

WHEN THE
“WHEELS ARE COMING OFF”
YOUR PROBATE

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WHEN THE “WHEELS ARE COMING OFF” YOUR PROBATE

PROLOGUE

When the wheels are coming off the administration of an estate, often you know it. You see the signs. Hear the squeaks and creaks. But not always. Sometimes everything is going all smoothly and all of a sudden – bam – off come the wheels. These materials will describe some ways the author has observed the wheels coming off of a probate administration. Often the observations have been up close.

Administering an estate is a dynamic process. The rules to be applied vary based on the particular circumstances and can change throughout a single administration. The rules to apply, or the processes to be invoked, in one estate may not be appropriate in, or applicable to, another estate. It is this dynamic nature that creates a need for us professionals and allows us to bring value to a particular situation. And it is this very nature of probating estates that allows for so many ways for the “wheels to come off”.

1. DON'T IGNORE YOUR CLIENT

If you represent the Personal Representative, communicate with the Personal Representative. That may sound obvious but the situation will arise where you will be tempted to do otherwise. You may slip into communicating with an intermediary, such as an adult child if your client is elderly or a lawyer in another state who may have known the family better than you. While the temptation is to deal solely with the intermediary, do not forget your client. On routine matters, working through the intermediary may be efficient. Doing so can be appropriate and

your engagement letter¹ should anticipate, and authorize, this possible line of communication. Even so, when the “big stuff” needs to be addressed, don’t ignore your client. Instead, deal directly with your client, particularly on the “big stuff.” Include your client on all communications, even as a recipient of a copy of all e-mails and letters.

2. PAY ATTENTION TO THE ESTATE’S INVESTMENTS

You should counsel the Personal Representative to review and, if appropriate, make a new investment plan. At the outset of the probate, the Personal Representative should affirmatively address the investable estate assets. The competing objectives of preferring an in-kind distribution, on the one hand, and eliminating market risk, on the other hand, must be reconciled.

Determining the estate’s likely liquidity requirements and raising that amount of cash as soon as possible is a good starting point in addressing the estate’s investments. If certain assets are likely to not be needed and are expected to be available to eventually distribute to residuary beneficiaries, consider soliciting reactions from the beneficiaries and perhaps even obtaining written consents from them to liquidate or hold.

Check the will. Every now and then a testator will direct the liquidation of the estate to cash. Failure to do so is also actionable.²

3. ONLY MAKE PROMISES YOU CAN KEEP

Don’t promise probate will be avoided based upon your estate planning techniques. Sure,

¹ You do have one of these for every matter, right?

² *National Society for Prevention of Blindness, Inc. v. Parson*, 374 So.2d 531 (Fla. 4th DCA 1979).

probate *might* be avoided, but it is hard, if not impossible, to guarantee that probate will be avoided. A letter from you at the conclusion of the planning engagement indicating probate may still be necessary can be helpful to you in later dealing with beneficiaries who challenge the need for any form of probate.

4. CHECK THE COURT FILE FOR CLAIMS

Check the claims filed against the estate. You might rely on the court's docket, often available online, to check on whether claims are filed, as it is more convenient than making a trip to the clerk's office. It may come as a shock but not all items filed in a particular estate make it onto the court docket (or at least the right docket). Punishing though it may be, a trip to the courthouse to go through the clerk's file can save embarrassment and perhaps some money.

5. BE MINDFUL OF POSSIBLE HOMESTEAD STATUS

If the decedent's residence is protected homestead property, then it is *not* part of the probate estate. Don't let your Personal Representative act like it is, and more importantly, don't *you* act like it is.

The Personal Representative may expend estate funds if property that reasonably appears to be protected homestead³ is not occupied by a person who appears to have an interest in the property.⁴ The Personal Representative can institute a proceeding to determine the status of the

³ Homestead property passing by intestacy or devise to those who could be heirs under *Snyder v. Davis*, 699 So.2d 999 (Fla. 1997) and Florida Probate Code § 732.103 is protected homestead. See Florida Probate Code § 731.201(20).

⁴ Florida Probate Code § 733.608(2).

putative homestead property. Once the property is determined to be homestead, the Personal Representative should take no further action, except to enforce the lien securing repayment of any amounts advanced from the estate.⁵

The Personal Representative does not have the authority to sell the homestead much less convey ownership. A contract for sale must be between the buyer and the homestead owner, not between the buyer and the Personal Representative.

6. REMEMBER TRUST BENEFICIARIES

If each trustee is also a Personal Representative, then the trust's qualified beneficiaries are also beneficiaries of the estate.⁶ So, don't forget about the qualified beneficiaries of the trust. In addition to listing the trust beneficiaries on the Petition for Administration, a receipt or waiver will also be required from these beneficiaries when closing the estate. Throughout the estate administration, don't forget about these trust beneficiaries.

In light of this requirement to treat trust beneficiaries as beneficiaries of the estate, you may wish to discuss with the fiduciaries at the outset of the matter structuring the fiduciaries in a manner such that not all of the trustees are also Personal Representatives. By taking these issues into account at the outset, you may eliminate the requirement of including the beneficiaries of the trust in the estate proceeding.

⁵ Florida Probate Code §733.608(3).

⁶ Florida Probate Code §731.201(2).

7. KEEP THE ESTATE CHECKBOOK

When laying down the ground rules for handling the estate's finances, discuss possession of the estate's financial records. As the trained professional, perhaps you should keep possession of the estate's checking account, instead of letting the checkbook be held by an untrained individual Personal Representative. By doing so, you will have better control over the deposits to, and payments from, this account.

This is not to suggest that the Personal Representative not be the one to sign the checks. You can maintain the blank, unsigned checks and prepare appropriate checks for the Personal Representative to sign.

8. AVOID THE SHOE BOX METHOD OF ACCOUNTING

The accounting is the most informative document the residuary beneficiaries will receive. The accounting begins with an inventory of assets subject to administration and describes all of the transactions that took place during the estate administration.⁷

An accurate estate accounting can only be prepared efficiently if the Personal Representative has maintained complete records for the estate. The need for proper records encourages keeping good records throughout the administration of the estate. This procedure should be followed if there is any chance an accounting will be required.

The adage "hope for the best and plan for the worst" applies here. Hope for waivers from all of the beneficiaries, but plan for no waivers. If waivers from all of the beneficiaries are not obtained (it only takes one holdout) and the Personal Representative is not prepared to produce the

⁷Florida Probate Rule 5.346.

accounting timely and efficiently, the Personal Representative may be as nervous as a long tailed cat in a room full of rocking chairs.

Consider preparing the accounting and providing it with the waivers to the beneficiaries. If the waivers are then returned, the accounting does not need to be filed, thereby keeping it out of the public records. If the waivers are not returned timely, then the accounting is ready to be served with the petition for discharge.

9. CHECK FOR CLAIMS

An objection to a claim filed in an estate is due no later than 4 months from the first publication of the notice to creditors or 30 days from the timely filing of the claim, whichever occurs later.⁸ But filing an objection is not enough. The objection must also be served on the claimant (or claimant's attorney) no later than ten days after the objection is filed.⁹ If the objection is not served, it is deemed abandoned.¹⁰ Failure to object to a claim under the right (wrong?) circumstances may expose the Personal Representative to liability.¹¹

10. EVALUATE CLAIMS BEFORE OBJECTING

A Personal Representative should not blindly object to every claim filed. Instead, a Personal Representative should investigate, at least to some degree, in order to determine the

⁸ Florida Probate Code §733.705(2).

⁹ Florida Probate Code §733.705(2).

¹⁰ *Kata v. Hayden*, 544 So.2d 315 (Fla. 2d DCA 1989).

¹¹ *Goggin v. Shanley*, 81 So.2d 728 (Fla. 1955).

appropriateness of the claim. Of course, when in doubt an objection should be timely filed, and served, to preserve the alternatives available to the Personal Representative.

11. EVALUATE PRIORITY OF ESTATE OBLIGATIONS

Often a Personal Representative rushes to pay claims as soon as received, even before the claims filing period expires. This is not a good idea. A review of all of the estate obligations in the context of the priority rules should occur prior to making any payments.

Valid claims and other estate obligations are to be paid in a prescribed order.¹² If estate assets are insufficient to pay all of the estate's obligations, those in the higher category are to be paid prior to those in a lower category.¹³

12. REMEMBER THE PERSONAL REPRESENTATIVE'S PROOF OF CLAIM

A Personal Representative may file a Proof of Claim during the creditors' period.¹⁴ This filing lists all claims the Personal Representative has paid or intends to pay. Once the Proof of Claim is filed it is as though the payees listed on the Proof had filed claims. In effect, the Personal Representative is doing the claimant's job.

Why should the Personal Representative step into the shoes of the claimant? Two reasons: to preserve estate tax deductions and for the Personal Representative's protection.

¹² Florida Probate Code §733.707.

¹³ Florida Probate Code §733.812.

¹⁴ Florida Probate Code §733.702(1).

An amount paid from an estate for a debt of the decedent is not deductible for estate tax purposes unless it was an enforceable obligation against the estate.¹⁵ If no claim is made and the obligation is nevertheless paid, the IRS can challenge the deduction.¹⁶

Similarly, if a Personal Representative pays an amount that is not an enforceable obligation, then beneficiaries may challenge the payment, which could result in a surcharge against the Personal Representative. A Proof of Claim should be promptly served on all interested parties to give them the opportunity to object to any or all “to be paid” items that are listed.¹⁷ For “to be paid” items to which no objection is made, the Personal Representative will have preserved estate tax deductions and be shielded from beneficiary complaints that the claims were improperly allowed.

13. EVALUATE MORTGAGES BEFORE MAKING PAYMENTS

If mortgaged real estate subject to administration is specifically devised, the Personal Representative has no authority to pay the mortgage from estate funds absent a direction in the will to do so.¹⁸ Let the specific devisee know about the mortgage obligation and try to arrange for the devisee to keep the mortgage current.

¹⁵ Internal Revenue Code §2053.

¹⁶ *Estate of Haggmann*, 60 T.C. 465 (1973); Rev. Rul. 75-177, 1975-1 C.B. 307.

¹⁷ Florida Probate Code §733.705(3).

¹⁸ §Florida Probate Code §733.803

14. KNOW THAT COMMUNITY PROPERTY EXISTS EVEN IN FLORIDA

An estate in Florida can include community property. If a decedent brought community property from another state to Florida, it may maintain its character.

There are eight community property states.¹⁹ Many, if not all, Latin American countries observe the community property regime. The law of each community property jurisdiction will vary somewhat from the law of other community property jurisdictions. A feature central to all is that assets acquired by earnings of a spouse during the marriage are owned 50/50 by each spouse. This ownership is in contrast to the determination made in common law jurisdictions, such as Florida, where the way in which an asset is titled determines ownership.

The character of community property brought into a common law jurisdiction can be preserved if the community property is identified as such. Maintaining the community characterization of the property can have favorable income tax consequences. Both halves of community property are entitled to a basis adjustment (step-up if the property has appreciated) at death.²⁰ Property jointly owned by spouses in a common law state will in most cases be entitled to a basis adjustment for only the half included in the decedent's gross estate.²¹

The Florida Uniform Disposition of Community Property Rights at Death Act was adopted to make the task of preserving the community character of property easier.²² A Florida decedent's surviving spouse should be queried as to where the couple lived during the marriage. If they lived

¹⁹ Arizona, California, Louisiana, Nevada, New Mexico, Texas, Washington (Wisconsin can also be considered a community property state)

²⁰ Internal Revenue Code §1014(b)(6).

²¹ Internal Revenue Code §2040(b).

²² Florida Probate Code §732.216.

at one time in a community property state some of the decedent's nominal probate assets may turn out to be community property and if so, only 50% should be reported on the estate inventory.

15. OBTAIN APPROVAL TO CONTINUE UNINCORPORATED BUSINESS

When the estate includes an unincorporated business, a plan for continuing that business should be presented to the court within four months after appointment. Absent authorization to continue the unincorporated business in a testate decedent's will²³, the Personal Representative must obtain court approval to continue the business for more than four months.²⁴ Failure to obtain the required approval lays the Personal Representative open to a surcharge action or removal. Of course, if the business is run successfully, the beneficiaries will rarely complain. So, it is only when the business does not perform well that the beneficiaries will look to the Personal Representative for damages.

16. OBTAIN APPRAISALS FOR HARD-TO-VALUE ASSETS

Although appraisals of estate assets are not required, the Florida Probate Code does permit a Personal Representative to obtain appraisals.²⁵ The Personal Representative is required to file an inventory of assets subject to administration showing the estimated, date of death, fair market value of each. Choosing the right appraiser for the asset to be appraised is fraught with more peril

²³ Authorization must be stated in "distinct and positive terms," *Beck v. Beck*, 383 So.2d 268 (Fla. 3d DCA 1980).

²⁴ Florida Probate Code §733.612(22).

²⁵ Florida Probate Code §733.604.

for the Personal Representative than might first appear. Consider these likely non-tax and tax issues:

- A. Appraisal is too high. When placed on the market for sale the asset generates no offers or offers so much lower than the appraised value that they can't at first be entertained. The market has spoken but getting the message across to the beneficiaries may be difficult. Consider having the property re-appraised in light of market experience. Obviously an overvalued asset will incur unnecessary estate tax in a taxable estate. This typically comes to light when the asset is sold for considerably less than appraised value shortly after the estate tax return is filed and the tax paid. Barring a generally volatile market for the asset or recently changed conditions affecting its value, the most logical low sale price explanation is that the appraisal overstated the value. The best evidence of fair market value is a sale in an arm's length transaction. The fact that the seller may be able to benefit from a capital loss on sale due to the income tax basis adjustment for the asset will probably be of cold comfort considering the more expensive estate tax detriment.²⁶ Filing a claim for refund based on the lower sale price may be in order. There is some peril here, too. The claim for refund may cause an estate tax audit that might not otherwise have occurred.
- B. Appraisal is too low. As mentioned above, estate assets are entitled to an income tax basis adjustment - either fair market value at death or on the estate's alternate valuation date(s) when alternate valuation is available. If the estate is not subject

²⁶ Internal Revenue Code §1014.

to estate taxation (completely covered by the applicable exclusion amount) appreciated estate assets essentially get a basis step-up at no tax cost. The higher the value, the higher the basis, the smaller the capital gain on later sale (or greater capital loss). An undervalued asset in a non-taxable estate will penalize the beneficiary with unnecessary income taxes if the beneficiary sells the asset. The Personal Representative must guard against “basis step-up by appraisal” euphoria which subjects the estate to overvaluation penalties.²⁷ By the same token, Uncle Sam can also impose undervaluation penalties.²⁸

Finally, the values on the inventory and the date of death values on the federal estate tax return should be reconciled. The inventory is ordinarily due to be filed much earlier than the estate tax return. Once the estate tax return has been filed, consider amending the inventory to make any necessary adjustments.

17. AVOID UNINTENDED LAPSES OF INSURANCE

The Personal Representative will likely have actual or constructive possession of items of property subject to casualty loss, items that may be the instruments of potential damage, or both. Keeping these assets adequately insured against risk is crucial to the well being of the estate and the Personal Representative.²⁹

²⁷ Internal Revenue Code §6662(e).

²⁸ Internal Revenue Code §6662(g).

²⁹ Florida Probate Code §733.612(13).

The decedent's automobile is an obvious example. The automobile should not be driven (or driven as little as possible) unless the Personal Representative is assured that adequate insurance is in place. Collision coverage may or may not be appropriate depending on the value of the automobile.

Residential real estate is another obvious example. If the real estate is unoccupied, the decedent's insurance may exclude coverage. If the residential real estate is a condominium, generally the association will have insurance on the structure and the Personal Representative's concern will only be with insuring the contents of the apartment and against liability claims. (Strictly speaking, the Personal Representative has no duty to keep insured residential real estate that is also homestead real estate.³⁰ As a practical matter the Personal Representative will be expected to keep the homestead secure. Prompt collaboration with the homestead beneficiary is essential.)

Insurance concerns put a premium (pun intended) on distributing (or perhaps selling) at the earliest legally safe time assets requiring insurance coverage.

18. CONSIDER ESTATE TAX APPORTIONMENT BEFORE PAYING ESTATE TAX

Often the decedent has identified in the governing instrument (will or revocable trust agreement) the source of payment of estate taxes. If the Personal Representative has control of the payment source (or the cooperation of the person who has), and there are sufficient funds to pay the tax, all is well and good.

³⁰ Florida Probate Code §733.607(1).

On occasion, the Personal Representative will be in a less comfortable position. For instance, if the decedent dies intestate or the governing instrument does not identify the tax payment source. In those cases, the Personal Representative resorts to Florida's estate tax apportionment statute.³¹ The apportionment statute requires those persons receiving non-probate assets included in the decedent's federal gross estate to bear a fair share of estate tax.

Persons in this category who come easily to mind are those receiving life insurance proceeds from policies included in the decedent's gross estate and surviving joint tenants of jointly owned property included in the decedent's gross estate. Collecting estate tax from these people may prove difficult but the Personal Representative has a duty to at least consider the issue.

The Personal Representative should obtain an order of tax apportionment from the probate court. This order will identify who owes tax and the amount or at least the proportions. The Personal Representative may petition for the order of tax apportionment at any time.³² The court retains jurisdiction to modify the order if the initial figures prove inaccurate. It will be in the best interests of the estate, and certainly the Personal Representative, to obtain the order of apportionment just as soon as the salient facts are known.

19. CONSIDER BENEFICIARIES' WISHES REGARDING NON-PRO RATA DISTRIBUTIONS

Estates often contain a number of issues of marketable securities and a number of beneficiaries entitled to the residuary estate. The Personal Representative will distribute these marketable securities in kind to the beneficiaries according to their shares of the residue. That is,

³¹ Florida Probate Code §733.817.

³² Florida Probate Code §733.817(7)(a).

the Personal Representative will divide each holding for distribution. The Personal Representative will initially plan to distribute these holdings pro rata among the beneficiaries. Often the beneficiaries will prefer that all of some holdings be distributed to some and all of other holdings be distributed to others. Or, the beneficiaries may prefer that some distribution arrangement between these two extremes be implemented. The Personal Representative should seek information from the beneficiaries before proceeding. Non-pro rata distributions can be made comfortably with the agreement of all the affected beneficiaries.³³

In addition, the Personal Representative and beneficiaries should understand any tax consequences of non-pro rata distribution. An income tax trap may exist if the non-pro rata distribution is not authorized. In this situation, the beneficiaries may be treated as having entered into a taxable exchange, i.e., I trade my 50% interest in asset A for your 50% interest in asset B, and vice versa.³⁴ The capital gain implications may be less than meets the eye because appreciated assets distributed in kind will have received a basis step-up.³⁵ Nevertheless, the Personal Representative should inform the beneficiaries of the potential for capital gain recognition leaving the beneficiaries to consult with their tax advisors. Obviously, the non-pro rata distribution agreement should be in writing. If the beneficiaries plan to adjust their non-pro rata in-kind distribution shares by market value, it is essential that they all agree on a future date certain when the assets will be valued. There will always be a hiatus between the time when the beneficiaries agree on the non-pro rata distribution and the time they have in hand the assets

³³ Florida Probate Code §§733.810(3) and 733.815.

³⁴ Rev. Rul. 69-486, 1969-2 C.B. 159.

³⁵ Internal Revenue Code §1014.

themselves, e.g., new stock certificates or other documents of title. The Personal Representative will not want to be held responsible for or hear complaints about market fluctuations taking place during the asset ownership transfer period.

20. THINK ABOUT DISCLAIMERS

At the outset of the estate administration, consider whether a disclaimer may be appropriate. The disclaimer may be necessary to preserve some desired tax benefit. Or a disclaimer may be appropriate to shift beneficial enjoyment at no gift tax cost.

The requirements for disclaimers are set forth in the Florida Statutes.³⁶ The rules must be carefully considered, and followed, when pursuing a disclaimer.

21. LOOK FOR ASSETS THAT MIGHT NOT BE OBVIOUS

Patently obvious though it may seem, the Personal Representative has the obligation of marshaling all of the decedent's assets subject to administration and identifying all assets of the decedent's federal gross estate (which necessarily includes all assets subject to administration) to determine if a federal estate tax return is required for the decedent's estate. This requires a thorough search of the decedent's records for evidence of assets in which the decedent had an ownership interest. The Personal Representative should ferret out all tax return copies (income and gift), title documents, deeds, ownership certificates, bank statements, securities account statements, life insurance policies, annuity contracts, trust instruments, retirement account statements and debts owed to the decedent. The Personal Representative might want to use

³⁶ Florida Statutes, Chapter 739.

Schedules A through I of the Federal Estate Tax Return, Form 706, as search checklists. The Personal Representative should promptly arrange to receive the decedent's mail. The problems that arise from an incomplete search include having to reopen the decedent's estate to get control of newly discovered assets for disposal (probably the most benign), having beneficiaries die during the interim, having to amend tax returns, and having to come up with money for interest and penalties on underpaid tax (probably the most malign).

22. FOREIGN BENEFICIARIES ARE DIFFERENT FROM DOMESTIC BENEFICIARIES

The general tax rule is that distributions to residuary beneficiaries of an estate carry out estate ordinary income to them and is taxed to them. The Personal Representative, on the estate's federal income tax return (Form 1041), takes a deduction from estate income for these distributions and the estate will not be taxed on the income carried out. The Personal Representative is not responsible for the beneficiaries' payment of tax on the income distributed; just the reporting the items of income on Schedule K-1.

However, if the beneficiary is a nonresident alien (a relative in the old country?), then this general rule will not necessarily apply. The Personal Representative may become a withholding agent required to withhold income tax from the amount distributable to the alien. The income subject to withholding and the withholding rate may vary depending on applicable income tax treaty rules.³⁷

³⁷ Treas. Reg. §1.441-1.

23. FILE FORM 56

The IRS can keep on sending tax notices to the decedent's last address in its records, until it receives a Form 56. The Personal Representative will receive the decedent's mail but the decedent's last address may not be the last address known to the IRS. It's good practice for the Personal Representative to file Treasury Form 56, Notice Concerning Fiduciary Relationship. This form places the Service on notice to send tax notices for the decedent to the Personal Representative.

24. CONSIDER ESTIMATED TAX PAYMENTS

Estates get a two year hiatus from the estimated tax payment requirement. Beginning with the first taxable year ending two years after the decedent's date death, estimated payments are required of estates.³⁸ However, if an estate closes in the first year when estimated tax payments would otherwise be due, typically no payments are required because in the final year of an estate all items of income are carried out to the beneficiaries.³⁹ Therefore, in most estates estimated payments will never be required.

However, in those estates that stick around for longer than most, estimated tax payments should be considered. The estimated tax payment forms are cleverly numbered Form 1041-ES. An estate which is a calendar year taxpayer files and pays on the same schedule as individuals: April 15, June 15, September 15, and January 15. A fiscal year estate will file and pay on the 15th day of its 4th, 6th and 9th months and on the 15th day of the first month following the close of the

³⁸ Internal Revenue Code §6654(1) and (2).

³⁹ Internal Revenue Code §661(a).

fiscal year. In the final tax year, if the Personal Representative has made estimated tax payments, they can be credited to the beneficiaries using a Form 1041-T.

25. PAY ATTENTION TO TAXES

If you represent the Personal Representative, you should be aware of tax issues. The direct responsibility for complying with tax issues may be assigned, by the client, to a competent accountant. However, that assignment does not eliminate the need for you to be aware of these issues.

Tax returns and tax issues present opportunities for mishaps through the estate administration process.

26. CONSIDER TAXES FOR OTHER STATES

If the decedent owned property in another state, a state estate or inheritance tax return may be required. This requirement may exist even if a Federal estate tax return is not required. Get competent counsel in that other jurisdiction to advise you and your client.

27. CONSIDER JOINT OR SEPARATE: INCOME TAX RETURNS

A Personal Representative has the authority to sign the decedent's final 1040 as a joint return with the surviving spouse.⁴⁰ Nominal joint income tax return rates are lower than the "Single" or "Married Filing Separately" rates. Nevertheless, some thought should be given to the decision to sign a joint return. The final return will include the decedent's income through date of

⁴⁰ Internal Revenue Code §6013(a)(2).

death but *all* of the surviving spouse's income for the year. The Personal Representative, on behalf of the estate, assumes the tax liability of the surviving spouse if the return is joint. The Personal Representative should be concerned about income tax liabilities that may be lurking out there. What if the surviving spouse is the product of a short term second marriage?

28. REALIZE NOT ALL TAX YEARS ARE THE SAME

The Personal Representative may choose a calendar tax year for the estate or a fiscal tax year. The fiscal year can't exceed twelve months and must end on the last day of a month.⁴¹

By electing a fiscal year the Personal Representative can defer the reporting of estate income by the beneficiaries because estate distributions to them carrying out income will be deemed made on the last day of the estate's taxable year.

29. CONSIDER A REVERSE QTIP ELECTION

If the decedent has unused generation skipping tax exemption and disposes of property in a qualified terminable interest property (QTIP) trust, then the reverse QTIP election should be considered. This election may not be necessary if the disposition of the QTIP trust on the death of the surviving spouse is outright. However, if there is the possibility of continuing trusts, then this election should be considered.

The election allows the decedent to be treated as the grantor, for generation-skipping transfer tax purposes of the QTIP trust. This is beneficial if the decedent's GST exemption is otherwise not used. The QTIP trust may need to be severed before applying this election.

⁴¹ Internal Revenue Code §645.

30. BE AWARE: NOT ALL SURVIVING SPOUSES ARE THE SAME

If the surviving spouse is not a citizen of the United States, warnings should sound loudly. Special rules will apply and can significantly alter the estate tax situation. A qualified domestic trust (QDOT)⁴² may be necessary in order to obtain a marital deduction.

31. REMEMBER SPECIAL RULES FOR PARTNERSHIPS

When a partnership interest is part of the decedent's estate, the income tax basis of the estate's interest in the partnership is adjusted to the estate tax value.⁴³

If the value of the partnership interest has increased it's likely because the assets owned by the partnership have increased in value. If the partnership has held assets inside the partnership it is likely the income tax basis inside the partnership is different from (less than) the value of the partnership.

The deceased partner's "inside basis" for partnership assets can be adjusted to match the "outside basis" in the partnership interest by the partnership electing under §754 of the Internal Revenue Code. The election must be made by the partnership. The Personal Representative should investigate the benefits of a §754 election and communicate with the partnership.

32. CONSIDER PERSONAL REPRESENTATIVE COMPENSATION

When the Personal Representative is the sole estate beneficiary or sole residuary beneficiary and the estate is not subject to estate taxation, the Personal Representative will

⁴² Internal Revenue Code §2056(d)(2)(A).

⁴³ Internal Revenue Code §1014.

generally not take a fee, unless the estate is insolvent. To do so would be to convert a non-taxable distribution into taxable income.

33. OPTIMIZE DEDUCTIONS BETWEEN ESTATE AND INCOME TAX RETURNS

The general rule is that an administration expense is deductible for estate tax purposes or income tax purposes, but not both. All tax rules seem to have an exception and this rule is no exception. (Pun planned.)

Just as the Internal Revenue Code identifies certain income in respect of a decedent, which is subject to both income tax and estate tax, the Code also allows certain deductions in respect of a decedent. Examples of these deductions are real estate taxes and investment expenses.⁴⁴

34. FOLLOW THE SEPARATE SHARE RULE

The separate share rule is an income tax provision previously applied only to trusts that now also applies to estates.⁴⁵ Simply stated, the separate share rule limits the ability to shift taxable income among beneficiaries based upon the distributable net income rules.⁴⁶

For example, in estate income tax year one, the Personal Representative distributes \$90,000 in cash to one of three equal residuary beneficiaries when the estate has \$90,000 of ordinary income. The distribution deduction is limited to \$30,000 (one-third of \$90,000) and the

⁴⁴ Internal Revenue Code §691(b).

⁴⁵ Internal Revenue Code §663(c).

⁴⁶ Internal Revenue Code §662(a).

estate will be taxed on the remaining \$60,000. Before the advent of the separate share rule for estates, the estate would have received a distribution deduction for the full \$90,000.

The separate share rule puts an additional emphasis on making timely and simultaneous distributions to all estate residuary beneficiaries in an amount necessary to carry out all estate ordinary income to them for taxation.

35. THINK ABOUT GIFT SPLITTING

Spouses can consent to having a gift made by one treated as though made one-half by each.⁴⁷ If either the deceased spouse or the surviving spouse made gifts prior to the death of the deceased spouse, the Personal Representative should consider electing to split gifts.⁴⁸

If the donor is the deceased spouse, the Personal Representative will need the cooperation of the surviving spouse. Conversely, if the surviving spouse is the donor, the Personal Representative may be requested to agree to split gifts. If the gifts are difficult to value, the Personal Representative should proceed cautiously to avoid unexpected results.

36. CONSIDER WHETHER THE ESTATE TAX RETURN DEADLINE SHOULD BE EXTENDED

The Personal Representative should always consider extending the due date of the estate tax return if an election for qualified terminable interest property (QTIP) will likely be made. The reason for the extension is that an additional six months can be obtained in which to decide upon the optimal amount of marital deduction. If the surviving spouse's health deteriorates, including

⁴⁷ Internal Revenue Code §2513.

⁴⁸ Treas. Reg. §25.2513-2(c).

the ultimate deterioration to room temperature, then less than a full election will likely save overall estate tax. With this approach, some estate tax will be paid in the first estate and the second estate will be entitled to a credit for previously taxed property.⁴⁹

37. CONSIDER A PARTIAL QTIP ELECTION

The Personal Representative should not assume that the full qualified terminable interest property (QTIP) marital deduction election should be made. The election may not be needed to reduce estate tax depending upon the extent of the estate and the status of the estate tax law.

38. CHECK THE TERMS OF CHARITABLE REMAINDER TRUSTS

Qualified split interest charitable remainder trusts must take one of two basic forms: a charitable remainder annuity trust or a charitable remainder unitrust. If a qualified split interest charitable remainder trust is to be established with a distribution from the estate, the Personal Representative should determine whether the trust meets the requirements. If not, the Internal Revenue Code allows for reformation of the trust to correct any deficiency.⁵⁰ The rules for reformation are strict and include certain timetables.

The deficiency may be readily apparent. For instance, a trust fails if the trustee is directed to pay all trust income to the non-charitable beneficiary and at the beneficiary's death the trust terminates and is paid out to charity. Similarly, a trust with authority for the trustee to invade trust principal for the non-charitable beneficiary fails the requirements.

⁴⁹ Internal Revenue Code §2013.

⁵⁰ Internal Revenue Code §2055 (e).

Of course, the defects may not be so obvious. Perhaps some of the necessary language addressing the excise tax provisions is missing.

The Personal Representative should scrutinize split interest charitable remainder trusts early in the estate administration. If defective, a court proceeding should be considered to reform the trust as permitted by the Internal Revenue Code. Even if the estate does not owe estate tax, and therefore qualification is not necessary for estate tax purposes, the trust should be reformed to obtain the income tax benefits of a qualified split interest charitable remainder trust.

39. DETERMINE S CORPORATION STATUS IN ESTATES

The Personal Representative may find the stock of an S Corporation as part of the estate. Maintaining the S status of the corporation (highly desirable for income taxation in most cases) may require special handling by the Personal Representative. Initially no problems arise because an estate can be an S corporation shareholder.⁵¹ Likewise, if the estate distributes the S stock outright to individuals the S status will continue if no one is a non-resident alien and the total number of S corporation shareholders will not exceed 75 (husband and wife count as one if stock is jointly owned).⁵² However, if the beneficiary entitled to the stock is a trust, then caution is required. To keep the S status, the trust must be either a Qualified Subchapter S Trust (QSST) or an Electing Small Business Trust (ESBT). The QSST requirements are:

- A. Trust must have only one income beneficiary.
- B. Principal distributions may be made only to the income beneficiary.

⁵¹ Internal Revenue Code §1361(b)(1)(B).

⁵² Internal Revenue Code §§1361(b)(1)(C) and 1361(b)(1)(A).

- C. Income beneficiary's trust interest must continue until the beneficiary's death or the end of the trust term.
- D. If the trust term ends during the income beneficiary's lifetime all remaining trust assets must be distributed to the income beneficiary.
- E. Income beneficiary must be a U.S. citizen or resident.
- F. The trust must not be a foreign trust.
- G. All trust income must be distributed to the income beneficiary at least annually.⁵³
- H. An election must be timely made.

The typical Qualified Terminable Interest Property Trust (QTIP Trust) for a surviving spouse will normally meet the QSST requirements.

Of course, many trusts will not qualify as QSSTs. For example, a typical trust for a minor over which the trustee has discretion to pay or withhold trust income would not qualify. In many situations, a trust which does not qualify as a QSST may still maintain S status if the trust qualifies as an Electing Small Business Trust (ESBT).

The requirements for an ESBT are:

- A. Cannot be a foreign trust
- B. Beneficiaries are limited to natural persons (but not non-resident aliens), estates or most charities (Section 170(c)(2) through(5) organizations)
- C. S stock was not purchased by trust

⁵³ Internal Revenue Code §1361(d).

- D. The trust is not a Qualified Subchapter S Trust (QSST)
- E. The trust is not exempt from tax
- F. The trust is not a charitable remainder trust (annuity trust or unitrust).⁵⁴
- G. An election is timely made.

Most of the trusts encountered by a Personal Representative that don't qualify as QSSTs will qualify as ESBTs. The ESBT allows more flexibility in trust terms than does the QSST (accumulation of income, more than one income beneficiary) but it comes at a price. The S corporation ordinary income actually or constructively received by the trust will be taxed at the highest income tax rate. The normal distribution rules do not apply, which means that distributions from the trust to the beneficiary will not carry out S corporation income.⁵⁵

EPILOGUE

Wheels come off probate administrations without fail. Like most impending mechanical failures, warning signs often are provided. Be aware and respond to the warning signs. With or without a warning, when the wheels come off, take proactive remedial action. In the long (but perhaps not the short) run, you will be glad you did.

⁵⁴ Internal Revenue Code §1361(e).

⁵⁵ Internal Revenue Code §641(c).