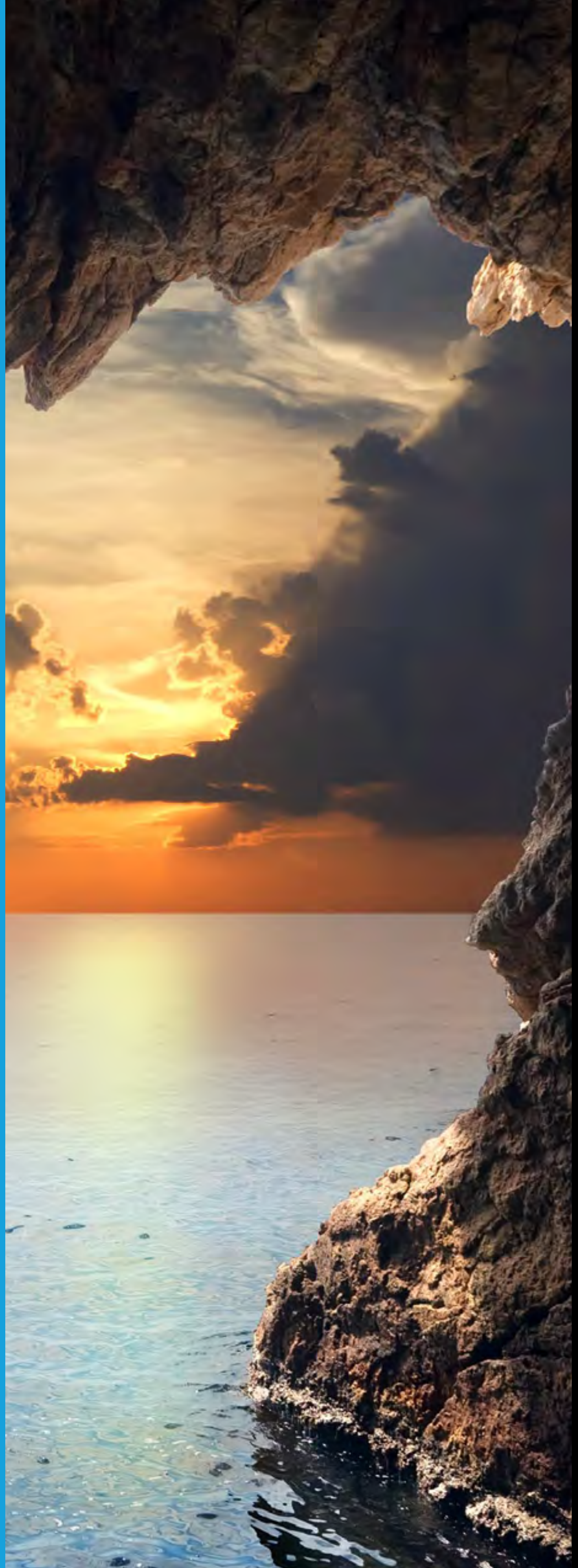
Postmortem considerations

In an ideal world, every wealthy individual has prepared for an orderly estate distribution, in favor of his or her family, charity, or a combination of both. Often such plans include proactively transferring wealth during his or her lifetime and leaving a thoughtful, well-constructed testamentary plan (updated as wealth and family considerations dictate) that takes taxes into consideration. But in the real world, many estate plans remain a work in progress for reasons ranging from evolving business complexity to family conflict, ill health, and indecision. Consequently, matters unconsidered by the testamentary plan make postmortem planning inevitable.



Postmortem considerations

US tax concerns during the administrative process for an estate

Developing a thoughtful, well-constructed estate plan during life leaves fewer actions and decisions to be taken by executors, trustees, and postmortem advisers, thus conserving both time and resources. The converse is also true; an estate plan that is vague, incomplete, or nonexistent is generally tax inefficient and leaves major decisions regarding asset management, estate liquidity, and the timing and nature of distributions to the estate's fiduciaries, advisers, and the courts, which consumes both time and resources.

For the families and beneficiaries of high net worth individuals, settling an estate can be consuming and stressful, beginning with the process of gathering information to create a net asset inventory (complete with necessary valuations of assets) and ending—often many years later—with the final distribution of assets. The period in between, the postmortem administrative period, often gives rise to complex tax, financial, and family considerations. While estate administration has its own legal and tax cadence, there is typically pressure to accelerate outcomes, even during the initial period of emotional loss.

Effective postmortem administration requires flexibility when responding to an estate's unique mix of assets, liabilities, and family considerations.

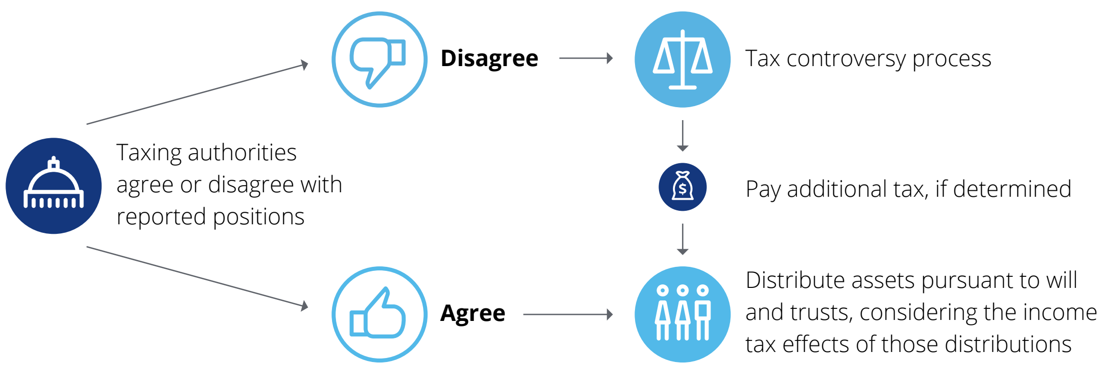
Every high net worth estate is unique. The type and level of activities required for settling the estate will depend on a host of factors, including the nature of the assets and liabilities, family considerations, and the extent and efficacy of the decedent's estate plan. For example, the approach for an individual who dies intestate (without a will or other testamentary declaration) will be very different from the approach for someone who dies with a thoughtful, well-constructed estate plan and a family office actively involved in its administration.

Effective postmortem administration requires flexibility when responding to an estate's unique mix of assets, liabilities, and family considerations. It requires one to be versatile enough to think outside of the box as circumstances arise while winding up the decedent's affairs.

While managing tax liabilities is often a specific goal during postmortem administration, equally important are the steps taken to accumulate and efficiently manage estate assets. This includes dealing with the issues every large enterprise encounters, proactively approaching administrative costs, closing the estate in a timely manner, and anticipating the impact of the estate's settlement on an asset management structure. While this is a much more complex topic than we can cover in a few pages—with implications as unique as the individuals involved—there are important considerations during this stage of family wealth management that require attention.

Steps from death to distribution

- Executor retains tax adviser for the estate
- Obtain asset, liability, and cash flow information
- Calculate federal, state, and foreign estate taxes
- Plan for liquidity to pay estate tax
- Report information to relevant taxing authorities



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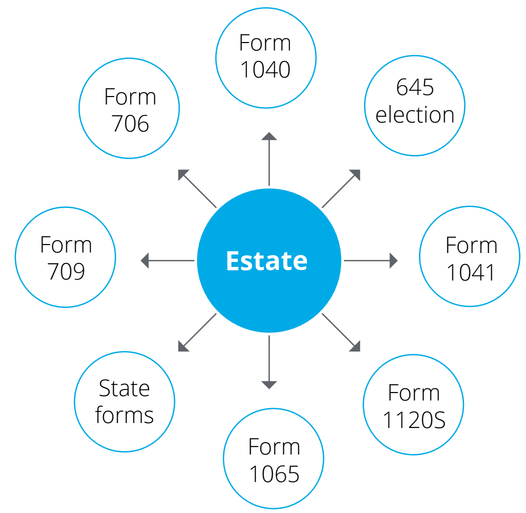
At a minimum, the executor or personal administrator will be responsible for filing federal and state income and estate tax returns. For income taxes, a chronological view is instructive, with the first major hurdle being the coordination of the decedent's unfiled individual Form 1040 (and related state income tax returns) with the filing of the estate's initial Form 1041 (and related state income tax returns). Hopefully, the final Form 1040 for the year of death will be the only unfiled individual income tax return. Because the final Form 1040 reports income properly reported only through the date of death, with all postmortem income being reported on the first Form 1041, income in the year of death must be allocated. While conceptually simple, making the allocation and reporting that allocation properly can be tedious, particularly in situations where the decedent owned interests in pass-through entities, including trusts, partnerships, limited liability companies (LLCs), and/or S corporations.

Additional complexities arise because the income tax basis of assets passing from a decedent is reset at fair market value as finally determined for estate tax purposes. Again, while conceptually simple, accounting for and tracking the new basis can be onerous, particularly if estate tax values are adjusted later during the estate tax examination process—especially for depreciable or depletable assets and those that are jointly owned with others (e.g., community property and joint tenancy). Complexity is increased exponentially if offshore investments exist. Consideration should be given to consolidating the preparation of the final Form 1040, the estate tax return Form 706, and the initial Form 1041 with one tax adviser.

Having the same tax adviser prepare the tax returns of entities substantially owned by or controlled by the estate or the family also may be advisable in order to manage the potential for errors. For example, if the decedent owned partnership interests, then a section 754 election must be considered. This election, made by the partnership, allows the partnership to reflect internally the change in the income tax basis of the partnership interest to fair market value at the date of death by allocating the change among the partnership's assets. The benefit (or potential detriment) to the estate and its successors is that coordinating the inside basis of assets with the basis of the partnership interest hastens basis recovery. However, it also reduces or prevents anomalies that can arise when the partnership is liquidated or the partnership interest is sold.

The universe of tax filings



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There are tax elections that must be made for the estate on its initial Form 1041. For example, the estate must elect a tax year and has the option of electing a fiscal year. Typically, a 12-month tax year is desirable, but it could be a different one, including a calendar year, if considerations dictate otherwise. A similarly fundamental election must be considered when the decedent had established revocable trusts. These trusts can be combined with the estate in a consolidated Form 1041 during most of the postmortem administrative period. Because of specific tax benefits provided only to estates, such a consolidation is recommended almost universally. However, as is the case with many tax elections, utilizing the benefits that they permit often introduces an element of complexity. Thus, the logistical implications of the election must be understood before the election is made.

The estate will continue to file federal and state income tax returns for each year of the postmortem administrative period.

The estate will continue to file federal and state income tax returns for each year of the postmortem administrative period. Eventually, the estate will terminate as assets are distributed to beneficiaries, or commonly, in favor of continuing trusts. Continuing trusts will be new taxpayers but, unlike estates, they must utilize a calendar year. Situations where any pecuniary bequest (distributions of a sum certain), whether in trust or otherwise, is funded with assets other than cash will result in gain or loss and should be planned carefully. Additional complications arise when a fiscal year-end estate terminates to a calendar year-end trust (or trusts) if income bunching and other problems are to be avoided.

Postmortem considerations

US tax concerns during the administrative process for an estate

In addition, the executor or personal administrator must prepare and file the estate tax return (Form 706), the decedent's as-yet unfiled gift tax returns (Form 709), and any applicable state tax forms related to the items reported on the federal forms. Estate tax returns for high net worth estates can be highly complex due to:

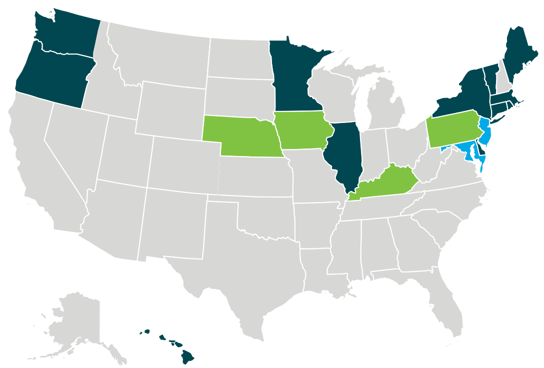
- Complicated issues regarding assets that may have been inherited recently from others
- Prior asset transfers that circumstances may require be included in the taxable estate
- The inclusion and taxation of assets owned jointly (for example, community property and joint tenancy)
- The determination of asset values generally through appraisals
- Technical issues regarding qualification for various estate tax deductions and credits

These returns take substantial time and effort to complete and are not merely the recapitulation of the old Form 1040. Also, the estate tax return is the last chance to reflect the decedent's generation-skipping transfer (GST) tax desires and, in many cases, correct GST missteps and inconsistencies that occurred during life. Care should be exercised to convey clearly the intended use of the decedent's GST exemption.

States may impose additional filing requirements. For example, if a decedent owns real estate in multiple states, these states may require their own estate tax returns and ancillary probate procedures. Similarly, if the decedent owned foreign property, the estate may be responsible for foreign estate and income tax returns.

State estate and inheritance tax rates and exemptions in 2017

State	Estate tax	Inheritance tax
Connecticut	$2M; **7.2%–12%**	
Delaware*	$5.49M; **0.8%–16%**	
Hawaii	$5.49M; **10%–15.7%**	
Iowa		0%–15%
Illinois	$4M; **0.8%–16%**	
Kentucky		0%–16%
Maine	$5.49M; **8%–12%**	
Maryland	$3M; **16%**	0%–10%
Massachusetts	$1M; **0.8%–16%**	
Minnesota	$2.1M; **10%–16%**	
Nebraska		1%–18%
New Jersey*	$2M; **0.8%–16%**	0%–16%
New York	$5.25M; **3.06%–16%**	
Oregon	$1M; **10%–16%**	
Pennsylvania		0%–15%
Rhode Island	$1.515M; **0.8%–16%**	
Vermont	$2.75M; **16%**	
Washington	$2.129M; **10%–20%**	
District of Columbia	$2M; **8%–16%**	



- State has an estate tax
- State has an inheritance tax
- State has both an estate and inheritance tax
- State has no transfer tax

* The estate tax has been repealed for 2018 and beyond in Delaware and New Jersey (though New Jersey's inheritance tax remains).

Note: Exemption amounts are shown for state estate taxes only. Inheritance taxes are levied on the posthumous transfer of assets based on the relationship to the descendant; different rates and exemptions apply depending on the relationship.

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Tax implications for settling the estate

It is clear from Internal Revenue Service (IRS) statistics that estate tax audits are effective in generating revenue because estate taxes are based fundamentally on asset values. Valuation is a less precise measurement process than those generally employed to measure income, and consequently, it is frequently the basis for controversy. Thus, estate tax returns—particularly returns showing taxes due—historically have been subject to a nearly 100 percent audit coverage rate. For high net worth estates, there is almost no question that estate tax returns will be subject to audit.

The executor has a fiduciary obligation to take tax positions within established norms. Particular care should be exercised in asset valuation where the burden of proof is clearly on the estate. Failure to do so could subject the estate to penalties—up to 40 percent of the deficiency assessment. Executors and personal administrators are well advised to seek competent advisers, especially valuation specialists, when preparing the estate tax return.

Although valuation controversies with the IRS are common, having a tax controversy turn into tax litigation remains uncommon. Statistically, well over 95 percent of controversies raised by an examiner are either resolved at the exam level or, more frequently, through the IRS internal appeals process.

For the high net worth estate, involving appraisers and professionals experienced in estate tax controversy, including appeals (either because of prior employment with the IRS or specialization in such proceedings) early in the exam process will generally save time, headaches, audit support costs, and, hopefully, tax dollars as valuation positions are sustained and controversies are settled efficiently.

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What type of team will the family need to assist during the administrative period?
When dealing with the estate of a high net worth individual, the executor or personal representative and the family will need access to four specific types of advisors throughout the postmortem administrative process.

These include:

- Accountants to handle the estate and income taxes and, potentially, certain fiduciary accounting activities.
- Attorneys to handle the probate and disposition of assets
- Appraisers or valuation specialists to support the calculation of estate tax. In addition, because many high net worth individuals fractionalize asset ownership or otherwise cause assets to be disproportionately shared, valuation support may be helpful in assisting in the equitable division of the state —particularly when there is a span of many years between death and distribution.
- Investment advisors to provide continued investment counsel. Depending on the mix of assets in the estate and the likely length of the postmortem administrative period, investment advisors can help the family maintain a prudent investment plan throughout the postmortem process. In a period of market volatility, professional investment advice will be particularly important.

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Special considerations for periods of market volatility and loss

Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, elect to use this alternate valuation in filing returns. To use the alternate valuation date, two conditions must be present:

- The value of the estate's assets must have declined since the date of death.
- Use of the alternative valuation must result in a reduction in aggregate estate and GST taxes.

In other words, the estate must have a tax liability. If the entire estate goes to a surviving spouse or to charity, the executor cannot elect to use alternative valuation.

The valuation approach becomes particularly important during periods of value volatility, such as that experienced in late 2008 and much of 2009. In periods of market decline, it is possible that the downward trend may extend beyond the alternative valuation date. Although skilled appraisers will work this into their summaries, it is difficult in practice since appraisals are typically based on information and events that occurred well before the alternative valuation date. In an audit, which typically takes place several years later, the IRS has the benefit of hindsight and will take issue with valuations that it believes are too aggressive.

Periods of declining value also have important income tax implications, particularly as the estate is distributing assets to successors. Estates are taxpayers in their own right; to the extent that an estate makes distributions, those distributions carry out tax attributes to the distributees and will reduce the estate's taxable income. But the law is clear that tax attributes carried out during administration are limited to income and some credits. If the estate is generating losses—either net operating losses or capital losses, as is common in turbulent economic environments—those losses must be accumulated at the estate or trust level and carried forward until the estate terminates, at which point they are distributable to certain beneficiaries. Excess deductible administrative costs in any year cannot be carried forward to offset future income and simply lapse, except in the final year of the estate when the excess expenses for that year are also distributable to certain beneficiaries.

Tax law allows the estate to take a second snapshot of asset value six months after the date of death and, if certain conditions are met, elect to use this alternate valuation in filing returns.

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Alternatives for paying estate tax liabilities

For many high net worth estates, one of the specific considerations in the final phase of postmortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay taxes.

Historically, the government has allowed estates with closely held businesses to pay off the tax liability arising from those businesses over a period of up to 15 years at favorable interest rates. However, the government recently has begun requiring the estate to bond for the outstanding liability or subject certain estate assets to special liens, thus making this avenue more expensive for business owners.

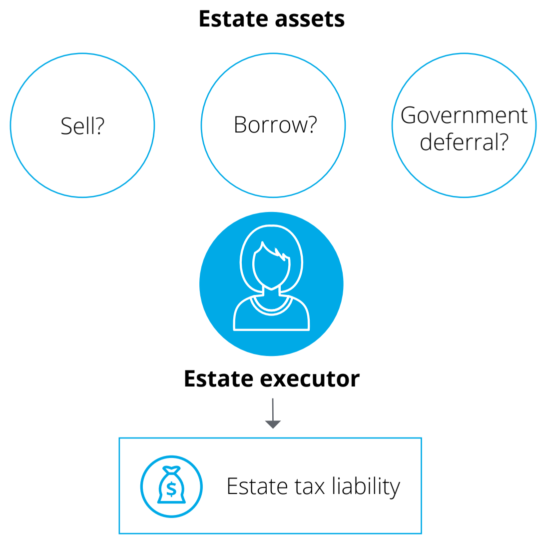
Another option, particularly for high net worth families, is to borrow from a related party at market rates, with the interest payments indirectly benefitting family members. Because greater care must be exercised when borrowing directly from a beneficiary, it is more common to borrow from a life insurance trust, from a closely held business, or against real estate. The interest paid to third parties can, if properly structured and documented, be considered a cost of administration that is deductible in determining the estate tax liability, thus decreasing the effective interest rate actually paid. Furthermore, if properly structured, the estate liability can be determined and the estate terminated before the borrowing is paid in full. This often results in an estate terminating earlier than would an estate that utilizes the government's 15-year tax deferral. In many cases, families use a combination of sources—government, banks, and related parties—to meet tax obligations.

The other alternative, selling assets, also can require careful planning. Sales arising from buy/sell or other owners' agreements can be particularly troubling since the terms of many such agreements, while legally binding, are not necessarily binding for estate tax purposes. Sales proceeds generated through corporate and partnership redemptions are subject to special income tax rules. Some sales transactions can give rise to ordinary income treatment, where other options might have permitted capital gain treatment.

Similarly, sales transactions that give rise to losses may complicate the future administration of the estate because losses generally are suspended until the termination of the estate. Finally, if there are to be excess sales proceeds not needed to pay taxes, liabilities, or the expenses of administration, it may be prudent to retain accounting and investment advisory specialists.

For many high net worth estates, one of the specific considerations in the final phase of postmortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds or sell assets to generate cash to pay the taxes.

How to pay the estate tax liability



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High net worth individuals

Prudence dictates that individuals should have an estate plan that accomplishes their current nontax objectives. Estate taxes should not drive the estate plan. Rather, adjustments to the plan provisions may be dictated by tax considerations that either facilitate or prevent the accomplishment of the plan's objectives.

Discussions about changes to the estate tax code have been circulating since its inception in 1916. Future legislation is by its nature speculative. However, the compromises which led to the estate tax as it now exists are more likely to preserve the tax than to contribute to its repeal.

How well the plan is accomplishing its desired ends need not be a matter of speculation, it can be determined by proactive monitoring and periodic adjustments.

Where possible, creating documents with a degree of administrative flexibility may help in periods of uncertainty, but are essential if the estate plan calls for continued asset management through trusts. Remember, the endgame is meeting wealth transfer goals in a manner that does not create or exacerbate family tensions.