HRBK Attorneys & Counselors HASSELBERG, ROCK, BELL & KUPPLER LLP

2017 Winter Series
Dealing with the IRS in Decedent's Estates
Marci M. Shoff, Esq.

Topics:

1. Settling Estates with Individual Tax Debt
2. 706 Updates
3. New IRS Form 8971
4. Trump Estate Tax Proposal
5. §2704 Regulations
6. DSUE Review

1. SETTLING ESTATES WITH INDIVIDUAL TAX DEBT

In order to settle the estate, the Executor/Administrator ("Representative") must settle with the IRS any tax debt owed by the decedent.

Facts:

- John Smith was 80 years old at death. Prior to retirement in 1994, John was an airline pilot for an international airline ("Company"). At his retirement, John had a vested interest in a pension plan and 401(k) plan with the Company. In September of 1994, John provided the Company with a federal tax withholding form indicating not to withhold any federal income tax from his monthly pension payments.

  John filed an individual tax return through calendar year 1997, but did not voluntarily file any subsequent returns. In June of 1998, John withdrew the balance of his

401(k) plan in a lump sum. He then opened four bank accounts in three different states. At the time of opening the accounts, John refused to provide the banking institution with a social security number and instead provided an IRS Form W-8/Certificate of Foreign Status. He then deposited the lump sum distribution of nearly $600,000 among the four accounts. During the following five months, John withdrew nearly all of the funds in cash by cashing numerous checks on the four accounts in amounts ranging from $9,000-$9,900 in order to avoid currency transaction reporting requirements. John spent or otherwise squandered the majority of the cash.

In 2003, John was charged with 23 counts of tax evasion and related charges (all felonies). With no criminal history, John entered into a plea deal with federal imprisonment for 20 months, 3 years supervised release and a fine of $5,000. John received no reduction in the amount of taxes owed to the IRS as a result of this plea deal.

Upon release, John worked with a tax relief firm and entered into a tax payment plan. Liens were filed on his real estate. John died July 2015. The Representative comes to you asking for assistance in working out the IRS tax debt.

Payment of Debt to IRS

The first option to consider is whether the estate can pay the tax debt in full.

755 ILCS 5/18-10: Classification of Claims Against Decedent's Estates:

1. Funeral and burial expenses, expenses of administration, and statutory custodial claims.
2. Surviving Spouse or Child's Award.
3. Debts due the United States.
4. Money due the Employees of Decedent...
5. Money and Property Received or Held in Trust by Decedent Which Cannot Be Identified or Traced.
6. Debts due the State and any County or governmental entity....
7. All Other Claims.

If the estate is able to pay the debt in full after payment of Class 1 and Class 2 Claims, then it should. If the estate is insolvent or partially insolvent, then the Representative should consider an Offer in Compromise. Prior to submitting an Offer in Compromise, the Representative must ensure that all individual tax returns are filed. An Offer in Compromise will be **automatically rejected** without consideration if the individual has not filed all tax returns.

Offer in Compromise ("OIC")

Internal Revenue Code §7122 allows the IRS to compromise tax obligations for less than the full outstanding liability.

IRS Stats[1]:

Offers in Compromise	**2012**	**2013**	**2014**
OICs Received	64,000	74,000	68,000
OICSs Accepted	24,000	31,000	27,000
% Accepted	38%	42%	40%

Note: Acceptance rates from 2000-2010 averaged 25-30%

Part 1 – The IRS has provided a "Pre-Qualified Tool" for taxpayers to complete prior to filing a Form 656/Offer in Compromise. It is found at http://irs.treasury.gov/oic_pre_qualifier/. If the Tool indicates that you qualify to apply for an OIC, then proceed to prepare a Form 656. The form itself appears to apply only to individuals, but it also is approved for use by estates.

Basis for Offer

- In order to apply for an OIC, the application must state one or more reasons for the offer.
  - Doubt as To Collectibility – Insufficient Assets
  - Exceptional Circumstances – Agree the amount is owed and there are sufficient assets to pay, but due to exceptional circumstances, requiring full payment would

[1] McKenzie, Robert E. *IRS Relaxes Offer in Compromise Rules.* http://www.forbes.com/sites/irswatch/2015/08/10/irs-relaxes-offer-in-compromise-rules/#4ee729f57c62 (August 10, 2015).

cause an economic hardship, be unfair or inequitable (must submit written narrative explaining circumstances).

Proposed Payment Terms

- Two Options:
  - Lump Sum Option – Considered "lump sum" if five or fewer payments will be made within 5 or fewer months from date of acceptance of OIC. Must provide a 20% initial payment on lump sum offer which is non-refundable (waived if you meet Low Income Certification – see Form 656). Lump sum payment offers are generally preferred by the IRS for obvious reasons.
  - Periodic Payments – if proposed offer will be paid in full within 6-24 months. First month payment must be included and monthly payments must be made while the IRS is considering the offer. (Initial and monthly payments waived if you meet Low Income Certification – see Form 656).

Part 2 - In conjunction with the filing of the Form 656, the Representative must also file a Form 433-A Collection Statement.

- Section 1 – Personal Information
- Section 2 – Employment Information for Wage Earners – skip for deceased individual
- Section 3 – Personal Asset Information – list all cash and investments, life insurance policies, real estate, vehicles and valuable personal property (do not list clothing, furniture and other personal effects).
- Section 4 – Self-Employed Information – skip for deceased individual
- Section 5 – Business Asset Information – skip for deceased individual
- Section 6 – Business Income and Expense Information – skip for deceased individual
- Section 7 – Monthly Household Income and Expense Information – skip for deceased individual
- Section 8 – Calculate Minimum Offer Amount – tricky for estates. Have to reference and attach explanation. Address estate assets, expenses incurred, anticipated administration

expenses (including attorney fee and executor fee), spouse and child award (if applicable) and expenses in maintaining estate assets (real estate insurance, taxes, etc...).

Part 3 – submit to IRS...Form 656, Form 433-A Collection Statement, supporting documents (3 months bank statements for each account, appraisals, bills of sale for estate assets, etc...), $186 application fee and initial or first monthly payment (both waived if you meet Low Income Certification – see Form 656).

IRS Next Steps[2]

- IRS will determine if OIC is "processable". Average 3-6 weeks.
- Assignment of IRS Examiner. Average 4-6 weeks.
- Examination. Average 4 weeks to 8 months.
- Negotiation with Examiner. Going back and forth with Examiner can take 8-12 months.
- Appeal or Not Appeal. If the OIC is rejected, you can appeal to the IRS Office of Appeals.

2. 706 UPDATES

Table of Recent Federal Estate Tax Exclusion Amounts:

2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000

[2] Parent, Anthony. *IRS Offer in Compromise Processing Time: It Takes How Long?.* https://www.irsmedic.com/2013/03/04/offer-in-compromise-processing-time/ (March 4, 2013).

Table of Recent Illinois Estate Tax Exclusion Amounts:

2011	$2,000,000
2012	$3,500,000
2013 and beyond	$4,000,000 absent change in law

Closing Letters

For estate tax returns filed after June 30, 2015, the IRS ceased the automatic issuance of an estate tax return closing letter for every estate tax return filed (except for returns that are filed solely for the purpose of electing portability and the portability election was denied). You have two options to get a closing letter:

- Call the IRS to request the closing letter: 866-699-4083. Be prepared to provide the name of the decedent, the decedent's SSN and the date of death. IRS suggests that the taxpayer should wait at least 4 months after filing the return before requesting the closing letter.
- Request an account transcript in lieu of an estate tax closing letter. An account transcript includes transaction codes and descriptions of those codes. A transaction code "421" along with an explanation "closed examination of tax return" indicates that the IRS's examination of the return is done and can serve as the functional equivalent of an estate tax closing letter. An account transcript can be requested by phone or by filing a Form 4506-T. Again, IRS suggests the taxpayer wait at least 4 months after filing the return before requesting the account transcript.

3. NEW IRS FORM 8971

In 2015, Congress created new IRC §1014(f) which requires beneficiaries to use date-of-death valuation for cost basis purposes that is no larger than the amount reported on the estate tax return. Congress also established new IRC §6035, which requires executors to file a new Form 8971 to

notify the IRS who the beneficiaries are along with a Schedule A that informs the IRS and the beneficiaries what their inherited cost basis is.

Who Must File:

A representative must file a Form 8971 if an estate tax return is *required* to be filed. Form 8971 is not required when:

- The gross estate plus taxable gifts is less than the basic exclusion amount;
- Estate tax-related forms (for example, 706-QDT, 706-CE and 706-GS(D)), are filed;
- The estate tax return is filed solely to make an allocation or election respecting the generation-skipping transfer tax; or
- The estate tax return is filed solely to elect portability of the deceased spousal exclusion amount (DSUE).

When To File:

Form 8971 must be filed for all returns filed after July 31, 2015. It is due to be filed on the earlier of: 30 days after the filing of the 706 or 30 days after the date on which the Form 706 was required to be filed (including extensions).

Where to File:

- **Form 8971 and Schedule A**:
  Department of the Treasury
  Internal Revenue Service Center
  Mail Stop #824G
  Cincinnati, OH 45999
- **Schedule A** (each beneficiary receives their own Schedule A; no beneficiary receives Form 8971)
  - In person
  - By email
  - US mail

  - Private delivery service
- The Representative must certify on Form 8971, Part II, Column D, the date on which the Schedule A was provided to each beneficiary and should keep proof of mailing, proof of delivery, acknowledgement of receipt or other relevant information in the estate's records.

Penalties:

If the Representative fails to file a Form 8971 & Schedule A when one is required to be filed by the due date and reasonable cause isn't shown, a penalty can be imposed.

- $50 per Form 8971 if filed within 30 days after due date.
- $260 per Form 8971 if filed more than 30 days after due date or not filed at all.

If the Representative fails to provide a Schedule A to beneficiaries by the due date, a penalty can be imposed:

- $50 per Schedule A if provided within 30 days after due date.
- $260 per Schedule A if it is provided more than 30 days after due date or not provided at all.

Beneficiary Reporting:

Beneficiaries who report basis in property that is inconsistent with the amount on the Schedule A provided may be liable for a 20% accuracy penalty under IRC § 6662.

4. TRUMP ESTATE TAX PROPOSAL

In general, President Trump has proposed a complete repeal of the estate tax with a plan to tax capital gains on assets upon the owner's death, with exemptions for small businesses and family farms on the first $10 million.

Example: John inherits 500 shares of Caterpillar stock from his father, Jack. The 500 shares are valued at $46,000 on Jack's date of death. Jack's basis in the stock is $21,000.

Under the **current estate tax laws**, John inherits the 500 shares with "stepped-up" basis, i.e. basis of $46,000. John only pays capital gains taxes upon the sale of those shares if sold for more than $46,000.

Under the **"Trump" plan**, John pays a capital gains tax upon inheriting the 500 shares of stock. He would pay tax on the deemed $25,000 gain. Assuming a capital gains rate of 20%, he would pay a tax of $5,000.

5. §2704 Regulations

The Department of the Treasury issues proposed §2704 Regulations on August 4, 2016. Under current rules, transfers of interests in family businesses and other minority interests may be discounted due to lack of marketability and lack of control. The concept is that if an individual is giving a percentage of interest in a family business to a child, it should be discounted because the child couldn't immediately turn around and sell his interest to a third party for the same amount. These types of discounts can result in significant tax savings.

The proposed regulations prohibit any significant discount for lack of control or lack of marketability associated with the transfer of an interest in a family-controlled entity. (Note: this only applies to entities.)

Example: Assume three siblings each inherited 1/3 of a family business from their parents. One sibling now wishes to transfer their 1/3 interest to their child. Assume that the business could be sold as a whole for $3,000,000. If a combined lack of marketability and lack of control discount were applied in the amount of 30%, the value of the 1/3 interest goes from $1,000,000 to $666,667. At a federal tax rate of 40%, the discount could save this family $133,334 in tax.

There is also a "three-year rule" contained in the proposed regulations that may prohibit certain discounts taken for transfers made within three years before the transferor's date of death. This is intended to address transfers made "in contemplation of death." It does not appear that the Department of the Treasury intends to make this look back period retroactive. For example, if a taxpayer makes gifts of interests in an entity subject to §2704 today, while the current regulations are still the law, and who dies less than three years after the date of the transfer, but after the new

regulations are finalized and adopted (assuming they contain the lookback period), the transfers would not be subject to the new regulations.

For more information, including commentary of a presentation by Catherine Hughes, Estate and Gift Tax Attorney Advisor in the Office of Tax Policy at the U.S. Department of Treasury, check out the article "Proposed Section 2704 Regulations" by George Schoenbeck of Sosin, Arnold and Schoenbeck, Ltd., published in the November 2016 issue of ISBA's Agricultural Law newsletter.

6. ESTATE TAX RETURNS/PORTABILITY OF DECEASED SPOUSE'S UNUSED EXCLUSION AMOUNT

"Portability" is a concept first introduced as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010. Portability allows a surviving spouse to use a deceased spouse's unused estate tax exclusion. The 2010 Act made Portability effective for married couples dying on or after January 1, 2011, but was set to expire on December 31, 2012. The American Taxpayer Relief Act of 2012 made Portability permanent.

In the past, estate tax planning attorneys have advised clients to attempt to equalize assets amongst themselves, or for high net worth clients, make sure each spouse owns at least as much as the amount of the estate tax exclusion at the time of his death. Traditionally, estate planning documents created a credit shelter trust (to hold the exclusion amount) and a Marital Trust (to hold the amount over the exclusion). Prior to the concept of Portability, clients who did not accomplish both of these goals were forced to pay higher taxes upon the death of the surviving spouse. Let's look at an example:

Deceased Spouse's Unused Exclusion Defined

Pursuant to Section 2010 of the Internal Revenue Code, the Deceased Spouse's Unused Exclusion (DSUE) is equal to the lesser of (1) the basic exclusion amount applicable to the estate of the surviving spouse and (2) the excess of (i) the basic exclusion amount applicable to the surviving

spouse's last deceased spouse's estate over (ii) the amount of such deceased spouse's taxable estate plus adjusted taxable gifts.

Election Required

In order to elect Portability of the DSUE, a timely filed estate tax return Form 706 must be filed and the election must be made properly. (IRS Form 706, Page 4.) An estate tax return is generally required to be filed within 9 months after the death of the deceased spouse, unless an extension has been granted. Extensions are available by filing a Form 4768. Six month extensions are automatic upon the filing of Form 4768.

One of the main considerations when deciding whether to file an estate tax return (and elect Portability) is the cost of the return, including the cost of obtaining formal valuations for all of the assets. This can include expensive appraisals of real estate and businesses. The final regulations adopted June 12, 2015 (T.D. 9593), provide that estates which would not otherwise be required to file an estate tax return do not have to provide appraisals for property passing under an estate tax martial or charitable deduction. If this exception applies, the executor need only use due diligence in determining the value of the property. For these items, the executor will only have to report the description, ownership and/or beneficiary of the property, along with other information necessary to establish the right of the estate to the deduction.

While many practitioners were excited about the prospect of Portability simplifying estate planning for their client, the cost of preparing and filing an otherwise unrequired estate tax return must be considered. Arguably, every estate should be filing an estate tax return regardless of value. It is impossible to predict the financial situation of a surviving spouse at her death. Some are more predictable (long term marriage, surviving spouse of very advanced age), many are less predictable (shorter marriage, surviving spouse of middle age). If no portability election is made for the estate of the deceased spouse, and if the surviving spouse has a taxable estate at death that could have been avoided, the executor, her attorney and her accountant could be liable for failure to educate the client of the benefits of filing.

PRACTICE POINTER: The takeaway from all of this is that you should immediately begin advising clients of their options regarding filing an estate tax return to establish Portability. You should have documentation in your file demonstrating that you advised the executor about Portability and the executor chose not to make the election, if applicable. See Sample Letter

Statute of Limitations Change

The statute of limitations on the return filed for the deceased spouse is extended until expiration of the statute of limitations for the estate tax return filed for the surviving spouse. The reasoning is that the IRS can examine the return of the deceased spouse in order to determine the proper DSUE to apply at the death of the surviving spouse.

Multiple Spouses

Remarriage after the death of the spouse does not in and of itself change the DSUE that is available to a surviving spouse. However, the IRS will prevent those decedents with multiple spouses from essentially "stacking up" the DSUEs from previous spouses. Therefore, the DSUE is available to a surviving spouse as along as the DSUE being used is from the "last deceased spouse". If the second marriage ends in divorce or annulment, then the surviving spouse remains the surviving spouse of the deceased first spouse and is still, therefore, entitled to the DSUE from their first spouse.

If the surviving spouse remarries and survives that second spouse (i.e. now has two deceased spouses), there are different rules. The amount of the DSUE is the sum of:

1. The DSUE amount of the surviving spouse's last deceased spouse as described in paragraph (a)(1) of this section (the most recently deceased spouse); and
2. The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

The practical takeaway from this is that a surviving spouse may use the DSUE from a "last deceased spouse" during her lifetime by making gifts, as long as at the time the gifts are made, the DSUE used is from the surviving spouse's "last deceased spouse." Thus, a spouse who has survived

multiple spouses may use each "last deceased spouse's" DSUE amount by gift before the death of the next spouse, and can continue so long as there are multiple deceased spouses with DSUEs. However, the surviving spouse cannot "stack" all of the deceased spouse's DSUEs to use at her death.

SAMPLE LETTER TO CLIENT RE: PORTABILITY

Portability of Dad's Federal Estate Tax Exclusion. We discussed the concept of "portability" of your dad's estate tax exclusion in order to protect more assets at your mom's death from federal (not Illinois) death tax. If you think your mom's estate might exceed the federal death tax exclusion at her death (now $5,490,000.00 and indexed for inflation), we would need to file a federal estate tax return now for your father's assets showing that we did not use all of his death tax exclusion because everything passed outright to your mom. Current federal law provides for "portability" of your dad's death tax exclusion for federal purposes. This would effectively double your mom's death tax exclusion to $10,980,000.00.

There is of course a cost involved in preparing the estate tax return simply for the purpose of protecting the portability of your dad's exclusion. There is no other reason to file it. Failure to file the return waives the opportunity to take advantage of portability. It cannot be revived.

The only wild cards in your case are whether congress might decrease the federal estate tax exclusion to a point where your mom's assets were worth more than the federal death tax exclusion at her death; or if your mom's assets increased in value so that her estate exceeded the death tax exclusion in effect at that time. In that case we would have blown the opportunity to use your dad's exclusion by failing to file now.

I will take no action to file any federal estate tax return unless you instruct me to do so in writing on behalf of your mom in the next ten days.

It is important to note that the Illinois exclusion is only $4,000,000.00 and portability does not apply for Illinois tax purposes. If your mom's estate exceeds $4,000,00.00 at her death, there will be an Illinois death tax.