Estate Planning Insights

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MIDDLE MATTERS: IT'S NOT PROBATE (AND IT'S NOT FUN)

In our initial newsletter (dated July 31, 2004), we discussed the first phase of the post-death process: Probate (which is usually pretty simple in Texas). In this newsletter, we will discuss the second phase of the post-death process: tax and administration matters. This middle phase is usually the longest and most complex (and the part that many clients dislike). As will be shown, however, it is an important, required step prior to reaching the last phase. In our next/final newsletter in this series, we will discuss the third phase of the post-death process: estate termination and distribution.

Phase Two. The second post-death phase that must be handled when someone dies involves "administration" and tax matters. Even if the Will of a deceased person ("decedent") does not have to be probated (due to all assets passing by other transfer methods, such as by beneficiary designation, right of survivorship, or a Living Trust that was fully funded prior to death), the "person in charge" of carrying out the decedent's final wishes must still handle the required tax and administration matters before distributing the decedent's assets to his/her beneficiaries. This is why those promoters who tout the Living Trust as a technique "to avoid probate", but further imply that little or no time, effort and money must be spent after the Living Trust creator dies, are not being entirely truthful. The probate process may be avoided, but tax and administration matters are never avoided when someone dies.

Fiduciary Handles Administration and Tax Matters. A decedent's "estate" is comprised of the assets being transferred by the decedent to others upon death, whether the transfer occurs due to the Will or the Living Trust Agreement– or otherwise. The person in charge of handling all post-death matters for an "estate" will be one of the following: (i) the Independent Executor named in the decedent's Will and appointed by the Probate Court, (ii) an Administrator appointed by the Court in cases where the decedent died without a Will or died without a Will that named an Independent Executor, or (iii) the (successor) Trustee of a Living Trust. In each case, the person in charge (hereafter referred to as the "Fiduciary") will have duties imposed by federal and state law, as well as duties imposed by the Will or Living Trust Agreement (if there is one).

Estate Tax Matters. The most significant legal obligation facing the Fiduciary will be complying with the requirements imposed by the federal estate tax laws. Lay people often assume that if they create a Living Trust to "avoid probate", they will also avoid the federal estate tax. Nothing could be further from the truth. The Living Trust is a tax neutral device. All assets placed in the Living Trust by the decedent continue to be considered to be "owned" by the decedent for federal estate tax purposes. In other words, assets held in the Living Trust are still part of the Trust creator's taxable estate. The Living Trust is merely an alternative transfer device, not a tax avoidance device. The Internal Revenue Service does not care what device, or combination of devices, a person uses to transfer assets at death. The choice of transfer method has no effect on the federal tax laws.

Thus, the Fiduciary has an obligation to (i) determine all assets owned by the decedent as of the date of death and (ii) value those assets in accordance with the valuation rules provided by the tax laws. If the decedent was married at the time of death, then community property laws must be taken into account in determining what the decedent owned.

Community Property Considerations. A married decedent will be deemed to own 100% of his/her separate property (if any) and 50% of the community property. If a couple living in Texas has been married for awhile, most (if not all) of their assets will be community property. This may surprise some people because some assets, such as an IRA, may be titled in just one spouse's name.

A lot of people mistakenly believe that the "owner" of an asset is the person whose name is listed in the title of the asset. While this may be true in a "title" state, it is not necessarily true in a community property state. In Texas, an asset that is titled in just one spouse's name is often community property. In those cases, the title merely indicates the spouse who is the "manager" of the asset.

When a marriage dissolves in Texas, either by death or divorce, the legal presumption (the starting point in determining ownership) is that *all assets* on hand are community property (owned 50% by each spouse). To overcome this presumption, the person claiming that an asset is his/her separate property must prove it by "clear and convincing" evidence (a pretty high standard). In determining whether an asset on hand at the time of a married decedent's death is community property or separate property, the relevant question is, "Was this asset acquired during the marriage while living in Texas, other than as a gift or inheritance by one of the spouses?" If the answer is "Yes", then the asset is community property, regardless of its title.

Some assets may start out as the separate property of one spouse, but slowly become community property due to "commingling". Commingling will occur if community property and separate property are placed in the same account. Many people seek to maintain the status of separate property owned prior to marriage or received as a gift or inheritance by placing it in a separate account, titled solely in their name. This is NOT sufficient. If any *earnings* (such as interest and dividends) are added to the account during the marriage, then the account will become commingled because, in Texas, all *earnings* during marriage, *even earnings from separate property*, are *community property*. A Marital Property Agreement entered into before marriage or during the marriage is one way to deal with this problem.

Identifying the Decedent's Assets. The federal tax laws require the Fiduciary to use due diligence in determining all assets the decedent owned at death. This can be a daunting task, made worse in some cases due to poor recordkeeping by the decedent. Every person can make his/her Fiduciary's life simpler (and reduce administration expenses) by periodically preparing an up-to-date Financial Statement, and keeping that statement, as well as other important information, in a place accessible to the Fiduciary after death.

Valuing the Assets. Once the Fiduciary has identified all assets owned by the decedent, the Fiduciary will need to follow applicable law in determining the value of those assets. In general, all assets must be valued at their "fair market value" as of the date of death. "Fair market value" means the price at which the asset would change hands between a willing buyer and a willing seller, both having knowledge of all relevant facts and neither being under a compulsion to buy or sell. For many assets, such as marketable securities, the Treasury Regulations provide a hard and fast valuation rule. Marketable securities must be valued for federal estate tax purposes at the mean between the high and low price on the date of death (not the closing price, as many people mistakenly think). In valuing real estate, the county tax-appraised value is often *not* reflective of true fair market value. Sometimes an appraisal or written opinion of value will need to be obtained from a knowledgeable professional.

Filing Requirement. Once the Fiduciary has valued all of the assets, he/she will then know whether a United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706 or "706") must be filed for the decedent's estate. The filing requirement is based on the total value of the decedent's *assets* (not the net value of the assets minus the liabilities). If the total fair market value of the "gross estate" of a decedent who dies in 2004 is less than $1.5 million, no 706 will need to be filed. If it's $1.5 million or more, then a 706, and also a Texas Inheritance Tax return, must be filed (the filing requirements will be changing over the next 7 years, first increasing and then dropping back to $1 million in 2011 and beyond). If the decedent's estate has a value equal to or greater than the filing requirement, the 706 and Texas inheritance tax return (sometimes jointly referred to as the "death tax returns") must be filed, even if no tax will be due. Estate tax might not be due either because the total amount of debts, expenses and other liabilities (which are subtracted from the total value of the assets) causes the net estate to be below the taxable amount or because the type of estate planning done in the decedent's Will or Living Trust makes it (currently) non taxable. We routinely create estate plans for married couples that result in no death taxes being payable on the first spouse's death. Again, however, the fact that no tax is due does not obviate the need to file the returns if the value of the decedent's gross estate exceeds the filing requirement.

Income Tax "Basis" Considerations. The Fiduciary is responsible for seeing that the death tax returns are prepared correctly. As our clients know, we routinely assist Fiduciaries in preparing these returns. It is important to note that the values reflected in the 706 affect more than the death taxes–they also provide the new basis for the assets for income tax purposes. In other words, the value used for each asset in the 706 becomes the new *basis* of that asset, used in determining gain or loss on a later sale of the asset. Many times, the decedent's assets receive a "tax-free" step up in basis on death, wiping out all of the built in capital gains (and eliminating or reducing future capital gains taxes). Thus, it is not always beneficial to value assets at their lowest possible fair market value in the 706. Further, the value reflected in the 706 for the decedent's interest in any community property assets will apply to *both halves* of the community property–the ½ owned by the decedent and the ½ owned by the surviving spouse. This advantage of increasing the basis in both spouses' assets is only available in community property states. A good Fiduciary will therefore consider both estate tax and income tax issues when preparing the 706. The Fiduciary will also make numerous tax elections in the 706, many of which, such as the allocation of the decedent's Generation-Skipping Transfer Tax ("GST") exemption, will have a very long term effect.

Disclaimers. The surviving spouse is often the Fiduciary for a deceased spouse. Even if he/she is not, however, the surviving spouse is usually a beneficiary of the decedent's estate. It is during this middle phase of the post-death process when the spouse will evaluate the "disclaimer option" that is often built into the decedent's estate plan. Many times, assets can be redirected in a more tax advantaged way by the spouse's execution of a *disclaimer* (refusal to accept a gift) after the decedent's death. The tax laws allow a spouse to disclaim assets passing to him/her in one form and still retain the use and benefit, and also control over, the assets held in a different form as a result of the disclaimer. If done correctly, this type of transfer by the spouse is not a taxable gift. Disclaimers are used a lot to fund a "Bypass Trust". The disclaimer must be made within 9 months of the decedent's death to be effective.

Filing Death Tax Returns and Paying Death Taxes. The Fiduciary must timely file the death tax returns and pay any estate and inheritance taxes due. Sometimes it is necessary to obtain an extension of time to file the returns (it is much more difficult to obtain an extension of time to pay the taxes due). If a Texas decedent owned any real property or minerals in other states, an inheritance tax return will usually have to be filed in each of those states, as well as for Texas.

If federal estate taxes (and Texas inheritance taxes) are due, they must be paid by the date that is 9 months after the decedent's death. Thus, in "taxable" estates, another duty of the Fiduciary during the administration period will be to determine the total amount needed to pay the death taxes, collect and secure existing cash, and, if necessary, liquidate assets so that there will be no problem in timely making the tax payments when due.

Income Tax Returns. In the meantime, the Fiduciary must also handle the federal income tax matters relating to the decedent and his/her "estate". A final United States Individual Income Tax Return (Form 1040) must be prepared and filed for the decedent to report all income earned by the decedent in the year of death, up through the date of death. If any income taxes are due, the Fiduciary is responsible for seeing that they are paid.

In addition to filing the individual income tax return for the decedent, the Fiduciary is responsible for preparing and filing United States Fiduciary Income Tax Returns (Form 1041 or "1041") to report all income earned by the decedent's "estate" (or Living Trust, if applicable), beginning on the day after the decedent's death through the end of the tax year, and each year thereafter until the "estate" is closed--when all administration matters are concluded (generally, after the estate tax matters are finished and all of the decedent's assets have been fully distributed to the beneficiaries). Because the administration period can last up to three years in some cases (and usually lasts longer than 1 year when a 706 is filed), this can mean that several 1041s will need to be prepared and filed by the Fiduciary. This type of return is usually prepared by a qualified C.P.A.

Other Administration Matters. During the second phase, in addition to the tax matters noted above, the Fiduciary must handle various other administration matters, including, but not limited to:

• paying the funeral expenses of the decedent (these expenses are deemed to be 100% payable solely out of the decedent's "estate", even if the decedent was married), • paying the decedent's share of debts due as of date of death (such as medical bills, credit card bills, etc.),
• securing, maintaining and insuring the assets,
• paying the decedent's share of other expenses that arise after death (such as administration expenses: attorneys' fees, accounting fees, appraisal fees, etc., and expenses relating to managing and maintaining the assets, such as property taxes, maintenance fees, repairs, insurance, etc.),
• collecting claims due the "estate" (such as income tax refunds, insurance premium refunds, etc.),
• making distributions during the administration period to members of the decedent's family who are entitled to support (such as the decedent's spouse and minor children),
• settling claims against the decedent and/or the "estate",
• resolving real property title problems, and
• selling assets that need to be sold, for whatever reason.

IRS Closing Letter. Sometime after the 706 is filed, the IRS will either issue a notice of audit or a "Closing Letter". If the IRS chooses to audit the 706, the Fiduciary will need to resolve the disputed estate tax matters with the IRS (gift and income tax matters can also be raised in the audit). Once the audit is settled, or once the Closing Letter is received for estates where the 706 was not audited, the Fiduciary is then able to enter into the third and final post-death phase: closing the "estate" and distributing the decedent's assets to the designated recipients (including trusts).

Because a Fiduciary has personal liability for the death taxes, it is unwise for the Fiduciary to distribute all of the decedent's assets to the beneficiaries prior to receiving the Closing Letter from the IRS. Many beneficiaries do not understand the reason for this delay by the Fiduciary. However, if all of the assets have been distributed before the Fiduciary receives the Closing Letter, and the IRS assesses additional estate taxes, the Fiduciary will have to pay those taxes out of his/her own pocket (unless all of the beneficiaries are willing and able to give back the money they previously received). Thus, it is too great a risk for most Fiduciaries to distribute all of the assets prior to receiving the IRS Closing Letter.

Our next newsletter will discuss the steps involved in the final part of the post-death process-–when the estate (or Living Trust) is ready to be terminated by the Fiduciary and the assets distributed to the beneficiaries.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below. Feel free also to submit proposed topics for future newsletters.

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