

Post-mortem considerations Keeping a complex process focused



In an ideal world, a wealthy individual has prepared for his or her family's future by leaving a well-constructed estate plan. But, in the real world, some estate plans remain a work in progress for reasons ranging from evolving legislation and complexity to family conflict and indecision. Consequently, post-mortem planning is inevitable; it is merely reduced in scope and complexity where lifetime actions are taken. The more comprehensive the estate plan during life, the fewer actions and decisions that must be taken by executors, trustees, and post-mortem advisors.

For the families and beneficiaries of high-net-worth individuals, settling an estate can be quite extensive, beginning with the process of gathering and determining the value of assets and ending — often many years later — with the distribution of assets. The period in between, the post-mortem administrative period, often gives rise to complex tax, financial, and other 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 assets and the state of planning that existed at the time of death. For example, the approach for an individual who dies intestate (without a will or other testamentary declaration) will be very different than the approach for someone who dies with a family office and a private trust company in place. By analogy, an estate's administration is much like playing a hand of cards — much depends on what cards you have been dealt.

The most effective post-mortem administration responds to the estate's unique mix of assets, liabilities, and family considerations. A little flexibility and, where necessary, thinking outside of the box can be very beneficial to those winding up the decedent's affairs.

While managing tax liabilities is a specific goal during post-mortem administration, equally important are the steps taken to accumulate and efficiently manage estate assets and administrative costs, close the estate in a timely manner, and anticipate the impact of the estate's settlement on any existing family office or other asset management structure.

This article offers a sense of what to expect during the post-mortem administrative period, including the factors that may complicate or simplify it. We also will touch on several questions, including: What are the important tax elections and decisions of which families should be aware? How does the presence of a family business affect post-mortem scenarios? Are there special considerations for periods of market volatility? While this is a much more complex topic than we can cover in a few pages, with implications as unique as the *individuals involved*, we hope this article provides a snapshot of this important stage of family wealth management.

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What is the post-mortem administrative period and what can the family expect to happen during this time?

The post-mortem administrative period is the span of time between death and the distribution of assets to a decedent's intended successors, including, on occasion, new trust vehicles. Many activities take place during this period, which often lasts much longer than survivors expect. There are typically three stages of post-mortem activity.

First, the executor or personal representative develops a snapshot of the decedent's financial position on the date of death and then uses it both to close out the decedent's books and to create a new legal entity — the decedent's estate. The estate then opens its own set of books and maintains these throughout the post-mortem period. Before the estate can pass assets to its beneficiaries, it must satisfy two other groups who have claim to the assets: creditors and tax authorities. The first stage of post-mortem administration, therefore, involves gathering assets, identifying and satisfying liabilities, and developing the team of advisors who will assist with the timely filing of estate and income tax returns. The executor and survivors also need to make certain decisions that will help them manage the process and make certain tax elections that affect subsequent tax matters.

The second stage involves determining the estate tax and preparing for its payment. Completing the estate tax return can be a considerable task because of the extensive disclosure requirements. It is even more complicated if pre-death planning was haphazard or outdated, or if the estate is involved in legal controversies. Considering the high likelihood of audit, the family will need to take care in preparing estate tax returns, which, because they are based on value, will require valuation knowledge to support the positions taken in the return. The process of raising cash for paying the estate tax liability often involves considerable time and effort, particularly if it requires selling assets or borrowing funds.

Once the audit process has been completed, the taxes are paid, and there are no outstanding obligations or controversies, the estate will be distributed according to the decedent's wishes as modified by the post-mortem actions that may be taken by the beneficiaries — for example, disclaimers of bequests, etc. This process must take into

account the proper apportionment of income earned, gains recognized, expenses incurred, and losses realized during the post-mortem administrative period, as well as the equitable allocation of both estate and income taxes among the estate's beneficiaries. Because the liquidation of an estate often occurs years after the date of death, the termination of the estate itself often gives rise to complicated income tax issues.

How long does it typically take to settle an estate, and what, if anything, can the family do to expedite the post-mortem process?

For very high-net-worth individuals, the post-mortem period can range from three to 10 or more years, with the average estate taking approximately five years to settle.

The administration of an estate is an organic process that will follow a course of its own, and there is little the survivors can do to influence the timing in a significant way. The most important thing a family can do to limit settlement time and costs is to move quickly to develop a complete picture of the decedent's assets and his or her intentions with respect to those assets. Survivors also can influence the duration of the estate by mitigating any controversies before they proceed to court and by planning at an early date, how to fund liabilities, expenses, and taxes.

What types of complexities typically extend the administrative period?

One of the common factors that influences the time required to conclude an estate is family politics. For example, it is not uncommon to have misunderstandings arise where there are children of different spouses and the parties do not agree with the stated plan for distributing assets. Disputes over assets — particularly disputes that end in litigation — ordinarily result in lengthening the post-mortem administrative period.

Even if family members are not disputing the division of assets, it is not unusual for a high-net-worth individual to have been involved in some form of litigation that involves his or her assets, perhaps through a business or other investment. For the estate to be settled, these matters also must be concluded. Similarly, tax audits or controversies with respect to tax liability can extend the time required to settle the estate.

Finally, because a complete inventory of assets is essential to proceeding with the estate's administration, situations where assets are difficult to locate and require forensic investigation to identify them can extend the process significantly.

How does the presence of a family business affect the administrative process?

Some critical post-mortem issues related to a family business typically involve its valuation and the equitable division of estate assets among beneficiaries where the value of the family business is disproportionately large. In situations where the ownership of the family business is shared with many beneficiaries, there are frequently issues involving control over the business and its future governance.

Families often hear the common myth that a family business must be sold to settle the estate and pay the resulting tax liability. In fact, this is a rare occurrence. Decisions to sell a family business during the post-mortem period more likely are driven by issues involving leadership succession and future governance. Is the family qualified to retain operational control? Did the decedent identify professional management to maintain and continue to grow the business's value? Even if these issues appear to have been addressed adequately, it is not infrequent that a dispassionate assessment might indicate that the family's wealth would be better served if the business were sold and its value otherwise deployed. Making such a dispassionate assessment together with qualified advisors is highly recommended. Making such decisions early in the post-mortem administrative process can help smooth the subsequent stages and promote a more efficient settlement.

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 post-mortem 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 estate — 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 post-mortem administrative period, investment advisors can help the family maintain a prudent investment plan throughout the post-mortem process. In a period of market volatility, professional investment advice will be particularly important.

Is it possible to modify a decedent's disposition of assets?

In cases where a decedent has not maximized his or her use of the available applicable exclusion amount, the family may want to consider use of qualified disclaimers. A disclaimer — which must be made within nine months of the date of death — enables beneficiaries to renounce their claims to estate assets, thus allowing them to pass to others, as directed by estate documents or governing state law. Doing so may increase the after-tax wealth ultimately retained by the family as a whole.

For example, assume a decedent's estate documents have not been updated to make full use of the \$3.5 million applicable exclusion amount allowable in 2009, but rather leave all but \$1 million to his spouse. In this situation the marital deduction is, in effect, overfunded, and \$2.5 million of his applicable exclusion amount is wasted. The surviving spouse may renounce her claim to \$2.5 million, which then, under the terms of the estate documents or underlying state law, is generally directed to their children. By doing so, the estate is not reducing its current tax liability, but it will reduce the estate tax liability of the surviving spouse. This is accomplished by reducing the surviving spouse's estate by the property represented by the \$2.5 million, which passes to the children. Of course, there are non-tax considerations that also impact this decision — not the least of which is the spouse's need for wealth — but it is an opportunity that may be considered.

What are the typical U.S. tax concerns during the administrative process for an estate?

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 final 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). Because the final Form 1040 reports income properly reported only through the date of death with all post-mortem 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 partnerships and/or S corporations. Additional complexities arise because the income tax basis of assets subject to the estate tax is reset at their fair market value as finally determined for estate tax purposes. Again, while conceptually simple, accounting for, and tracking, the new basis can be tedious, particularly if estate tax values are adjusted later during the estate tax examination process — especially for depreciable or depletable assets and assets 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 and the initial Form 1041 with one tax advisor.

Having the same tax advisor prepare the tax returns of entities 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 Sec. 754 election by the partnership 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 that arises 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 reduces or prevents anomalies that can arise when the partnership is liquidated or the partnership interest is sold.

There are tax elections that must be made for the estate on its initial return. For example, the estate must elect a tax year. Typically, this will be 12 months based on the date of death, but it could be a different date, including a calendar year end, at the executor's discretion. 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 post-mortem administrative period. Because of specific tax benefits provided only to estates, such a consolidation is recommended almost universally. However, as is the case with some tax elections, achieving 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 post-mortem 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 end. 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.

In addition, the executor or personal administrator must prepare and file the estate tax return (IRS Form 706 and the applicable state tax form(s)) and the decedent's as yet unfiled gift tax returns — IRS Form 709 and the applicable state tax form(s), if any. 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 may need to be included in the taxable estate, the includibility and taxation of assets owned jointly (community property and joint tenancy for example), the determination of asset values, and technical issues regarding qualification for various estate tax deductions and credits. These returns take substantial time and effort to complete. Also, the estate tax return is the last chance to reflect the decedent's generation-skipping transfer (GST) tax desires. Care should be exercised to convey clearly the intended use of the decedent's GST exemption. In addition, as discussed below, the Form 706 carries a high likelihood of audit.

States may impose additional filing requirements, depending on the situation. 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.

Why do estate tax returns with a liability have a greater chance of audit? What are the implications for settling the estate, and what can the family do to ease the audit process?

At 45 percent, the estate tax carries the highest effective tax rate of any federal tax levied — higher than corporate or individual income taxes. Furthermore, estate taxes are based fundamentally on asset values. Valuation is an inherently less precise measurement process than those generally employed to measure income and, consequently, is subject to greater scrutiny.

It is clear from IRS statistics that estate tax audits are effective in generating revenue. Consequently, estate tax returns — particularly returns showing taxes due — historically have been subject to a nearly 100 percent audit coverage rate. While coverage rates fell during the period when the repeal of the estate tax was considered actively, indications are that they are heading back up to historical levels with the addition of new examination resources at the IRS. For high-net-worth estates, there is almost no question that estate tax returns will be subject to audit.

Preparing an estate tax return is not the place for a high-net-worth estate to take shortcuts. The executor has a duty of care to take for filing 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 advisors, including valuation specialists, when preparing the estate tax return. Employing an appraiser accustomed to supporting valuations and conclusions reached on estate tax returns may add cost in the short term, but it potentially can save time, headache, audit support costs, and tax dollars down the road.

Given the high audit coverage ratios and the relative imprecision of valuation, it is very common for controversies to arise with the IRS during the audit process. Still, having a tax controversy devolve to 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 are resolved through the IRS's internal appeals process. For the high-net-worth estate, involving professionals experienced in estate tax appeals (either because of prior employment with the IRS or specialization in such proceedings) early in the exam process potentially may be cost effective, may diminish the risk of litigation, and should therefore contribute to the more expeditious termination of the estate.

Are there 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 applicable, to 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, and use of the alternative valuation must result in a reduction in taxes. In other words, the estate must have a tax liability, so 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 early 2009. In periods of market decline, it is possible that the downward trend may extend beyond the alternative valuation date. Although this should be considered in the appraisals used to support estate tax returns, it is difficult in practice since appraisals typically look at sales of comparable assets that occurred on or before the alternative valuation date. Nevertheless, executors should use care in developing appraisals in this scenario. 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 as it terminates. 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 credits. If the estate is generating losses — either net operating losses, capital losses, or unutilized expenses, as is common in turbulent economic environments — those losses and suspended expenses must be accumulated at the estate or trust level and carried forward until they terminate. Some of the losses may be distributed to beneficiaries at termination, but in many cases they can lapse with no one benefitting.

What are the alternatives for paying estate tax liabilities?

For many high-net-worth estates, one of the specific considerations in the final phase of post-mortem 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 to pay the taxes, or sell assets to generate cash.

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 and has become more aggressive in applying liens to estate assets, 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, thus, in many cases resulting in an estate that terminates 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 trust 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.

What should a high-net-worth individual do to manage post-mortem considerations in light of potential estate tax law changes?

Discussions about changes to the estate tax code have been circulating for decades. The fact is, except for the certain knowledge that the federal estate tax will not be repealed, no one can predict what will happen with new legislation, or when. The only certainty is that, when a new legislation does occur, high-net-worth individuals will have to review and likely amend their estate documents.

A common course of action remains having an estate plan in place that accomplishes your current non-tax objectives and then keeping that plan current. Where possible, creating documents with a degree of flexibility may help in periods of uncertainty. Although this means leaving certain decisions to survivors, ingrained flexibility potentially can reduce time commitments and complications down the road. Beyond that, individuals should remain cognizant of taxes and use available exclusions prudently, but it is wise not to let taxes dictate the plan. Remember, the end goal is preserving family wealth and doing so in a manner that does not create or exacerbate family tensions.

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