the close of the tax year as made in that preceding tax year. IRC § 663(b).

To the extent the executor does not make distributions, the tax is paid by the estate. Under 2011 rate schedules, an estate reached the top tax bracket of 35% when it has only $11,350 of income. Therefore, distributions to the beneficiaries can be advantageous if the beneficiaries

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pay taxes at less than the top tax bracket. There may also be advantages if a beneficiary lives in a state with a low or no state income tax.

Capital loss carry forwards and net operating losses pass out to beneficiaries in the final year of the estate.

C. Calendar/Fiscal Year.

An estate (and an electing revocable trust) may elect a fiscal year. The fiscal year is adopted by filing the first income tax return using that year. Treas. Reg. § 1.441-1(c)(1).

The first fiscal year cannot exceed 12 months. For example, if the decedent died on August 4, 2011, the estate's fiscal year end would have to be no later than July 31, 2012.

Election of a fiscal year can provide an opportunity to defer taxable income. Assume an estate with a fiscal year ending May 31. The estate's income tax return is therefore due on September 15. From the date of death through mid-2012, the estate has taxable income of $50,000. If tax will be paid from the estate, it must be paid by September 15, 2012. If instead a distribution is made to the beneficiaries in April, 2012, the executor will issue a Schedule K-1 to each beneficiary who is picking up DNI. The Schedule K-1 will be issued when the estate files its return. The distributions are treated as if made to beneficiaries on the last day of the estate's fiscal year. Section 662(c) states:

> If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

Accordingly the distribution will carry out 2012 income to the beneficiaries. If they are individuals, the tax will not be due until the beneficiary files his or her return on April 15, 2013.

This deferral can be the most extreme when the estate has a fiscal year that ends early in the year. For example, consider an estate that has a fiscal year ending on January 31. Such an estate may earn income from February 1, 2011 to January 31, 2012. The executor makes a substantial distribution at any time before January 31, 2012. Accordingly, that income will be included in the beneficiary's 2012 income and tax will be due in April, 2013. In this way, the tax bill on income earned largely in 2011 does not come due until 2013.

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Because estates quickly reach the highest income tax bracket, the executor should estimate the estate's income and determine when distributions would be advantageous.

D. Section 645 Election.

1. The trustee of the decedent's revocable trust can make an election to be treated as part of the estate for income tax purposes.

2. This simplifies the trust and estate accounting. It also means that the revocable trust can take advantage of the opportunity to use a fiscal year for income tax reporting. The election also makes the rules that apply to estates and trusts more consistent during the period of estate administration. For example, the charitable income tax deduction that applies to estates would also apply to trusts. The revocable trust could deduct amounts permanently set aside for charity as well as amounts actually paid to charity.

3. The election is made by filing a Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." The election must be filed by the due date for the related estate, including any extension of time granted for the estate's income tax return.

E. Distributions in Satisfaction of a Pecuniary Gift

A distribution of appreciated property in satisfaction of a pecuniary bequest is treated as a sale of the asset followed by a distribution. For example, assume that a decedent owned stock with basis of $50,000. On the date of death, the value of the stock was $90,000, and accordingly that became the new basis of the stock in the hands of the estate. The decedent's will included a $100,000 bequest to his sister. During the period of estate administration, the stock appreciates in value to $100,000. Pursuant to his discretion under the will, the executor distributes the stock to the sister in full satisfaction of the $100,000 bequest. The estate is treated as if the executor had sold stock for $100,000 and distributed cash to the sister. The estate has a capital gain of $10,000.

F. Where to Deduct Expenses

Certain expenses can be deducted on the estate's 1041 or the federal estate tax return for the estate. These include estate administration expenses, such as accounting and legal fees and the expenses of selling assets. *See* IRC sections 212 and Treas. Reg. § 20.2053-3. Section 642(g) of the Code provides that these expenses cannot be double-deducted. The personal representative and his or her advisors should coordinate to determine where it is best to deduct the expenses.

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IV. Filing Requirements for Federal and State Estate Tax Returns

A. Background: Federal and State Estate Taxes

The federal estate tax is imposed on a decedent's gross estate. The gross estate is all of the decedent's property or property interests, including joint property, property that passes to a beneficiary designated by the decedent, property that the decedent gave away but in which the decedent retained an interest, annuities, trusts in which the decedent held a power of appointment, etc.

Each decedent's estate now has an exemption from estate tax that is now equal to $5.12 million. There are unlimited deductions for transfers to (or to certain trusts for the benefit of) a surviving spouse or charity. Above these exemptions and deductions, a flat 35% tax applies. Under current law, the exemption is indexed to inflation. However, current law also is about to expire. Unless Congress acts by December 31, 2012, the existing law will "sunset" and 1997 law will be reinstated. If 1997 law applied now, the federal estate tax exemption would be $1 million and the top tax rate would be 55%.

No one can predict what a lame duck Congress will do before December 31, 2012, and some commentators have even questioned whether such a Congress will act at all. Meanwhile, the 2013 Budget proposed by the Obama administration calls for a restoration of the estate tax that applied in 2009. If passed, that law provides an estate tax exemption of $3.5 million and a top tax rate of 45%. (The gift tax exemption would be lowered to $1 million.)

Illinois state law does not perfectly parallel federal law. Under Illinois law, the state estate tax exemption is $3.5 million, and this is scheduled to increase to $4 million for the estates of decedents dying next year or thereafter. In addition, Illinois law recognizes a state-only QTIP election. This means that a marital trust can be treated as a QTIP for state law while no federal QTIP election is made – the trust does not qualify for the marital deduction. This allows, with careful drafting, for a married couple to optimize use of the larger federal estate tax exemption at the death of the first spouse to die, without incurring any tax liability until the death of the surviving spouse.

B. Federal and State Estate Tax Return Filing Requirements

A federal estate tax return is required for any decedent whose gross estate (plus any taxable gifts made and any specific exemption available allowable under repealed Code section 2521) exceeds the federal estate tax exemption, *i.e.,* $5.12 million under current law. This is true even if, after deductions, the taxable estate is less than that amount or even zero. Illinois requires a return for any decedent whose estate files a federal estate tax return. 35 ILCS 405/6(c). Under

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current law, an Illinois tax can occur in estates that do not reach the federal estate tax filing threshold. The instructions to the Illinois estate return naturally state that a return must be filed in those cases.

The federal estate tax return is due nine months after the date of death. There is an automatic extension of six months that is available on election. However, the payment of taxes generally cannot be extended. The tax payment is due nine months after the date of death even if filing the return on extension. An estimated tax payment must be made at that time. The Illinois return and payment is due when the federal return and payment are due, including extensions. 35 ILCS 405/6(a).

C. Portability of Exemption

The tax law that has been in effect since January 1, 2011 (the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, or "TRUIRJCA") established the "portability" of a decedent's estate tax exemption. For the first time, a decedent's estate can elect to make available any of the decedent's unused estate tax exemption to the estate of the surviving spouse at his or her subsequent death. This is a useful stop gap: if the couple has failed to divide their assets and one spouse is significantly wealthier, the couple can still optimize use of their estate tax exemptions even if the poorer spouse dies first. Of course, TRUIRJCA has only a two-year shelf life, but portability may well be preserved in the next estate tax law. The Obama administration 2013 budget would preserve portability.

In September, 2011, the IRS issued Notice 2011-82 to provide guidance on procedures for electing portability. The notice says that the timely filing of a Form 706, prepared in accordance with the instructions for that form, will constitute the making of a portability election by the estate of a decedent dying after Dec. 31, 2010. Thus, by timely filing a properly prepared and complete Form 706, an estate will be considered to have made the portability election without the need to make an affirmative statement, check a box or make some other election on the 706. Until the IRS revises Form 706 to expressly contain the computation of the deceased spousal exclusion amount, a timely filed and complete Form 706 that is prepared in accordance with the instructions for that form will be deemed to contain the computation of the deceased spousal unused exclusion amount, thereby satisfying the requirements in section 2010(c)(5)(A) for making an effective election.

V. How the Generation-Skipping Transfer Tax Affects Your Clients

The generation-skipping transfer tax or "GST" is a separate tax on transfers to grandchildren and more junior generations. There is an exemption from the GST that is currently

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equal to the estate tax exemption, or $5.12 million. The GST is imposed at the maximum estate tax rate (IRC section 2641(a)(1)), so the purpose of learning about the GST is usually to learn to avoid it. In order to do so, counsel for the estate must identify where GST transfers will or may occur and how GST is automatically allocated or allocated on gift and estate tax returns. The two most common examples of a GST transfer are a simple gift to grandchildren (or trusts for them or a gift to a multi-generational trust.

A. Skip Persons

The GST is imposed on transfers or distributions to "skip persons." A skip person can be an individual or a trust. An individual is a skip person if he or she is assigned to a generation that is two or more generations below the decedent's or "transferor's" generation. A trust is a skip person if it is for the benefit of skip persons only.

B. Generation Assignment

The GST is imposed on transfers or distributions to beneficiaries who are assigned to two or more generations below the grantor. Generation assignment can be based on family relationship or age. Given the nature of trusts and estate practice, generation assignment is most commonly based on family relationship.

A descendant of a grandparent of the transferor is assigned to a generation by comparing the number of generations between the descendant and the grandparent with the number of generations between the transferor and the grandparent. A present or former spouse of the transferor is assigned to the transferor's generation.

A spouse's relatives (and even the relatives of a former spouse) are also assigned generations in the same fashion. The spouse is assigned to the transferor's generation. A descendant of a grandparent of a spouse or a former spouse of the transferor is assigned to a generation by comparing the number of generations between the spouse and the grandparent with the number of generations between the descendant and the grandparent. A present or former spouse of a descendant of a grandparent of either the transferor or the transferor's spouse or former spouse is assigned to the same generation as the descendant.

Generation assignment by age applies to beneficiaries who are not descendants of the transferor or his or her spouse or former spouse. A person born no later than 12.5 years after the transferor is assigned to the transferor's generation. A person born between 12.5 and 37.5 years after the transferor is assigned to the next generation. A person born more than 37.5 years after the transferor is a skip person; that person is assigned to the generation that is two generations below the transferor. Each subsequent generation is counted off by 25 years each.

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C. Allocation of GST Exemption

The personal representative must allocate GST exemption on the federal estate tax return. The amount of GST exemption is the portion not used by the decedent during his or her lifetime. Counsel should therefore examine the decedent's gift tax returns, checkbooks and other records and determine whether any GST exemption might have been automatically allocated during lifetime.

GST exemption is automatically allocated to gifts to skip persons. However, there is an annual exclusion from the GST that is narrower than the gift tax annual exclusion. It does apply on direct gifts to a skip person. So assume that in 2013 a proud grandparent gives $20,000 to a grandchild who has just graduated from college. Of that amount, $13,000 is sheltered from GST by the annual exclusion, and an automatic allocation of $7,000 of GST exemption is made in order to avoid incurring GST on the transfer.

GST exemption is also automatically allocated to gifts to GST trusts. (Note, however, that most GST trusts do not qualify for the GST annual exclusion, so allocation of the full amount of the gift is necessary to shelter the trust.) GST trusts are generally trusts that may benefit a skip person. A typical GST trust is one that is administered for the entire lifetime of the decedent's children, and at their death passes to grandchildren or to trusts for them. Specifically, a GST trust is "a trust that could have a generation-skipping transfer with respect to the transferor" unless it falls within a list of exceptions, which include:

1. The trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons before the individual reaches age 46 or on the occurrence of an event that may reasonably expected to occur before the individual reaches age 46. Accordingly, imagine a typical trust for the benefit of the decedent's child. The decedent is concerned that the beneficiary may be too immature to receive the property outright, so the trust provides that the decedent's child may withdraw one-third of the trust property at age 30, one-third at age 35, and the balance at age 40. The trust is not a GST trust because a GST transfer is actuarially unlikely.

2. The trust instrument provides that the trust benefits will pass to one or more non-skip persons on the death of another individual who is at least 10 years older than the non-skip persons. Imagine a trust for the decedent's mother that will pass to the decedent's children at their grandmother's death.

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3. The trust would be included in the estate of a non-skip person if he or she died immediately after the transferor. This also cannot be a GST trust because it will be taxed in the estate of a non-skip person.

4. A charitable lead annuity trust, a charitable remainder unitrust, and a charitable remainder annuity trust are not GST trusts. A charitable lead unitrust is also not a GST trust if it passes to non-skip persons when the charitable lead interest expires.

Having identified how much of the GST exemption was used during lifetime, the personal representative now can form a plan for allocating the decedent's remaining GST exemption on the estate tax return. Ideally, this would be allocated to a trust that is sheltered from estate tax and that has a long duration. Generally, the personal representative would want to prioritize any trusts with the longest duration. The rule against perpetuities, which traditionally limited the duration of trusts, may be waived under Illinois law. It has also been modified or repealed in numerous other states. Accordingly, if the estate plan includes a perpetual trust, GST exemption should be allocated to it. Preferably, the GST exemption would not be allocated to trusts that require mandatory payment of income; as a tax matter, the GST exemption is most efficiently used with a trust that is likely to grow.

GST exemption can also be leveraged. For example, the personal representative may wish to allocate exemption to trusts holding assets with a depressed value, or assets that were discounted for estate tax purposes. A family business interest, for example, may have been valued with discounts for a minority interest and lack of marketability. GST exemption may be allocated to a trust holding those assets to optimize the benefit of the exemption.

A charitable lead unitrust also may provide an excellent opportunity for leveraging the GST exemption. A testamentary CLUT – a CLUT established at death – provides an estate tax charitable deduction that is equal to the present value of the stream of income to charity. Accordingly, the taxable value of the trust is the value of the property funding the trust, reduced by the value of the charitable lead interest. If the personal representative allocates exemption equal to the difference between the property funding the trust and the value of the charitable lead interest, then the entire trust should pass free from GST when the lead interest has terminated.

Consider the current extremely low interest rate environment. Assume a testator establishes a CLUT with a 25 year term, paying 5% to charity, remainder to perpetual trusts for descendants. The testator's will directs the funding of this trust with the maximum amount of property that would result in no taxable estate. The testator has remaining a $5 million estate and GST exemption. Both are allocated to the testamentary CLUT. Funding the trust with $17.9 million would absorb the entire $5 million of GST and estate tax exemptions. In each year, charity would receive a 5% unitrust payment. The payment in the first year would be $895,000.

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If the CLUT earns an average 3% per year, in 25 years the descendants' trusts will receive $10.5 million. If the CLUT earns an average 5% per year, the descendant's trusts will receive $17 million in 25 years.

D. Reverse QTIP Election

At a decedent's death, GST exemption can also be allocated to a QTIP marital trust established for the benefit of the decedent's spouse. Without the special provision that allows election of "reverse QTIP" treatment, this would not be effective because a QTIP trust is included in the surviving spouse's estate under section 2044 of the Code. The surviving spouse would therefore be treated as the transferor of the trust for GST purposes. However, under section 2653(a)(3) of the Code, the marital trust may be treated – for GST purposes only – as if the QTIP election were not made. Thus, GST exemption can be allocated to the trust effectively because the transferor, for GST purposes, was the decedent and not the surviving spouse.

Allocating GST exemption to a QTIP trust by use of a reverse QTIP election is not the most optimal way to use GST exemption. The marital trust must pay out income and the trust will be included in the surviving spouse's gross estate at his or her death. However, allocating GST exemption to a marital trust should be done if there is no better transfer or trust that could use the exemption more advantageously. A reverse QTIP election is better than failing to use GST exemption.

VI. Accurate and Inclusive Valuation of Assets

The federal estate tax return requires the personal representative to report the identity and value of all of the decedent's property and property interests. The assets are valued as of the date of the decedent's death. If the personal representative elects, however, all of the estate's assets may be valued as of the date that is six months after the date of death. Assets sold, exchanged or disposed of during the interim period are valued as of the date of disposition. The "alternate valuation date" election is available only if it reduces the gross estate and the tax due. Further, the election does not apply to any asset the value of which falls only because of the passage of time.

The types of assets are organized in nine chief schedules.

A. Real Estate

Real estate is reported on Schedule A. If the real estate in the estate is held by an entity, it should be reported on Schedule F instead. The instructions clarify that real estate held as part of a sole proprietorship should also be reported on Schedule F.

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Clients frequently seem to want to economize on appraisals of real estate. They frequently propose using a tax assessed value. Nonetheless, for residential real estate or raw land, obtaining a real estate appraisal from a licensed appraiser usually costs just a few hundred dollars.

If the real estate is held as a tenancy-in-common with a third party, the parties should determine whether it is cost-effective to hire a qualified appraiser to value the real estate at a discount. The discount would generally reflect the lack of marketability inherent in a tenancy-in-common interest. Nonetheless, the Service recently ruled that the only discount permissible in valuing such an interest is the cost of partition.

B. Stocks and Bonds

Except as to closely held corporations, stocks and bonds are amongst the easiest items to value. A security or bond is valued by averaging the high and low price on the date of death. If the date of death occurred on a weekend or holiday, the high and low prices on the first business day preceding and on the first business day following the date of death are used.

Dividends and interest that have accrued as of the date of death must also be reported on Schedule B.

There are a number of services that will provide date-of-death values (including accrued interest and dividends) for a few dollars per position.

The IRS has accepted interpolated values for securities (such as many hedge funds) that are valued only monthly.

Stock in closely held corporations and S corporations also must be reported on Schedule B. The personal representative should retain a qualified appraiser for the purpose of valuing any interest in a privately held corporation. The appraisal is likely to value the stock at a discount, which would reflect (i) that the stock may be subject to transfer restrictions that limit its marketability and (ii) that the stock may constitute a minority interest, which would limit the owner's control over the corporation. Marketability and minority interest discounts on the value of closely held business interests is one of the most, if not the most, litigated topics at the IRS audit and appellate levels. Therefore, choosing a good appraiser (and an appraiser who is a good writer) and reviewing the appraisal closely is crucial. These appraisals can be quite expensive. Depending on the complexity of the entity and the business, fees can range from $12,000 to above $20,000. This fee is gauged, however, against a 25-40% discount in the value of the business interest.

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C. Mortgages, Notes and Cash

Cash is reported on Schedule C; this should include all checking and savings accounts. Cash receivables are normally listed as miscellaneous property on Schedule F.

The personal representative must also list any mortgages owned by the decedent and any notes. Notes are normally valued at their unpaid principal and accrued interest. However, IRS regulations provide that a personal representative may establish that a note is not worth its face value. This may be because its interest rate does not reflect market rates or it has become uncollectible in whole or in part because of the insolvency of the debtor or the value of the collateral. Particularly in today's financial environment, a personal representative should closely scrutinize any note reported on the return. It is possible that a note once made under market conditions became less valuable because of changes of fortune that occurred during the recession and that are still occurring. Moreover, a personal representative should be aware of the risks involved with intra-family loans. It is possible that the IRS may argue that an intra-family loan made during hard economic times was partly or wholly a disguised gift. In that case, the estate could be liable for interest and penalties on an unreported gift.

D. Insurance on the Decedent's Life

Insurance policies or proceeds are included in the gross estate if the proceeds are paid to the estate or if the decedent "exercised incidents of ownership" over the policies. In other words, insurance policies not owned by a third party, including a trust, will be included in the gross estate. The policies must be reported on Schedule D and the personal representative must get a "Form 712" from the issuer. This reports the proceeds paid out plus any accrued interest as of the date of death. Policy loans will reduce the net proceeds paid.

Joint-and-survivor policies must be included on Schedule D, even if the decedent is the first insured to die and the proceeds have therefore not paid out. If the surviving spouse is the remaining owner, then the marital deduction will be available for any cash value in the policy.

E. Joint Property

Property owned by the decedent and one or more third parties as (i) tenants by the entirety or (ii) joint tenants with rights of survivorship are listed on Schedule E. Part 1 of Schedule E lists only "qualified joint interests." These are interests in which the decedent and his or her spouse are the only joint tenants. The decedent's interest should qualify for the marital deduction when it passes, by operation of law, to the surviving spouse.

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Property owned by one or more joint tenants other than the decedent and his or her spouse appears on Part 2 of Schedule E. The names and addresses of the additional co-tenants must be provided. The extent of the decedent's interest in the asset is determined by the instrument of ownership (e.g., a deed or account agreement) and by state law. For example, the Uniform Multiple-Person Accounts Act provides that when all owners are living, "an account belongs to the parties in proportion to the net contribution of each to the sums on deposit, unless there is clear and convincing evidence of a different intent." This uniform law is not widely adopted, but many states have statutes that address the ownership of joint accounts, pay-on-death accounts, and trust accounts.

F. Miscellaneous Property

Property not specified for any other schedule must be reported on Schedule F. Commonly reported items include:

1. QTIP Marital Trusts. Any property that is includible under Section 2044 of the Code (because of an election in the estate of the first spouse to die to treat the property as QTIP property) must be included on Schedule F. All of the trust assets – whether real estate, securities, cash, etc. belong on Schedule F even though the property would normally be identified on other schedules.

2. Tangible Personal Property. When clients are in assisted living or a nursing home and have already given away the bulk of their tangible property, it is reasonable to estimate a value of a few thousand dollars and state "valued by the personal representative." Otherwise, an appraiser should be engaged to value the tangible personal property. The fee can vary widely, depending on whether there are valuable art or antiques in the home.

3. Partnership Interests, LLC Interests, and Sole Proprietorships. Business interests held in any of these forms are reportable on Schedule F, including any property held as part of a sole proprietorship. The same appraisal considerations that apply to valuations of closely held corporations are likely to apply to any non-public partnership or LLC. Single member LLCs should also be reported on Schedule F.

4. Farm Property. This would include livestock, crops, and equipment. If the farm is owned by an S corporation, it should be reported on B, and if the property is part of an LLC or partnership, it will be included in that appraisal.

5. Claims. Any claim, expectancy or settlement should be included on Schedule F. This might include a wrongful death claim, for example.

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6. Other Contract Rights. This might include unexpired options or other financial instruments.

7. Insurance Policies on the Life of Another. If the decedent owned a policy on the life of a third party, it must be reported on Schedule D. The value of a policy that has not paid out is determined from the policy's "interpolated terminal reserve." This is generally the cash value plus unearned premiums paid.

8. Royalties, etc. The personal representative should value and list on Schedule F any patents, copyrights, trademarks, royalty interests, licenses, etc. Again, the personal representative is likely to need a qualified appraiser with a specialty in intellectual property rights to value these interests accurately.

9. Receivables. This could include tax refunds, magazine refunds, checks received after the decedent's death or checks not cashed by the decedent, unpaid wages, bonuses, deferred compensation, medical insurance reimbursements, etc.

10. 529 Plan Gifts. Under section 529 of the Code, a person may elect to have a gift to a 529 plan for another person prorated over 5 years. This allows the donor to frontload a 529 plan by using up 5 years' of annual exclusion gifts at once. In other words, any donor may in 2012 make a $65,000 gift to the 529 Plan of a child, grandchild or other beneficiary, without using up any part of the donor's lifetime gift tax exemption. However, if the donor fails to survive the entire five years, the gifts for the years following the year of death come back into the gross estate and are reported on Schedule F.

G. Schedule G: Transfers During Lifetime

The chief item on Schedule G will likely be any funded living trust of the decedent. Such assets are valued and reported on Schedule G rather than on the schedules dealing with specific types of property.

Also reportable on Schedule G is gift tax paid by the decedent for all gifts made by the decedent or his or her spouse within three years before death. The purpose of this provision in Section 2035 of the Code is to eliminate the use of deathbed gifts as a means for avoiding estate tax on gift tax dollars actually paid. The distinction is meaningful because the estate tax is tax-inclusive, while the gift tax is not.

Schedule G requires the reporting of any property that the decedent transferred during lifetime, but in which he retained either the right to determine the disposition of it, or the right to use it. A typical example would be a charitable remainder trust for life. The donor made a

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transfer of the assets but retained the right to an annuity or unitrust payment. In that case, the value of the CRT would be included in the estate, with presumably an offsetting charitable deduction. A qualified personal residence trust would be another common example, if the decedent dies before his right to live in the home expires.

Finally, Schedule G also requires the reporting of any property interests if the decedent relinquished a power over it within three years of death. For example, if a decedent gave up a general power of appointment during that period, the property would be included in the decedent's gross estate. If the decedent transferred a life insurance policy to trust and died within three years of the transfer, the policy will not escape taxation and must be included on Schedule G. The decedent's transfers can be tracked by reviewing his or her gift tax returns for the preceding three years.

The personal representative should attach to the estate tax return any living revocable trust, any other trust that relates to a Schedule G transfer, and all of the decedent's gift tax returns.

H. Schedule H: Powers of Appointment

Any general power of appointment held by the decedent should be reported on Schedule H. This would normally be a trust over which the decedent holds a power to appoint the trust property to himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. A common example would be a third party trust established for the benefit of the decedent, but which is not GST exempt. The donor of that trust might choose to give the decedent a general power of appointment so that the trust would be taxed in the decedent's estate, rather than being subjected to the GST. This approach would save taxes if a portion of the decedent's estate tax exemption can be used or absorbed by the non-exempt trust.

Other less common examples can include a trust that the decedent could use to satisfy his or her legal obligations. For example, assume that the decedent was trustee of a trust for the benefit of his or her descendants. The trust authorized the trustee to make support distributions to the beneficiaries, regardless of any party's obligation to support a beneficiary. The decedent/trustee does in fact make distributions for his children's support, to pay expenses that he would have been required to pay in the absence of the trust. The Service is likely to argue that such a trust should be included in the decedent's estate and reported on Schedule H.

The decedent must also report unlapsed Crummey powers on Schedule H. If a trust gives the decedent the right to withdraw a portion of any gifts to the trust, the lapse of that withdrawal right is the relinquishment of a general power of appointment to the extent that it exceeds the greater of (i) 5% of the trust property or (ii) $5,000. Sometimes trusts therefore state that any excess withdrawal right will "hang" or continue in effect until it can lapse harmlessly in a future

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year under the "5 by 5" safe harbor. Any such hanging withdrawal rights and any currently exercisable withdrawal rights in excess of the 5 by 5 amount will be included in the decedent's gross estate and reported on Schedule H.

I. Schedule I: Annuities

IRAs, commercial annuities, 401(k) plans and other qualified and non-qualified retirement plans are reportable on Schedule I.

VII. Disclaimers and Alternatives for the Surviving Spouse

A. Disclaimers

Disclaimers present a tax option that is available to all beneficiaries. A disclaimer is simply a refusal of property that would have been transferred to the disclaimant by gift or inheritance. This includes all forms of death transfers, like pay on death accounts, life insurance benefits paid by beneficiary designation, and joint tenancy with right of survivorship. For purposes of this part of the seminar, a tax-qualified disclaimer is a disclaimer that does not result in gift by the disclaimant to the beneficiaries who receive the property in lieu of the disclaimant.

A very typical example of a desirable disclaimer is a parent who leaves property to children who are already wealthy. Assume a parent leaves her entire estate of $750,000 in equal shares to her three children. The oldest child, A, has had a highly successful career in real estate development. A and A's spouse have estates substantially in excess of $10 million total. Rather than adding to an estate that is already subject to estate tax, A disclaims her right to receive one-third of the parent's estate. It therefore is distributed, under state law, as if A had predeceased her parent. 755 ILCS 5/2-7(d). Under the parent's will, A's one-third share of the residue instead passes to trusts for A's children. A has not made a gift to them, and the parent has ample GST exemption to shelter the trusts for A's children from GST. A and A's children are better off, and there is no disadvantage to the parent's estate.

B. Time of Disclaimer

A disclaimer must comply with federal tax law and state property law. In Illinois, the chief difference between federal and state law is that there is no time deadline in Illinois for making a disclaimer. Under federal law, a disclaimer must be made within nine months of death. IRC § 2518(b)(2). Accordingly, in Illinois a beneficiary can theoretically disclaim an interest years after a transfer; however, that disclaimer will constitute a gift to other beneficiaries because it is not a qualified disclaimer for gift tax purposes.

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Please note also that the "nine months from the date of death" deadline is mere shorthand. The technical deadline for any disclaimer is:

The date that is nine months after the later of:

- The date on which the transfer creating the interest in such person is made, or
- The day on which the disclaimant turns 21 years of age.

IRC § 2518(b)(2). This means that if the interest is created at death under the decedent's will or living trust, a beneficiary designation, or the intestacy law, then the deadline for a qualified disclaimer is indeed nine months after the date of death.

But be aware: A trust interest may pass to a successor beneficiary because of the decedent's death, and that interest may not be disclaimable because the interest was created long before death. For example, assume a decedent establishes a QTIP marital trust for the benefit of his or her spouse. The trust does not give the spouse a general power of appointment. The spouse then dies. The QTIP trust is included in the spouse's gross estate. Nonetheless, the successor beneficiaries of the now-deceased spouse may not make a qualified disclaimer of their interests, because those interests were established at the death of the first spouse to die. *See* Treas. Reg. § 25.2518-2(c)(3)(i).

C. Other Requirements for a Qualified Disclaimer

In addition to the timing requirement, the following additional requirements apply:

1. The disclaimer must be irrevocable and unqualified.

2. The disclaimer must be in writing.

3. The disclaimer must be delivered to the transferor, or his legal representative, or the holder of legal title to the property that is the subject of the disclaimer.

4. The disclaimant may not have accepted the interest or any benefits of it. This is logical because a disclaimant who has already accepted the property would be making a meaningful gift to the other beneficiaries.

5. As a result of the disclaimer, the disclaimer must pass without any direction by the disclaimant, to either the spouse of the decedent or to a person other than the disclaimant. A disclaimant may not designate the alternate takers.

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IRC section 2518(b). These requirements demonstrate that a qualified disclaimer is meant to be a "hands off" act by the disclaimant. If the disclaimant simply steps back and refuses to accept the property, allowing it to pass as it would if he or she were not living, then the disclaimant is not treated as making a taxable gift to any other beneficiary.

A sample disclaimer is attached. The disclaimer may also have a space for acknowledgment of delivery.

D. Additional Flexibility for Spousal Disclaimer

For tax reasons, a spouse may wish not to receive property outright but rather to have it pass into trust for the benefit of the spouse (and possibly other beneficiaries as well). This might be a trust that is sheltered by the decedent's estate tax exemption and GST exemption. The spouse may make such a qualified disclaimer (as long as the language of the document permits it), despite requirement 5 above. A disclaimer to a trust for the spouse's benefit, and of which the spouse is a trustee, is still a qualified disclaimer if the surviving spouse as trustee may make distributions only according to ascertainable standards. Treas. Reg. 25.2518-2(e)(2), and 2(e)(5), Examples (4) through (6). Note that the surviving spouse must relinquish any powers of appointment in such a trust as well, in order to avoid falling afoul of the rule that an interest must pass to other beneficiaries without directly by the disclaimant.

E. Renunciation of the Will

Under Illinois law, a surviving spouse may elect not to receive benefits provided under the decedent's will, if any. If the surviving spouse renounces the will, the surviving spouse will receive one-third of the probate estate if the testator left one or more descendants, or one-half of the probate estate if the testator left no descendant. 755 ILCS 5/2-8(a). If the surviving spouse makes such an election, property passing to him or her pursuant to the election should qualify for the marital deduction from federal and state estate tax. Note that renunciation of the will applies to probate assets only; property that passes in non-probate form (like joint ownership, pay-on-death direction, and beneficiary designation) cannot be claimed by a renouncing spouse.

F. Partial QTIP Election

In Illinois, the estate tax exemption is less than the federal estate tax exemption. However, it is still possible to draft so that the entire federal exemption is used without incurring Illinois estate tax. The decedent's formula might leave to a credit shelter trust the maximum amount of property that can pass free from all death taxes. The remainder would pass to a marital trust.

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The personal representative or trustee can divide that marital trust and make an Illinois-only QTIP election as to part of it. That means the trust will (i) be sheltered from federal tax by the remaining federal estate tax exemption and (ii) not be subject to Illinois state estate tax until the surviving spouse's later death. Accordingly, a decedent with $6 million in assets might fund (i) a credit shelter trust fully sheltered from federal and state estate tax, funded with $3.5 million, (ii) an Illinois QTIP trust that is sheltered from federal estate tax and on which Illinois state estate tax is deferred, funded with $1,620,000 and (iii) a federal and state QTIP trust, funded with the balance of the estate or $880,000.

G. Use of Deceased Spouse's Capital Gain Exclusion

In certain cases, a surviving spouse may wish to sell his or her home within two years of the deceased spouse's death. The purpose of such a sale is to take advantage of the deceased spouse's capital gains exclusion. A widowed taxpayer may sell his or her home within that period of time and receive a capital gains exclusion for the $500,000 exclusion for a married taxpayer. Code § 121(b)(4). If the home is sold more than two years after the deceased spouse's death, the widowed spouse will have only his or her own $250,000 exclusion available.

Current depressed real estate values make it hard to imagine the application of this rule. But assume that a long-married couple bought their house in 1972. Their basis in the home is $50,000. At the death of the first spouse to die, in 2011, the property is worth $800,000 because of its advantageous location and lot size. The basis in one-half of the value of the home is stepped up to $400,000 on the date of death. The surviving spouse's half of the home still has unrealized gain of $375,000. If the surviving spouse may wish to downsize or move into assisted living, a decision about selling the home should be made promptly.

The information described herein is of a general nature, based on information currently available, and should not be relied upon to make planning, purchase, sale, or exchange decisions without seeking personal professional advice.

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