Even After Death, Steps Can Be Taken to Lower Estate Taxes

By Bruce Givner

Parents should consult with competent counsel and complete their estate tax planning long before serious illness or death. When the first parent dies, there is usually no estate tax because of the combination of the lifetime transfer tax exclusion ($2 million effective Jan. 1, 2006) and the unlimited marital deduction. However, even after the surviving parent's death, some estate tax planning is possible.

In contrast, post-mortem income tax planning options are available, such as how to "stretch out" distribution of the decedent's qualified plan benefits and how to step up the basis in partnership assets using an Internal Revenue Code Section 754 election.

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There are also options on how to defer the payment of the estate tax through the mandatory five- to 15-year deferral under the code's Section 6166, or by asking the Internal Revenue Service's permission to defer under Section 6161. There is even an excellent instrument – a disclaimer under Internal Revenue Code Section 2518 – which can be used to lower the next generation's estate tax, as when the decedent's wealthy daughter disclaims the bequest and, as a result, the decedent's assets skip a generation and go to grandchildren. However, the following discussion focuses on options available to reduce the decedent's estate tax.

By way of background, less than 0.6 percent of all the 141 million tax returns (of all types) filed in 2001 were audited. However, of the 5,700 estate tax returns (IRS Form 706) filed showing gross estates of more than $5 million, 27 percent were audited. As a result, the most important first act is the selection of a skilled certified public accountant to prepare the Form 706 under tax counsel's guidance. Much of the work needed to complete the form is information gathering and analysis, a process at which CPAs are often more skilled, and less expensive, than tax lawyers. (Despite that observation, many tax lawyers – but not this author –prepare the Form 706.) Also, beyond the technical expertise required in completing Form 706, the sad truth is that its physical organization and appearance is often a factor in whether or not it is selected for audit.

Some opportunities to reduce the estate tax are mechanical, and best left to the CPA. For example, a medical expense the decedent incurred, but did not pay, may be deducted as a debt on the Form 706 or as a medical expense on the decedent's income tax return (Form 1040). In a larger estate, the estate tax savings may be sizeable. Assume the decedent's combined federal and state income tax bracket is 45 percent; the estate is in a 46 percent estate tax bracket (the rate for 2006); the decedent's adjusted gross income is $100,000; and there are medical expenses of $27,500. If medical expenses are deducted on the decedent's 1040 form, income tax liability will be reduced by $9,000 because the first $7,500 of medical expenses are not deductible (medical expenses are not deducted until they exceed 7.5 percent of adjusted gross income). If the medical expenses are deducted on the estate tax return, estate taxes will be reduced by $12,650. Although the decedent's final 1040 will be $9,000 higher, that $9,000 is deductible on the Form 706, reducing the estate tax by $4,140. So deducting the medical expense on the estate tax return saves $7,790.

Large opportunities to reduce the estate tax relate to what are often the most important exhibits to an estate tax return: appraisals of the decedent's assets. Accordingly, the selection of competent appraisers, whether of assets or businesses or both, is critical. Though the client (executor, trustee, estate) will bear the cost, tax counsel should recommend and hire the appraisers. Clients and CPAs often do not have as much experience, expertise and patience in dealing with appraisers. In large estates, counsel may even engage one appraiser as an adviser, and use that appraiser's advice in guiding the appraiser whose report will be attached to the Form 706. As a result, the taxpayer has a strong argument that the initial appraiser's report is privileged, as it was intended to assist counsel in rendering legal advice.

In working with appraisers, counsel watches for facts that can impact value. One example: if the decedent's ownership in a property was partial, e.g., a tenancy in common. See *LeFrak v. Commissioner*, 66 TC Memo 1297 (1993), in which the court awarded 20 percent lack of control (minority) and 10 percent lack of marketability discounts for a tenancy-in-common interest.

Another example: if the real property is subject to environmental contamination, with the concomitant cleanup liabilities. See *Necastro Est.*, TC Memo 1994-352, in which the court reduced the real estate's value by 34 percent because of the cost of environmental remediation (cleaning up soil, removing underground storage tanks, and performing a hydro-ecological investigation), even though the contamination was discovered five years after the decedent's death.

One more example: if people, even relatives, have legitimate claims against the decedent. See *Ribblesdale Est.*, TC Memo 1964-177, in which the court, after giving the transaction special scrutiny, determined that notes the decedent gave each year to her wealthy son for money she borrowed from him were valid claims against the estate.

There are other tools to reduce the estate tax. In *Estate of Graegin*, TC Memo 1988-477, the estate borrowed money to pay the estate tax from a company in which the decedent held an interest. The loan had a balloon payment of principal and interest upon maturity (15 years). The estate, however, took an upfront deduction of the interest due on the note and the Tax Court allowed the deduction as an administration expense. The IRS issued a litigation guideline memorandum in response stating that, for the interest to be deductible, it must be certain to be paid and subject to reasonable estimation. Also, the loan must have substance and commercially reasonable terms. IRS private letter rulings since *Graegin* have blessed this structure, e.g., PLR 199903038 and PLR 200020011. Again the CPA's role is important, because the income tax on the interest earned by the note may make the transaction less favorable than it may at first appear.

Another opportunity arises from the continuing confusion regarding irrevocable grantor trusts, sometimes referred to as "intentionally defective inter vivos trusts." The concept of a trust: (i) which is irrevocable; (ii) the assets of which are not includible in the decedent's gross estate for estate tax purposes; but (iii) the income of which is taxed to the grantor, is a difficult one for clients, and even many CPAs. These trusts are powerful tools to transfer wealth from parent to child, because the parent's estate is reduced by the income tax obligation, while the trust grows outside the parent's taxable estate for the children's benefit. They are commonly used to own life insurance and as the contingent beneficiaries of qualified personal residence trusts (aka house GRITs) and grantor retained annuity trusts (used to transfer interests in family limited partnerships and "S" corporations). Tax counsel may discover that irrevocable trusts the decedent created during lifetime were improperly reported as simple (the income was taxed to the children as beneficiaries) or complex (the trusts paid the tax on their own income) trusts. Having the CPA file corrected returns to burden the decedent with the income tax obligation may save tax given the difference in rates between that paid by the children – or trust – and the estate tax rate.

Given the likelihood of an audit, and the IRS's tendency to issue a summons to everyone involved in the process, counsel must – in exploring estate tax reduction opportunities (pre- and post-mortem) – be careful that planning is done so as to preserve the attorney-client privilege and work-product doctrine. See *Segerstrom v. U.S.*, 2001-1 USTC 50,315, in which during the estate tax audit the IRS issued summonses to counsel who helped the family form LLCs for assets previously held directly by the family. The IRS argued that the documents were not protected because (i) they related to securing business, not legal advice; (ii) the privilege was waived because of the presence of third parties; and (iii) that the documents contained facts, not confidential communications. Happily, the court granted the motion to quash, finding that the documents fell within the lawyers' representation for purposes of rendering legal advice and assistance in estate planning. The court found no waiver of the attorney-client privilege due to the presence of third parties during conversations or correspondence between the family and counsel, as the communications were rendered at counsels' request to assist in providing legal services. Finally, the court concluded that the documents either clearly contained privileged information or non-privileged facts that were so interwoven with privileged information that disclosure of one would result in improper disclosure of the other.

When planning was not done in a timely fashion during lifetime, the opportunities to reduce the decedent's estate tax are few. However, as demonstrated above, those few opportunities may make a significant difference in the net to the heirs.

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