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The Probate Process
From Start to Finish

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Tax Reporting and Post-Mortem Tax Matters

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VI. **TAX REPORTING AND POST-MORTEM TAX MATTERS**

a. Final Tax Returns Timeline, Forms and Filing Procedure
b. Requesting Deadline Extensions
c. Income Tax Considerations in Probate
    i. Selecting a Tax Year: Calendar or Fiscal?
    ii. Decedent's Final Income Tax Return
    iii. Estate Income Tax Return
    iv. Tax on Income Earned by Estate after Decedent's Death
    v. Beneficiary Income Tax Considerations
d. Proper Use of Disclaimers and Valuation Discounts
e. Claiming Estate Tax Portability
f. Estate and Gift Tax Considerations - When Do You Need to File Form 706?
g. Coordinating with Decedent's Accounting or Investment Advisors
h. GST Tax Implications
i. Handling Common Property Tax Issues

VII. TAX REPORTING AND POST-MORTEM TAX MATTERS

Stephen M. Johnson[1]

Introduction

In this session, we pull our focus back from state probate law, and pan out to survey the tax landscape. As we survey the tax landscape, we will explore three types of tax returns – individual, fiduciary, and inheritance taxes. As we have already seen today and will continue to see more this afternoon, probate law is the realm of state law, while tax law weaves federal, state, and local threads into the legal tapestry. This session explores federal taxes (individual and fiduciary income taxes on the 1040 and 1041, the estate tax on the 706, the gift and GST taxes on the 709) and state taxes (Kansas and Missouri individual and fiduciary income taxes and property taxes).[2] In the taxes realm, many resources are available to answer questions or check on a point of tax law, and the practitioner should consult those resources as needed.[3]

When a person dies, all the assets and liabilities in her own name become her probate estate.[4] Probate law revolves around gathering, administering, and distributing the decedent's probate estate to various parties. Our focus is a related but distinct issue: handling taxes from the decedent's income and reporting inheritance and property taxes due when assets are transferred to heirs.

A. Final Tax Returns Timeline, Forms and Filing Procedure

Final 1040

A decedent's estate must file tax returns on the decedent's behalf to show the decedent's final income and expenses. Just as an adult files their 1040 income tax return each year to report their taxable income, so a decedent's estate files a final 1040 return to report the decedent's taxable income in their final year on Hamlet's "mortal coil."[5] The final 1040 has the same filing criteria as other 1040 returns.[6]

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[2] Kansas and Missouri do not have state estate, gift, or generation skipping transfer (GST) taxes. K.S.A. §79-3220(c) et seq.; V.A.M.S. §143.311. Charles J. Andres et al., *Probate and Trust Administration* (2008) ("Kansas Probate"), §§5.2-5.4. K.S.A. §79-15,253; V.A.M.S. §§145.011 – 145.955.

[3] IRS Publication 559 and IRS instructions for Forms 706, 709, and 1041. Jonathan G. Blattmachr et al., *Income Taxation of Estates & Trusts* (2015) ("Income Tax"); Blattmachr et al., *The Circular 230 Deskbook* (2016) ("Circular 230"); John R. Price et al., *Price on Contemporary Estate Planning* (2016) ("Estate Planning"); William M. McGovern et al., *Wills, Trusts & Estates* (2004) ("Wills"); Keith Schiller, *Art of the Estate Tax* (2016) ("Estate Tax"); *2016 U.S. Master Tax Guide* & *2016 U.S. Master Estate & Gift Tax Guide*; Alan S. Acker, *Income Taxation of Trusts and Estates* (2014) ("Income Taxation").

[4] A person's death and her estate's simultaneous birth invokes the probate law, K.S.A. §§59-101 et seq.; V.A.M.S. §§473.010 et seq. Pub. 559, p. 15. Assets held in trust, with beneficiary designations, or held or transferred via non-probate routes are outside the decedent's probate estate.

[5] Pub. 559, pp. 3-9.

[6] Pub. 559, p. 4.

Final 1040 Due Date
The decedent's final Form 1040 is due when their 1040 would be due if they were still alive.[7] If a decedent filed on a calendar tax year (as most individuals do), the final Form 1040 is due on April 15, and reports the decedent's income from January 1 through the decedent's date of death, while the Form 1041 reports income from the decedent's date of death through December 31.[8] If a decedent filed her taxes on a fiscal year, her final Form 1040 will be due on the 1st day of the 4th month after the close of her final tax year.[9]

Filing the Final 1040
The decedent's personal representative files the decedent's final Form 1040.[10] To indicate the 1040 is the decedent's final 1040, write "DECEASED," the decedent's name, and the date of death across the top of the 1040.[11] For a married decedent, the decedent's personal representative can file a joint Form 1040 with the decedent's surviving spouse.[12] The decedent's short year final Form 1040 can yield "tax savings" since "income earned in only part of a year" receives "a full year's exemption and full standard deduction, if claimed."[13] An individual's 1040 income and deduction items are the same for a decedent's final 1040, so the decedent's personal representative must determine the decedent's gross income and deductions for the decedent's final tax year.[14]

The decedent's final 1040 can be efiled or filed by mail to the IRS Service Center where the decedent lived or had their business.[15] If the final 1040 has a tax payment, the filing address is different than if the 1040 reports a refund or no tax due. Publication 559 has illustrative samples of the final 1040, Form 1041, and a worksheet to reconcile the decedent's various income sources.[16]

Now that we have explored the decedent's final 1040, let's discuss how to get a tax deadline extension.

B. Requesting Deadline Extensions

Some estates or fiduciaries need more time to properly complete and file the decedent's tax returns.[17] Perhaps the estate is large, has complex assets, or the heirs have been challenging to find. Whatever the cause, tax deadline extensions are available.[18] The deadlines are: 9 months after death for the Form 706 estate and GST tax return, April 15 of the year after the distribution for GST distributions or terminations, April 15 of the

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[7] Code §6072(a); Reg. §1.6072-1(b); Pub. 559, p. 4.
[8] Pub. 559, p. 4; *Income Tax*, §2:1 – 2:2.
[9] Reg.§ 1.6072-1(b).
[10] *Income Tax*, §2:2.
[11] Pub. 559, p. 4.
[12] Code §6013(a)(2); Pub. 559, p. 4; *Income Tax*, §2:2.
[13] *Income Tax*, §2:2.
[14] *Id.*, §2:2; Pub. 559, pp. 4-9.
[15] Code §6091; Reg. §1.6091-2; Pub. 559, p. 21.
[16] Pub. 559, pp. 27-42, 44.
[17] Steve Akers, 2016 ACTEC Annual Meeting Musings, pp. 13-18.
[18] Pub. 559 has a helpful form and deadline checklist (p. 43).

year after the gift was made for the Form 709 gift tax return, April 15 of the year after death for the final 1040, and the 15th day of the 4th month after the end of the estate's tax year for the Form 1041 fiduciary income tax return.[19]

If the fiduciary will not be able to file the tax return before the deadline, a filing extension is available, but needs to be requested.

Final 1040

For the final 1040, the IRS grants an automatic 6 month extension upon the taxpayer or fiduciary filing Form 4868.[20] An extension is granted if: (1) all or part of the taxpayer's estimated income tax is paid and Form 4868 indicates the payment is for an extension, (2) Form 4868 is efiled, or (3) Form 4868 is mailed with payment of the estimated tax due. A Form 4868 extension must be filed *before* the 1040's due date, with a reasonable estimate of the tax due.[21] But a Form 4868 extension does *not* extend the tax payment time, interest and penalties still apply, and interest is due on any unpaid tax running from the 1040's original due date.[22]

Form 1041

The 1041 filing deadline is 3.5 months after the estate's tax year closes.[23] The IRS grants an automatic 5 month extension for filing a Form 1041 upon filing Form 7004.[24] Since the extension is automatic, no signature or reason for extension is needed.[25] A Form 7004 extension must be filed on or before the Form 1040's due date.[26] A Form 7004 extension can be efiled.[27] The paper filing location depends on which form's deadline needs an extension.[28] But a 7004 extension does *not* extend the tax payment time (or the *beneficiary's* deadline for filing her return and paying taxes), and the total income tax estimated owed on Form 1041 must be paid in full by the 1041's regular due date. [29]

Form 706

The IRS grants an automatic 6 month extension for filing a Form 706 upon filing Form 4768.[30] Form 706 is filed by mail at: Department of the Treasury, Internal Revenue

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[19] Pub. 559, p. 43. A time extension, filing for an EIN, or paying estimate taxes is *not* electing a tax year. Reg. §1.441(c)-1; *Income Tax*, §3:7.3.
[20] Pub. 559, p. 4.
[21] Reg. §1.6081-4.
[22] Reg. §1.6081-3(b), -4(c).
[23] Code §6072(a); Reg. §1.6072-1(a); *Income Tax*, §3:7.1.
[24] Code §6081; Reg. §1.6081-6T(a)-(b); *Income Tax*, §3:7.1; Pub. 559, p. 20.
[25] Pub. 559, p. 20.
[26] Pub. 559, p. 20.
[27] Pub. 559, p. 20; Form 7004 instructions, p. 1.
[28] Form 7004 instructions, p. 4.
[29] Regs. §§1.6081-6T(c), -6T(d); *Income Tax*, §3:7.1; Pub. 559, p. 20. The estate's fiduciary is "personally liable" for "unpaid tax" to the amount distributed if before "distribution and discharge" the fiduciary "had notice" or failed to exercise "due diligence" to find the tax due. Reg. §1.641(b)-2(a); *Income Tax*, §3:7.1.
[30] Form 706 instructions, p. 3.

Service Center, Cincinnati, OH 45999.[31] Form 706 and the Form 4768 6 month extension cannot be efiled.

Form 709
The Form 709 gift tax return is filed annually as needed.[32] Form 709 is due after January 1 and on or before April 15 of the year after the gift was made.[33] If the gift donor died in the prior year, the fiduciary must file the donor's Form 709 by the earlier of: (a) the donor's estate tax return due date (with extensions) or (b) April 15 or the donor's gift tax return due date (with extensions).[34] Form 709's due date can be extended two ways: by (1) getting a 1040 extension (which automatically applies to Form 709) or (2) by an automatic 6-month extension upon filing Form 8892.[35] But importantly, neither 709 filing extension route extends the time to pay the gift or GST taxes. A gift or GST tax payment extension is obtained separately.[36]

Now that we have explored various tax filing deadline extensions, let's look more closely at income taxes in probate.

C. Income Tax Considerations in Probate

Statute of Limitations
Timing is everything and proper tax filings start the 3 year statute of limitations clock.[37] But the three year clock does not apply where (1) the return is false or fraudulent, (2) the taxpayer (or fiduciary) willfully tried to evade taxes, or (3) no return was filed. Failing to file a return or pay the tax owed can trigger penalties. Thus late tax filings should be filed immediately to start the 3 year statute of limitations. The penalty for failing to file a tax return is usually 5% of the unpaid tax for one month, with another 5% for each partial or whole month, up to 25%.[38] The taxpayer is liable for a penalty for not paying taxes when due, unless reasonable cause exists.[39]

1. Selecting a Tax Year: Calendar or Fiscal?

A taxpayer can choose tax years: a calendar or a fiscal year. When an estate files a Form 1041 hinges on the estate's tax year.[40] A taxpayer without a "required taxable year" can elect any tax year (calendar or fiscal) on the first return.[41] The estate's fiduciary can choose to end the tax year on "any month that falls within one year of the decedent's death."[42] And if the estate's first year does not end exactly one year after the decedent's

[31] Form 706 instructions, p. 3. The estate may elect installment payments or postpone the tax attributable to a reversionary or remainder interest. Code §§6166, 6163; Form 706 instructions, p. 3.
[32] Form 709 instructions, p. 1.
[33] Code §7503; Form 709 instructions, p. 1.
[34] Form 709 instructions, p. 1.
[35] Form 709 instructions, p. 4.
[36] Reg. §25.6161-1.
[37] Code §6501; *Income Tax,* §3:7.2. A "substantial omission of income" expands the clock to 6 years. *Id.*
[38] Code §6651.
[39] Code §6651(a)(2).
[40] Form 1041 instructions, p. 8.
[41] Code§ 441; Reg. §1.441-1(c)-1; *Income Tax*, §3:7.3.
[42] Code §441; *Income Tax*, §3:7.3.

death, a short year return is filed.[43] This short year helps the estate by "spread[ing] income over more tax years."[44] And a taxpayer on a short tax year claims the full year's deductions and exemptions.[45] An estate can choose a cash or accrual accounting method.[46]

When choosing a calendar or fiscal tax year, the calculus depends on several variables. The estate could have (1) IRA income, (2) IRD issues, (3) a capital gain, or (4) fiscal year reporting could determine when the money is taxed to the beneficiaries.[47] The tax year choice can be used to: (1) finesse income and defer income taxes, (2) match the estate's best interest with the beneficiary's best interest, (3) coordinate income reporting so there is only one tax return to file when the probate estate is settled, (4) handle tax losses so losses reflected on the final return flow through to the beneficiaries (for items like attorney's fees and itemized deduction items), and (5) allow an estate and trust to be treated as one taxpayer via the §645 election. A fiscal year estate can finesse distributions: a beneficiary who receives a distribution in one year may not need to report the income until the next calendar year - a beneficiary's income is deemed distributed on the last day of the estate's fiscal year, regardless of when the distribution was paid.[48] The estate's fiduciary files both returns by April 15 after the tax year's close.[49]

2. Decedent's Final Income Tax Return

When reporting income in probate, we distinguish between the decedent's income during life (on the final 1040) and the decedent's post mortem income (on the estate's 1041).

A fiduciary can choose where some tax deductions or exclusions are taken. Examples include medical expenses, reinvested gains from condemnation awards, prorated depreciation, and tax-free §1031 exchanges.[50] For these items, the fiduciary should consider advantageous tax treatment and the estate's best interest. When allocating deductions that can be taken on various tax returns, the estate and its fiduciary need to seek out accounting, tax, and legal counsel to make a wise decision – tax allocation questions often need to be answered case-by-case with a tailored solution.

While the estate's first tax year begins the day the decedent dies, any income earned the day the decedent dies goes on the final 1040.[51] Let's review the income and expense items reported on the final 1040.

The decedent's grantor trust income, or other trust income (if any), is reported on their final 1040.[52] The final Form 1040 has 13 deductible items: (1) educator expenses (Line

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[43] Code §443; *Income Tax*, §3:7.3.
[44] *Income Tax*, §3:7.3.
[45] Code §§443(a)(2), (c); *Income Tax*, §3:7.3.
[46] Code §446(c); *Income Tax*, §3:7.3.
[47] Most estates pay estimated taxes. Code §6654(l); *Income Tax*, 3:7.5.
[48] Code §662(c); *Income Taxation*, A-31; *Kansas Probate*, §5.5; *Estate Planning*, §§12.7, 12.9- 12.10.
[49] Code §6012(b)(1); Reg. §1.6072-1(b).
[50] *Income Taxation*, §2:2.
[51] *Income Tax*, §3:7.3.
[52] Danforth & Zaritsky, *Grantor Trusts* (Bloomberg BNA no. 819, 2015).

23), (2) some business expenses (Line 24), (3) the health savings account deduction (Line 25), (4) moving expenses (Line 26), (5) self employment tax deduction (Line 27), (6) self employed SEP, simple, or qualified plan deduction (Line 28), (7) self employed health insurance deduction (Line 29), (8) early savings withdrawal penalty (Line 30), (9) alimony paid (Line 31a), (10) IRA deduction (Line 32), (11) student loan interest deduction (Line 33), (12) the tuition and fees deduction (Line 34), and (13) the domestic production activities deduction (Line 35).[53]

Allocating Tax Deduction Items
Allocating deductible items can be a complex calculus. Some items are only deductible on one return, while others items present choices with various effects – e.g. final medical expenses can be deducted on the final 1040 or the 706.[54]

3. Estate Income Tax Return

Now that we've dealt with the decedent's income during life (on the final 1040), we move on to the estate 1041.[55] An estate 1041 reports income earned on while the assets are in probate. The estate files a 1041 if the estate had: (1) at least $600 gross income for the tax year or (2) a nonresident alien beneficiary.[56] An estate filing a 1041 must give "information" to beneficiaries who receive distributions or to whom an "item" from the "taxable year is allocated."[57] Often a Schedule K-1 is used to report an estate beneficiary's share of income, deductions, or credits, flowing into their Form 1040.[58] The estate beneficiary must report their income and expense share consistently on their 1040 with the Schedule K-1.[59]

Let's review the estate 1041 income and expense items. Form 1041 has 10 deductible items: (1) interest (Line 10), (2) taxes (Line 11), (3) fiduciary fees (Line 12), (4) charitable deduction (Line 13), (5) attorney, accountant, and return preparer fees (Line 14), (6) items not subject to the 2% floor (Line 15a), (7) net operating loss (Line 15b), (8) allowable miscellaneous itemized deductions subject to the 2% floor (Line 15c), (9), income distribution (Line 18), (10) estate tax (Line 19), and (11) exemption (Line 20).[60]

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[53] Form 1040 instructions, pp. 30-37.
[54] *Estate Planning*, §12.13.
[55] An estate 1041 is filed annually until termination. An estate terminates when administration is complete, all liabilities paid, and assets distributed. Reg. §1.641(b)-3(a); *Income Tax*, §3:9. The final 1041 may be filed even if the estate keeps reasonable amounts to cover unknown or contingent liabilities or expenses (*not* beneficiary claims). An estate should file a final 1041 if administration is substantially complete and assets are distributed. The IRS presumes an estate can be closed in 24 months. If more time is needed, check the Other Information section box on Form 1041 where the estate is open over 24 months, and attached a statement explaining the delay. An estate needs an EIN (using Form SS-4) to file a 1041. The fiduciary files Form 56 to inform the IRS when her fiduciary status begins and ends.
[56] Code §§6012(a)(3), (4); Regs. §§1.6012-3(a)(1)(i)-(ii); *Income Tax*, §3:7.1. If ancillary administration occurs, each fiduciary must file a separate 1041. Reg. §1.6012-3(a)(3); *Income Tax*, §3:7.1.
[57] Code §6034A(a)(2); *Income Tax*, §3:7.1.
[58] Regs. §§1.6041-1(a)(2), 1.6012-3(a)(1)(ii)(A); *Income Tax*, §3:7.1.
[59] Code §6034A(c); *Income Tax*, §3:7.1.
[60] Code §§67, 642(d), 651-652, 661-663; Form 1041 instructions, pp. 22-25; *Income Tax,* §3:2.1[D]; *Income Taxation*, A-36, A-46 – A-47; *Estate Planning*, §§10.4.5, 10.4.7.

An elections checklist could be consulted as a guide.[61] Estate taxes paid are deductible, to eliminate double taxation (income and estate taxes on the same IRD item).[62]

Deducting Estate Expenses
Estate expenses are deductible on Form 706 to determine the gross estate's value, and the estate tax (if any) owed.[63] Medical expenses paid before the decedent's death can be deducted on the final 1040. Estate administration expenses can be deducted on the final 1040 if the executor waives the right to deduct expenses on Form 706 (e.g. if the 706 is not be filed). The executor can treat medical expenses paid by the estate as paid by the decedent when the medical services were given, but medical expenses must be paid within a year of death. The executor should attach a statement to the final 1040 stating the expenses were not and will not be claimed on Form 706.[64] Medical expenses deducted from estate taxes are fully deductible, but medical expenses deducted from income taxes are only deductible if over 10% of AGI (or over 7.5% of AGI if over 65).[65]

The final 1040 can take the standard deduction, but an estate may owe self-employment tax.[66] Estates can take a $600 personal exemption.[67]

Deductible expenses include funeral expenses and administration expenses. A deductible expenses must be actually and necessarily incurred for estate administration, including asset collection, debt payment, and distributions to heirs.[68] Attorney's or fiduciary fees, and related expenses are deductible. Credits against the estate tax would be claimed.[69]

Fiduciary Fees
Fiduciary fees are deductible on Forms 706 and 1041. *Knight* teaches that the 2% itemized deduction floor often applies to an estate's fiduciary fees.[70] A taxpayer may take a miscellaneous itemized deduction if the item's cost exceeds 2% of AGI.[71] Some itemized deductions are deductible in full, but any costs outside Code §67(b)'s ambit are miscellaneous itemized deductions, so the 2% floor applies.[72] An estate's fiduciary fees, including for investment advisory services, are not on the §67(b) list, so the 2% floor applies.[73] An individual's investment advisory expenses are fully deductible costs.[74] Using this logic, an estate can only fully deduct fiduciary fees if the money was (a) "paid

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[61] *Estate Planning*, §12.49.
[62] Code §691(c); *Income Taxation*, A-45; *Income Tax*, §2:3.4.
[63] *Estate Planning*, §2.16.
[64] Regs. §§1.642(g)-1; 20.2053-1(d).
[65] Code §213; *Estate Planning*, §12.3.4.
[66] Code §63(c)(6); *Estate Planning*, §10.4.6.
[67] *Id.*
[68] Reg. §20.2053-3(a).
[69] Code §§2010-2016; *Estate Planning*, §2.17.
[70] *Knight v. IRS*, 552 U.S. 181 (2008); Pub. 559, p. 23. *Knight* was about trusts, "applies equally to estates." *Knight,* at 181, n.1. Blattmachr et al., "*Knight v. Com'r.*," *Tax Management Memorandum* (2008).
[71] Code §§63(d), 67(a).
[72] Code §67(b) (fully deductible itemized deductions a/k/a 2% AGI floor exceptions).
[73] Code §67(e).
[74] Code §212.

or incurred in connection with" estate administration and (b) "would not have been incurred" for property outside the estate.[75]

The §645 Election: Treating a Trust as Part of an Estate
Our focus is probate estates and taxes, not trust income taxes. But the §645 election may help some estates where the decedent had a trust.[76] A §645 election must be made by the first (estate or trust) 1041's filing deadline, even if the combined estate and trust lack enough income to file Form 1041.[77]

§645 Election
To make the §645 election, the executor files a 1041 (for the estate and a qualified revocable trust (QRT)) and Form 8855.[78] The §645 election is irrevocable and the 1041 is filed under the estate's name and EIN.[79]

The §645 election stands until the "applicable date," the later of (a) 2 years after the decedent's death or (b) 6 months after estate taxes are determined.[80] The estate does not terminate until the earlier of (a) the "applicable date" or (b) when the qualified revocable trust and the estate have distributed all their assets.[81] The final estate tax day is the earliest of (a) 6 months after an estate tax closing letter is issued, (b) the final disposition of a refund claim about estate taxes, (c) execution of a settlement agreement about estate taxes, (d) a court order about estate taxes, or (e) the statute of limitation expiring for collecting estate taxes.[82]

The §645 election has advantages and disadvantages. A §645 election bars (a) splitting income with another taxpayer and (b) allocating depreciation or depletion between the fiduciary and beneficiaries may be better for a trust than an estate.[83] But the §645 election allows (a) the ability to use a non calendar year, (b) to deduct some passive losses, (c) to deduct and amortize some reforestation expenses, (d) to receive a charitable deduction beyond unrelated business income, and (e) affect the trust's state and local taxes.[84]

The §645 election has five effects on Form 1041. First, the estate and trust's income,

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[75] Code §67(e)(1).
[76] *Income Tax*, §3:8.
[77] Reg. §1.645-1(c); Form 8855, p. 3. If the estate is given a 1041 filing extension for its first tax year, Form 8855's due date is the 1041's extended due date. If the 1041 is filed late, the §645 election may be unavailable. Filing a trust 1041 depends on the trust's taxable and gross income levels, and the trust's grantor terms. A trust 1041 is required if a non-grantor trust has: (1) any taxable income, (2) at least $600 gross income, or (3) a nonresident alien beneficiary. Code §641.
[78] Reg. §1.645-1(c)(1)(i)
[79] Code §645(c); Reg. §1.645-1(e)(1). An estate's 2 year estimated tax payment exception applies to a trust making the §645 election. Code §6654(l)(2)(A). The §645 election does not relieve the trust of its 1041 obligation for the tax year ending with the client's death, but the trustee doesn't need to file Form 1041 for the trust's short year (the client's death until December 31). Reg. §1.645-1(d)(2)(i).
[80] Code §645(a), (b)(2); Reg. §1.645-1(f)(2)(ii).
[81] Reg. §1.641-1(b)-3.
[82] Reg. §1.645-1(f)(2)(ii).
[83] *Income Tax*, §3:8.
[84] *Income Tax*, §3:8.

deductions, and credit are combined, and only one personal exemption is allowed.[85] Second, the executor and trustee must reasonably share the tax bill.[86] Third, the executor and trustee must timely pay their shares of the tax bill.[87] Fourth, the estate and trust are treated as separate shares for calculating distributable net income (DNI) and certain distributions.[88] Fifth, a charitable deduction is allowed.[89]

Now that we have reviewed the estate's 1041, let's move on to discuss income earned after the decedent dies, income in respect of a decedent.

4. Tax on Income Earned by Estate after Decedent's Death

All income, unless specifically exempted, is taxable.[90] This income tax axiom applies to income that flows in after the decedent's death just as it applies to income that comes in before the decedent's death. The timing of the decedent's death vis-à-vis receiving income highlights the tax symmetry of income in respect of a decedent (IRD) and deductions in respect of a decedent (DRD).

IRD and DRD

Income in respect of a decedent (IRD) is income due and payable to (but not yet realized by) the decedent at her death.[91] The taxpayer earned IRD money *before* death, but was not paid the money until *after* her death.[92] IRD is reported on Form 1041, not the final Form 1040, if the money was received after the decedent's death. IRD money is taxed the same way in the beneficiary's hands as the income would have been taxed in the decedent's hands while the decedent was alive. If the estate or someone else entitled to IRD transfers their right to IRD before receiving and reporting the IRD as income, the transfer may trigger accelerated IRD reporting.[93]

The parallel provision in the income tax of IRD is deductions in respect of a decedent (DRD).[94] Just as IRD is income earned during the decedent's life but not paid until after the decedent's death, so DRD are expenses accrued during the decedent's life but not paid until after the decedent's death. DRD eligible expenses include trade or business expenses (Code §162), deductible interest (Code §163), deductible taxes (Code §164), investment expenses (Code §212), and the depletion deduction (Code §611).[95] DRD does not include alimony due before the decedent's death and paid after death, losses deductible under Code §§165-166, the charitable deduction carryover, the net operating carryover, the capital loss carryover, or the decedent's unpaid medical expenses.[96] But

[85] Reg. §1.645-1(e)(2)(ii).
[86] Reg. §1.645-1(c)(1)(ii).
[87] Reg. §1.645-1(c)(1)(ii).
[88] Reg. §§1.64501(e)(2)(iii)(A), 1.663(c)-4. The separate share rule applies to allocating (not creating) DNI.
[89] Code §642(c); Reg. §1.645-1(e)(2)(iv).
[90] Code §61(a).
[91] Code §691; Regs. §§1.691(c)-1, -2(a)(1)(ii); Pub. 559, p. 9.
[92] *Income Tax*, §2:3; Acker, *Income in Respect of a Decedent* (2010).
[93] Code §691(a)(2); *Income Tax*, §2:3.2.
[94] Code §691(b); *Income Tax*, §2:3.3.
[95] *Income Tax*, §2:3.3.
[96] *Id.*

the geometry is imperfect: DRD cuts a narrower swath than IRD.

Tracing

Another Form 1040 and Form 1041 issue is tracing income and expenses. Tracing arose before the 1954 IRS Code and the *Dean* case, but DNI and the 1954 Code simplified the tracing issue.[97] An income or expense item can be properly allocated based on decedent's Social Security number (Form 1040) or the estate's EIN (Form 1041).

Form 706 and Form 1041 Deductions

When weighing allocating deductions to Form 706 or Form 1041, look at best interests and tax efficiency – where will the items yield the greatest tax savings or beneficial impact for the client?

Traditionally deductions were allocated to Form 706, not to Form 1041. Historically federal estate taxes were a major issue for clients, while now portability is often the only reason to file a 706. Portability is great where estate taxes could come into play, but clients who will not owe estate taxes can avoid Form 706 preparation costs.

Net Investment Income Tax (NIIT)

The Affordable Care Act (2010) added the NIIT was added to the income tax landscape. Passive activities may trigger net income investment taxes for an estate.[98] File Form 8960 with the IRS to report NIIT. For individuals, the NIIT applies if a U.S. citizen or legal resident has net investment income (NII) and modified adjusted gross income over $250,000 if married filing jointly, $200,000 if single and head of household, or $125,000 if married filing separately. Individual taxpayers report NIIT from the 8960 on Line 60, box b (Form 1040, p. 2).

The NIIT applies to individuals and estates. The NIIT is a 3.8% Medicare contribution tax on NII of some taxpayers. NII includes interest (including substitute interest), dividends (including constructive dividends, and distributions treated as dividends), non-qualified annuities, royalties, rents (other than income derived in the ordinary course of a trade or business that is not a passive trade or business), trades and businesses the client is passively involved in or trades or businesses that consist of trading financial instruments or commodities, investment of working capital, and some capital gains.[99] NII excludes: sale of some active interests in partnerships and S corporations, distributions from certain qualified plans, or self-employment income.

Unless specifically exempted from NIIT, estates have NIIT liability if they have undistributed NII *and* their AGI is over the dollar amount at which the highest tax bracket for an estate begins for the tax year. For estates, the 3.8% NIIT tax applies to the *lesser* of (a) undistributed NII or (b) AGI amount over the dollar amount at which the highest tax bracket applicable to the estate begins for the tax year. Estates report and pay NIIT on Form 1041.

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[97] Acker, *Income Taxation*, A-4; *Dean v. IRS*, 102 F.2d 699 (10th Cir. 1939).

[98] Code §1411; Regs. §§1.1(i)-1T, 1.1411-4, -5, -6, -7, -8, -9; Acker, *Income Taxation*, A-64 – A-75.

[99] IRS Pubs. 550, 559 (pp. 15-24), and 925.

Kansas and Missouri Fiduciary Income Taxes
A Kansas estate's fiduciary must file a Kansas K-41 return reporting Kansas income.[100] And non-Kansas estate's fiduciary must file a K-41 to report Kansas source income.[101] A Missouri estate's fiduciary likewise must file a Missouri MO-1041 return if a federal 1041 is due.[102] And a non-Missouri estate's fiduciary must file a MO-1041 reporting $600 or more Missouri source taxable or gross income.[103]

5. Beneficiary Income Tax Considerations

When the estate makes distributions to a beneficiary or the estate has a choice of when to distribute income to beneficiaries, the beneficiary's income tax considerations arise.

Estate Distribution Taxes
If a person receives an estate distribution, the estate distribution rules would apply. Estate beneficiaries are taxed on income passing to them as distributions, but only to the extent of distributable net income (DNI). When income flows to a beneficiary, the income keeps its character in the beneficiary's hands. Estate distributions are included in the beneficiary's gross income to the extent of (1) the distribution amount or (2) the estate's net income.

Three factors affect if the estate passes the income to the beneficiary, or retains the income. First, the decedent's will may specify the income to be paid based on the beneficiary's age, life condition, the income type, or income only (not income and principal). Second, distributable net income or DNI. And third, the income distribution deduction.

Distributable Net Income (DNI)
DNI is the estate income available to distribute to a beneficiary and the income ceiling taxable to the beneficiary.[104] DNI is reported on Schedule B (Form 1041). DNI is the estate income ready to distribute to estate beneficiaries. An estate's income distribution deduction is the lesser of (a) DNI or (b) distributions to beneficiary (excluding distributed tax exempt interest). Estates must take the income distribution deduction, so estates cannot elect to pay taxes on distributions for beneficiaries.[105] DNI is the upper limit of the income distribution deduction, which an estate can take.

Separate Share Rule
The separate share rule protects multiple estate beneficiaries from paying taxes on each other's money.[106] When separate shares exist, DNI is calculated separately for each share. A beneficiary is only taxed on the income belonging to and distributed to her separate

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[100] K.S.A. §79-32, 109(a)(1)(c); Nenno, *State Income Taxation* (2013), A-58 – A-59.
[101] K.S.A. §§79-3220(c); 79-32, 110(d); 79-32, 134; 79-32, 136.
[102] V.A.M.S. §§143.481(3), (4); Nenno, *State Income Taxation*, A-61 – A-62.
[103] *Id.*
[104] Code §643; Regs. §§1.643(a)-0 – (a)-7; *Estate Planning*, §10.4.4.
[105] Code §§652 and 662.
[106] Code §663(c); Regs. §§1.663(c)-1 - -5; *Estate Planning*, §12.37.

share. Separate share calculations and each beneficiary's DNI are reported on separate statements attached to Form 1041.

Income Distribution Deduction
The distribution amount (1) actually made or (2) otherwise paid, credited, or required shape the income distribution deduction. The estate can take an income distribution deduction for the interest income distributed, paid, or credited to the beneficiary, or required to be distributed, paid, or credited under the estate's terms. The income distribution deduction is limited to DNI. Estate distributions have tax symmetry: When a beneficiary receives a distribution, the beneficiary must report on the 1040 the same amount the estate claims on the 1041 as an income distribution deduction. Estates must take the income distribution deduction, so estates cannot elect to pay taxes on distributions for beneficiaries. The executor calculates the estate's DNI and income distribution deduction on Schedule B (Form 1041, pg 2) to see if income is (1) actually distributed, or (2) otherwise paid, credited, or distributed. This determines the income allocable to the beneficiary on Schedule K-1 (Form 1041).[107]

Another trust income tax element arises for beneficiaries with the increasingly popular beneficiary defective inheritor's trust (BDIT). A BDIT is an irrevocable trust established by a family member or third party for a beneficiary, which is designed to afford asset protection and creditor protection to the beneficiary, while allowing the beneficiary to pay the trust's income taxes (rather than the trustee paying the trust's income taxes from the trust assets).

D. Proper Use of Disclaimers and Valuation Discounts

IRS, Kansas, and Missouri Disclaimers
What if an estate or trust beneficiary is to receive a property interest that she does not want? She may disclaim the property interest, renouncing her legal right and claim to the inheritance.[108] A "qualified disclaimer" by a third party causes the property to pass to the decedent's surviving spouse and qualify for the marital deduction.[109]

State and federal disclaimers exist and should be invoked together when a beneficiary seeks to disclaim and renounce her inheritance. The IRS Code's term of art is a "qualified disclaimer."[110] A qualified disclaimer is irrevocable and unequivocal refusal to accept a property interest that satisfies four tests: (1) in writing, (2) received by the transferor within 9 months after the later of (a) the day when the transferring creating the interest is made or (b) the day when the person making the disclaimer turns age 21, (3) the person making the disclaimer must not have accepted the interest or any benefits before disclaiming, and (4) the interest must pass to a person other than the disclaimant.[111] A

[107] Code §§102, 642(c), 643, 651(a), 652(a), 661, 662, 663(a)(1), (a)(2); Regs. §§1.102-1, 1.642(c)-3(b)(2), 1.661(a)-2(c), 1.663(a)-1; Form 1041 instructions, pp. 24-25, 27-28.
[108] Garner, *Black's Law Dictionary* (2014), 562.
[109] Code §§2046, 2056, 2518.
[110] Code §2518
[111] *Id.* The 9 month deadline for a "qualified disclaimer" triggers a direct skip, taxable termination, or taxable distribution. *U.S. Master Estate & Gift Tax Guide*, ¶2465.

"qualified disclaimer" of a general power of appointment after 1976 does not release the power and is not a taxable gift.[112]

Kansas and Missouri both use the "disclaimer" term of art.[113] A "qualified disclaimer" under the IRS Code may sweep more broadly than a Kansas or Missouri "disclaimer."[114] Kansas law gives the broad contours of disclaimers, including that a disclaimer be in writing and with notice given, describe the property, interest, or power being disclaimed, describe the "extent" of the "declaration of disclaimer" and "be signed and acknowledged by the disclaimant."[115] Disclaiming one's interest under a will is merely renouncing a property right, not changing the legal status or relationship between the testator and the disclaimant.[116] Kansas law follows the IRS Code's 9 month disclaimer deadline.[117] Disclaiming an inheritance of property under a Will is an all or nothing proposition – a devisee cannot accept the Will's benefits while rejecting its burdens.[118] A Kansas disclaimer is "filed and recorded" in the probate court with jurisdiction to administer the decedent's estate.[119] A timely Kansas disclaimer "relate[s] back" to "the decedent['s]" "date of death."[120] Following the IRS rules, a Kansas disclaimer, "when filed and recorded," "shall be final" and "cannot be revoked and shall be binding."[121]

Missouri law requires a disclaimer be "made by a writing showing an unconditional refusal to accept a transfer," where the writing is "signed by the disclaimant," and "delivered on or before nine months."[122] Missouri considers acceptance of a property interest, including "acceptance of benefits," and acceptance "precludes any later disclaimer."[123] Missouri expressly recognizes disclaimer rights "under any other statute" (e.g. the IRS Code) or "under the common law": These other disclaimer rights are congruent and run in parallel with Missouri's disclaimer law, which "does not abridge or affect" these other disclaimer rights.[124]

Valuation Discounts

Various valuation discounts are available: the minority discount and lack of marketability discount are the most commonly claimed.[125] A minority discount is available for someone who owns less than a majority of an asset. A lack of marketability discount is

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[112] *U.S. Master Estate & Gift Tax Guide*, ¶655.
[113] K.S.A. §59-2291 *et seq.*; V.A.M.S. §§469.010 *et seq*., 461.048.
[114] Cline, *Disclaimers* (2010); Bogert, *Trusts & Trustees* (2016), §§170-171.
[115] K.S.A. §59-2291(a), (b). A disclaimer of a Will distribution must be intentional and affirmative. *Production Credit Ass'n v. Mater*, 27 Kan. App.2d 700 (2000). A legatee or devisee could disclaim a Will distribution at common law (rejecting testator's offer), but an intestate distributee could not disclaim. *Id.*
[116] *Estate of Estes*, 239 Kan. 192 (1986). A disclaimant retains standing to contest a will or attack a probate filing. K.S.A. §59-2293; *Estate of Estes*, 239 Kan. 192 (1986).
[117] K.S.A. §59-2292(a); *Matter of Ramsey's Estate*, 229 Kan. 7 (1981).
[118] *Nusz v. Nusz*, 155 Kan. 699 (1942).
[119] K.S.A. §59-2292(b).
[120] K.S.A. §59-2293(a); *Strom v. Wood*, 100 Kan. 556 (1917).
[121] K.S.A. §59-2293(d);
[122] V.A.M.S. §§469.020.1.
[123] V.A.M.S. §§469.030.1.
[124] V.A.M.S. §§469.110.
[125] *Estate Planning*, §§7.16, 11.1.2.

available for someone who owns an asset that is closely held, privately held, or otherwise cannot be easily sold publicly. Driven by the facts, the Tax Court may allow substantial discounts: (1) A combined 47% lack of marketability and minority discount was allowed for a 27.5% partnership interest, (2) a 40% combined marketability and minority discount allowed for a 40% limited partnership interest, or (3) a 20% minority discount, 25% lack of marketability discount, and a 10% portfolio discount.[126]

E. Claiming Estate Tax Portability

To Port or Not to Port: Filing Form 706, That is the Question[127]

Form 706 is the fount of portability.[128] Portability is a great estate planning tool for married couples.[129] Portability began in 2010 and is now a permanent part of the estate planning landscape.[130] Portability is the "deceased spousal unused exclusion amount" or "DSUE amount."[131] The applicable exclusion amount is the basis exclusion amount plus portability (or the DSUE amount).[132] Just as estate planning has undergone a sweeping paradigm shift from an estate tax focus to an income tax focus, so portability is "a paradigm shift in estate planning for married couples."[133] Portability is part of Congress' favorable treatment of married taxpayers, along with the marital deduction and unlimited gifting between married spouses. Portability is not available for a spouse's unused gift or GST tax exemptions. Portability has triggered "an explosion" of estate tax filings "where no estate tax is due."[134] Indeed, few estates need to file a Form 706 to pay estate taxes, but many estates file Form 706 to claim portability.[135]

Often portability is a good idea - especially for spouses whose net worth is close to or could become close to the federal estate tax exemption during their remaining lifetime.[136] But portability may not be as useful to spouses with lower net worth or income where there is no possibility of reaching the federal estate tax exemption. For those clients, portability may actually be uneconomical – the pursuit of a phantom tax benefit, which incurs more time and expenses than it is worth.

Portability gives a choice between inheriting outright vis-à-vis inheriting in trust.[137] Portability has numerous advantages vis-à-vis using trusts in an estate plan, including: (1) simplicity, (2) stepped up basis when the surviving spouse dies, (3) use with depreciating assets, (4) use with retirement assets, (5) use with a residence, (6) IRD tax efficiency (by

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[126] *M. Hoffman Estate*, T.C. Memo 2001-109; *E. Dailey Esate*, T.C. Memo 2001-263; *P.Adams et al*., D.C. Tex. 2001-2.

[127] Hamlet, Act III, Scene i, Line 57. Blattmachr et al., "Portability or No," Journal of Taxation, 118:5 (2013); *Estate Tax,* §§4.5A, 7A.8; Steve Akers, 2016 Heckerling Musings, pp. 68-71.

[128] Reg. §20.2010-2T(a); *Estate Tax*, §4.5A.

[129] *Estate Tax*, Ch. 7A.

[130] American Taxpayer Relief Act (2012).

[131] Code §2010.

[132] Code §2010(c)(2); *Estate Planning*, §§2.12, 12.27.

[133] Blattmachr,"Portability or No," 233.

[134] *Estate Tax*, §1.2.

[135] *Estate Tax*, §5.3.

[136] *Estate Tax*, §1.3 (Portability is "outstanding insurance" against estate and income taxes for a "vast swath of the married population"). The martial deduction and QTIP trusts are useful. *Id.*, §1.10, n.118, Ch. 2.

[137] Abendroth portability paper (2015 KCEPS). Both papers are incorporated here.

not funding the first spouse's unused estate tax exemption with IRD), (7) market declines after the first spouse's death, (8) lower state exemption amount (for states with an estate tax), (9) avoid state estate taxes, (10) create a grantor trust for descendants, and (11) avoiding complex tax funding formulas.[138]

But trusts also have some advantages over portability: (1) using the first spouse's GST exemption (which can be wasted with portability), (2) creditors' claims of the surviving spouse, (3) protection from unwise financial decisions, (4) no DSUE indexing for inflation, (5) estate tax credits (which can be wasted with portability), (6) remarriage forfeiture if the surviving spouse remarries and survives the new spouse, (7) shelter of appreciation and income, and (8) avoiding potential audit issues with filing Form 706.139 By using portability (and not a trust), various issues arise: (1) income tax consequences, (2) Form 706 must be filed, (3) the effect of inherited exemptions, and (4) second marriages.[140] A trust can shift income to any beneficiary, so that it is not taxed in the surviving spouse's hands.[141] If a trust is used instead of portability, Form 706 may not be required. A trust can be beneficial for a surviving spouse is the first spouse did not use their gift tax exemption and left a large unused estate tax exemption. And a QTIP trust would work better in a second marriage scenario.[142]

Portability is useful where: (1) a small first estate exists, (2) with very wealthy clients to fund a grantor trust for descendants, (3) to achieve stepped up basis flexibility, (4) state death tax planning, (5) for a small nonmarital share, (6) to avoid funding the nonmarital share with IRD assets, or (7) for older couples without children.[143] Portability must be elected by filing a Form 706 estate tax return for the deceased spouse.[144]

F. Estate and Gift Tax Considerations - When Do You Need to File Form 706?

Form 1041 (fiduciary income taxes) is distinct from Form 706 (estate taxes) and Form 709 (gift taxes). Form 706 needs to be filed if (1) estate tax is owed or (2) the surviving spouse elects portability. And Form 709 needs to be filed if the decedent made a gift to a family member or friend of more than annual exclusion amount or beyond the lifetime gift tax exemption, or non-exempt generation skipping gifts.[145] Inheritance taxes are paid by the donor, not the recipient.

Estate Tax

America's estate tax celebrates its centennial this year, having debuted in 1916 to help "finance" World War I (and like the Great War's profound legacy) stayed "when the

[138] Blattmachr,"Portability or No," 234-236.
[139] *Id*., 236.
[140] *Id*., 238-240.
[141] *Id*., 239.
[142] *Id*., 240.
[143] Blattmachr,"Portability or No," 241-242.
[144] Code §2010(c)(5).
[145] Code §§2503(b) and 2505(a).

fighting stopped."[146] Estate taxes are owed when a person dies with a gross estate that exceeds the estate tax's lifetime threshold.[147] For 2016, the first $5.45 million is exempt from estate tax; for 2015, $5.43 million; and for 2014, $5.34 million.[148] The estate tax is 40% of the amount the gross estate is over the threshold. The estate tax is reported on Form 706 and computed by subtracting deductions from the gross estate.[149]

Form 706 includes various schedules depending on a case's facts.[150] The Form 706 estate tax is filed in person at the local IRS office or by mail in Cincinnati, Ohio, but cannot be efiled.[151] Late filing penalties for a Form 706 estate tax return can be substantial.[152]

Estate beneficiaries receive a stepped up basis in each asset.[153] A protective special use valuation election is available.[154] No payment extension is available.[155] Estate tax liens may be imposed if the full tax owed is not paid promptly.[156] The marital deduction and charitable deduction are powerful tools to reduce estate tax owed.[157] The Form 706 estate tax return is due within 9 months after the decedent's date of death.[158] A sample cover letter and required documents checklist should be consulted.[159]

Federal Estate Tax and Allocating Deductions

If the federal estate tax is owed, Form 706 deductions should be taken first, as the federal estate tax is up to 40% of the estate's value. Second, Form 1041 deductions would be taken, since the estate income tax rate reaches the highest individual tax rate at $12,400 of income. Third, the final 1040 deductions would be taken, since the individual tax rate applies to an estate.[160]

If the federal estate tax is not owed (and regardless of portability), Form 1041 deductions would be taken first, since the estate's income tax rate equals the highest individual tax rate at $12,400 income, and second, the final Form 1040 deductions would be taken, since the individual tax rate applies to an estate.[161]

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[146] Sitkoff, "Trusts & Estates: Implementing Freedom of Disposition," 58 SLU L. J. 643, 668 (2014).
[147] Code §§2033-2044; *Kansas Probate*, §5.14; *Estate Planning* §2.13.
[148] Rev. Proc 2015-53; Rev. Proc. 2014-61; Rev. Proc. 2013-35.
[149] Code §§2001(b), 2051, 2053-2058. Form 706 instructions; *Wills*, §15.3; *Kansas Probate*, §5.1.5(a). A prior transfer credit is allowed against the estate tax (Code §2013). *Estate Tax*, §§2.3-2.4.
[150] Schedules B, C, D, E, F, G, H, I, J, K, L, M, O, P, Q, R, and U. *Estate Tax*, Chs. 10-26.
[151] *Estate Tax*, §5.2.
[152] *Estate Tax*, §§5.6, 5.8, Ch. 27. *Circular 230*, §3:2.2.
[153] Code §1014; *Estate Planning* §2.15.
[154] *Kansas Probate*, §5.1.4(c)(3). Valuation disputes trigger estate tax audits. *Estate Tax,* §4.6, Ch. 9.
[155] Code §§6151(a), 6311; Reg. §301.6311-2; *Kansas Probate*, §5.1.5(d).
[156] Code §§6321, 6323; *Kansas Probate*, §5.1.2.
[157] Code §2056, 2055(a); *Kansas Probate*, §§5.1.3(b), (d).
[158] Code §6075(a); Reg. §20.6075-1.
[159] Reg. §20.6016-4; *Kansas Probate*, §§5.1.5(b), (c).
[160] *Estate Planning*, §12.11.
[161] *Estate Planning*, §12.12.

Gift Tax
America's gift tax was added to the IRS Code in 1932, and linked with the estate tax.[162] A gift occurs when one person transfers an asset to someone else in exchange for less than the asset's fair market value.[163] Depending on the amount involved and the timing, gift tax could be owed.[164] If gift tax is owed, it is up to a 40% federal gift tax on any gift over the annual exclusion amount ($14,000 per recipient) or the lifetime exclusion amount ($5.45 million in 2016, $5.43 million in 2015, or $5.34 million in 2014), along with filing a Form 709 to report the gift's taxable portion.[165]

Gift tax is paid by the donor, not the recipient. A gift recipient receives the donor's carryover basis.[166] If the gift donor is married and the donor's spouse co-owns the property, the donor and spouse could elect to gift split and give $28,000 tax free to the recipient.[167] The gift splitting election is made by checking a box on Form 709 and filing Form 709, even where no gift tax is owed.[168]

G. Coordinating with Decedent's Accounting or Investment Advisors

Tax planning is vital for entrepreneurs, business owners, and many clients. But Circular 230 can make navigating the IRS Code or counselling a fiduciary to do so seem daunting. If you advise clients on tax matters, when the IRS does an audit or asks questions, the client will rely on the attorney's advice. Will your tax advice stand up to an IRS audit or Tax Court scrutiny? If not, avoid tax law and defer to tax experts. Circular 230's Section 10.37 allows an advisor's reasonable and good faith reliance on other advisors.[169]

While attorneys and financial advisors need to understand the broad contours of their clients' taxes, the best practice is to have accountants or other tax professionals do a client's tax preparation work. Many attorneys and financial advisors do not have accounting or tax backgrounds. Preparing a client's taxes or giving financial advice when one is only qualified to practice law may be detrimental to a client, reflect poorly on the law firm, or give rise to malpractice or other legal or ethical claims. Thus coordinating with the decedent's accounting or financial advisors is paramount for an attorney.

A brief tour of Circular 230 is helpful for coordinating with the decedent's accountant and investment advisors. Circular 230 began in 1921 to regulate tax practice before the IRS.[170] Circular 230 is complex: we briefly look at four highlights from the latest

[162] Pub. 559, pp. 24-27. Attorney and Iowa Congressman C. William Ramseyer (1875-1943) designed the estate and gift taxes. Soled et al., "Asset Preservation," 72 Wash. & Lee L. Rev. 257 (2015); Cooper, "Ghosts of 1932," 9 Fla. Tax. Rev. 875 (2010); Sitkoff, "Trusts & Estates,"58 SLU L. J. 643, 668 (2014).
[163] Code §§2503(b), 2505(a), 2511(a); Reg. §§25.2511-1(a), (c).
[164] *Estate Tax*, Ch. 6; *Circular 230*, §3:2.3.
[165] Rev. Proc 2015-53; Rev. Proc. 2014-61; Rev. Proc. 2013-35.
[166] Code §1015; *Estate Planning*, §2.4.5.
[167] Code §2513; *Estate Planning*, §2.7.
[168] *Estate Planning*, §§2.10, 2.10.4; *Estate Tax,* §6.2.6.
[169] *Circular 230,* §2:3.2[A].
[170] *Circular 230,* §4:5.

revision.[171] First, covered opinions, second, written tax advice, third, competence, and fourth, compliance.

- *Covered Opinions*

The covered opinion rules (Section 10.35) are repealed.[172] The covered opinion rules led many accountants and attorneys to include a Circular 230 disclaimer in emails, letters, websites, papers, or blogs. Repealing the covered opinion rules means no opt out disclaimer is needed.

- *Written Tax Advice*

The IRS gives and the IRS takes away. Section 10.37 now covers written tax advice, including emails and texts.[173] Any written tax advice must: (1) be based on reasonable factual and legal assumptions, (2) reasonably consider relevant facts the practitioner knows or reasonably should know, (3) use reasonable efforts to identify relevant facts to written advice, (4) not rely on any unreasonable representations, statements, findings, or agreements, (5) relate the law to the facts, and (6) not assume a tax return will not be audited.[174] Federal tax matters are defined broadly. Section 10.37 does not require auditing or verifying information from clients or third parties, unless the information looks unreasonable.

Circular 230's preamble allows a tax practitioner to look at (1) the engagement's scope, (2) the advice type and specificity the client wants, (3) and other facts and circumstances for what must be included in client communications. Circular 230 keeps Section 10.34(b)'s standard for tax return positions.[175]

- *Competence*

Circular 230 follows the states' lead in adopting competence rules. Section 10.35 says each tax practitioner must be competent to work on taxes.[176]

- *Compliance*

Circular 230 now extends the compliance rules (Section 10.36) to "all matters" under Circular 230.[177]

The other side of the coordination coin is being sure the decedent's accounting or investment advisors are not practicing law without a license. Kansas and Missouri do not define "practicing law," but practicing law has traditionally been understood to include court appearances. An accountant or a financial advisor cannot represent a client in probate court or in probate or trust litigation. May an accountant or financial advisor draft a will, establish a trust, or start a corporation or LLC for a client? This is less clear legally, but the prudent reply is "no."

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[171] Circular 230 (http://www.irs.gov/pub/irs-pdf/pcir230.pdf).
[172] *Circular 230,* §4:15.
[173] *Circular 230,* §4:14.
[174] *Circular 230,* §4:14.1.
[175] *Circular 230,* §4:13.
[176] *Circular 230,* §4:15.9.
[177] *Circular 230,* §4:17.

Some professionals want to keep all the advisory roles "in house" or offer comprehensive, holistic services to clients. This instinct is fine, but the client's best interest must be the lodestar. While it could be advantageous or in the client's best interest to have the attorney also be the CPA and the financial advisor, most professionals and most firms do not have the expertise or competence to do so. If you or your firm has the expertise to do various accounting and investment advisory services "in house," that may be an attractive option for clients, but the various parts in your firm's apparatus may also create conflicts of interest. Attorneys and accountants each have confidentiality rights in work papers and may take a lien in client's property for unpaid bills.

Working with the client's existing professionals will (1) reduce client friction or anxiety, (2) potentially reduce bills, (3) bolster professional relationships, good will, and referral opportunities among advisors, (4) limit liability and mitigate risk of malpractice or client complaints, and (5) best comply with law and ethical standards which apply to the various professions. Kansas and Missouri regulate attorneys, accountants, financial advisors, funeral directors, real estate agents, and local banks.

By coordinating with the decedent's accounting or financial advisors, we best serve our clients, promote a collegial professional and advisory community, and encourage referrals and the advancement of the state of the art in our respective professions.

Strong client relationships and healthy working relationships with outside advisors often yield long term client relationships and business success, which may include working with wealthy families or multi-generational businesses to build a lasting legacy in the community. What if a family with multi-generational wealth or business interests wants to leave a legacy for generations to come with dynasty trusts or skip an already affluent generation and transfer wealth to grandchildren or great grandchildren? Potentially complex generation skipping transfer tax issues arise, which we will now explore.

H. GST Tax Implications

Generation Skipping Transfer (GST) Tax[178]

The GST tax was enacted in 1986 to limit "great accumulations of wealth" in America to a "reasonable inheritance."[179] The GST tax is triggered by a transfer from generation one (a grandparent) to generation three (a grandchild), where generation two (the child - the grandchild's parent) is skipped.[180] GST taxes are reported on Form 709, but the GST "is the only transfer tax" often "assessed many years after the transfer."[181] For 2016, the first $5.45 million of GST is exempt, for 2015, $5.43 million, and for 2014, $5.34 million.[182]

[178] *Estate Tax*, Ch. 25.

[179] Sitkoff, "Trusts & Estates," 58 SLU L. J. 643, 668 (2014) (quoting FDR's 1935 statement: "The desire to provide security for one's self and one's family is natural and wholesome," but best "served by a reasonable inheritance. Great accumulations of wealth cannot be justified on the basis of personal and family security"); GST history (https://www.naepc.org/journal/issue01f.pdf).

[180] Code §§2601-2663. *Wills,* §15.4; Harrington, *Generation-Skipping Transfer Tax* (Bloomberg BNA Tax, 850-2nd, 2014); *Kansas Probate*, §5.18; Abendroth, "GST Tax," 2015 KCEPS.

[181] Abendroth, "GST Tax," 127.

[182] Rev. Proc 2015-53; Rev. Proc. 2014-61; Rev. Proc. 2013-35; *Estate Planning*, §2.27.

The GST design is often used in wealthy families to transfer monies from one generation to another when the middle generation (children) is already wealthy and does not want the older generation's (grandparents) inheritance, so the inheritance skips to the younger generation (grandchildren). The child whose generation is skipped over is called a "skip person."[183] In a wealthy family, each spouse's GST exemption should be carefully allocated.[184] The GST tax is triggered by: (1) a taxable termination, (2) a taxable distribution, or (3) a direct skip.[185] A taxable termination happens when a trust interest ends (by death, time lapse, or release of power of appointment), causing a skip person to receive the trust interest.[186] A taxable distribution happens when trust income or principal are distributed to a skip person other than by a taxable termination (e.g. a normal trust distribution to a skip person).[187] A direct skip is a property transfer subject to the estate or gift tax which is made to a skip person, such as a grandparent giving a grandchild property taxable by the estate and/or gift taxes.[188] The GST also has exclusions and exemptions.[189] The GST tax rate is the maximum estate tax rate (currently 40%) times the GST inclusion ratio.[190]

The Form 709 GST tax return must be filed by the responsible party.[191] GST tax triggered by a direct skip (not in a trust) is due when the estate or gift tax returns are due.[192] All other GST tax returns are due by the 15th day of the 4th month of the tax year close for the return year – usually April 15 after the GST triggering event.[193]

GST and Income Taxes

Where GST is due, two possible income tax deductions are available. First, where GST tax is owed from a taxable termination or a direct skip, an income tax deduction is allowed for GST taxes paid.[194] Second, if GST taxes arise on income distributions, an income tax deduction can apply.[195]

I. Handling Common Property Tax Issues

Kansas

On January 29, 1861, Kansas became the 34th state admitted to the Union. Kansas has had property taxes for many years.[196] Kansas' Department of Revenue's website has this FAQ on Kansas property taxes, and Johnson County, Kansas has this property tax

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183 Code §2613(a); *Kansas Probate*, §5.1.8(c)(4).
184 *Estate Planning*, §§2.29, 2.41.
185 *Estate Planning*, §§2.24 – 2.41.9.
186 Code §2612(a); Regs. §§26.2612-1(b), (d), 26.2651-1; *Kansas Probate*, §5.1.8(d); *Estate Planning*, §§2.25.2, 2.32.3.
187 Code §2612(b); Reg. §26.2612-1(c); *Kansas Probate*, §5.1.8(e); *Estate Planning*, §§2.25.3, 2.32.2.
188 Code §2612(c); Reg. §26.2612-1(a); *Kansas Probate*, §5.1.8(f); *Estate Planning*, §§2.32.1, 2.38.1.
189 Code §§2611(b), 2642(c); *Kansas Probate*, §5.1.8(g); *Estate Planning*, §2.30.
190 Code §§2641, 2642(a); *Kansas Probate*, §5.1.8(c)(5).
191 Code §2662(a)(1); Reg. §26.2662-1(c); *Estate Planning*, §2.38.
192 Code §2662(a)(2)(A); *Estate Planning*, §2.39.
193 Code §2662(a)(2)(B); *Circular 230*, §3:2.2[A].
194 Code §691(c)(3); *Income Tax*, §2:3.6.
195 Code §164(a)(4), (b)(4); *Income Tax*, §2:3.6.
196 K.S.A. §§79-101 et seq.

website.[197] Kansas property taxes are based on an annual valuation by the county appraiser in each of Kansas' 105 counties. Kansas property taxes are used to fund city and county governments, for roads, parks, fire protection, police protection, public schools and other local services.

All Kansas property "not expressly exempt" is taxed in Kansas.[198] Kansas "real property" is "listed, valued, returned, and equalized."[199] Each county clerk maintains all real estate assessment rolls.[200] Each county's appraiser has a duty "from actual view and inspection" and other information "within the appraiser's reach" to decide "the fair market value" of all real property within the county.[201] Property tax assessment and collection is administrative, not judicial, so absent fraud (or oppressive, arbitrary, or capricious conduct amounting to fraud), courts will not overrule the county appraisal and tax assessment.[202] Buildings or other improvements on land are similarly assessed and taxed.[203] Kansas surface and mineral rights are taxed separately.[204] When multiple people own Kansas land, they are "assessed jointly," and if one owner pays "the whole tax" or "redeem[s] the whole tract" from delinquent tax bills, the paying owner has a lien on the delinquent owner's share.[205] A "forced sale" or "auction" price indicates fair market value if those match a sale as "an arms length transaction between a willing buyer and seller."[206] Agricultural land is valued under different rules.[207]

Kansas law has property tax rates and defines fair market value.[208] Appraisals, including for *ad valorem* taxes, must be written and according to "generally accepted appraisal standards."[209] The appraiser has a duty to appraise property annually.[210] Real estate is classified in 7 categories as part of the appraisal process.[211] The appraiser must "actually view" "and inspect" "every parcel" of land every 6 years."[212] These valuations are at fair market value.[213] Agricultural land is land "devoted to the production of plants, animals or horticultural products" and now excludes lands "used for recreational purposes."[214] So land with a tree canopy but no agricultural or livestock use is now recreational use land. Taxpayers who own agricultural land pay a lower property tax rate than taxpayers who own recreational land.

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[197] http://www.ksrevenue.org/pdf/pvdhomeowner.pdf; http://www.jocogov.org/dept/treasury-and-financial-management/real-estate-and-personal-property-tax
[198] K.S.A. §79-101.
[199] K.S.A. §79-401.
[200] K.S.A. §79-408 (West Supp. 2015).
[201] K.S.A. §§79-411, -501.
[202] K.S.A. §79-411; *Cities Service Oil Co. v. Murphy*, 202 Kan. 282 (1968).
[203] KS Const. Art. 11, §1; K.S.A. §79-412; *Appeal of Andrews*, 18 Kan.App.2d 311 (1993).
[204] K.S.A. §79-420.
[205] K.S.A. §79-426.
[206] K.S.A. §79-501.
[207] K.S.A. §§79-501, -1476.
[208] K.S.A. §79-503a (West Supp, 2015).
[209] K.S.A. §§79-505(a)(1), (2) (West Supp. 2015), 79-504(b).
[210] K.S.A. §79-1455.
[211] K.S.A. §§79-1439(a), (b)(1)(A)-(G) (West Supp. 2015).
[212] K.S.A. §79-1476 (West Supp. 2015).
[213] K.S.A. §79-1476 (West Supp. 2015).
[214] K.S.A. §79-1476 (West Supp. 2015).

The Kansas director of property valuation supervises county assessors in the "due performance" of "their duties."[215] The property valuation director has supervisory tax authority in Kansas.[216] The property valuation director can "review any valuation change" in a county and submit "all necessary interrogatories and questions" to the taxpayer and local county officials.[217] The state's board of equalization equalizes tax valuation and assessment across Kansas.[218]

Appeal

A taxpayer can pay property taxes under protest while appealing the county's valuation.
A Kansas taxpayer has 30 days to "complain or appeal to the county appraiser" after the valuation notice's mailing.[219] The county appraiser has "an informal meeting with the aggrieved taxpayer," where the appraiser has the "duty" to show evidence "to substantiate the valuation."[220] The appraisal is presumed to be "valid and correct," rebuttable "by a preponderance of the evidence," unless the taxpayer offers "a complete income and expense statement for the property" for the past 3 years within 30 calendar days after the informal meeting.[221]

A formal appeal from the informal meeting with the county appraiser is heard by the state board of tax appeals with a "time and place for a hearing" set within 5 days of the appeal's receipt.[222]

Upon paying taxes, the taxpayer is entitled to a receipt.[223] Kansas law details the tax due date.[224] A Kansas taxpayer may pay taxes under protest and appeal the appraisal or taxes due.[225] A taxpayer may partially pay a delinquent tax bill.[226] Kansas may sell a taxpayer's real estate to pay their overdue tax bill and real estate listing and notice rules apply.[227] Notice of the sale is to be published in a "county newspaper" once a week for 3 consecutive weeks immediately before the week when the sale occurs."[228] An affidavit of publication is filed and the county treasurer sells the property.[229] Taxpayers have a right of redemption.[230]

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[215] K.SA. §79-1401.
[216] K.S.A. §§79-1402, -1404.
[217] K.S.A. §§79-1404a (West Supp. 2015), -1408.
[218] K.S.A. §79-1409 (West Supp. 2015).
[219] K.S.A. §79-1408 (West Supp. 2015).
[220] K.S.A. §79-1408 (West Supp. 2015).
[221] K.S.A. §79-1408 (West Supp. 2015).
[222] K.S.A. §§79-1476 (West Supp. 2015), -1481 (West Supp. 2015).
[223] K.S.A. §79-2002.
[224] K.S.A. §79-2004 (West Supp. 2015).
[225] K.S.A. §79-2005 (West Supp. 2015).
[226] K.S.A. §79-2034 (West Supp. 2015).
[227] K.S.A. §§79-2301 (West Supp. 2015); -2302 (West Supp. 2015).
[228] K.S.A. §79-2303.
[229] K.S.A. §79-2306.
[230] K.S.A. §§79-2401a, -2403.

Missouri

On August 10, 1821, Missouri became the 24th state admitted to the Union. Missouri has had property taxes for many years.[231] Missouri law governs property taxes.[232] Missouri defines the relevant terms, including "real property."[233] Missouri real property is "class one" for taxes.[234] Missouri distinguishes "residential property" from "agricultural and horticultural property," among other distinctions.[235] Missouri "agricultural and horticultural property" is assessed for the "true value in money," which is "its fair market value."[236] Missouri counties have prescribed taxing authority.[237]

Missouri "real property" is "liable for taxes," assessed annually.[238] In Missouri, a "county assessor" shall consider prior "decisions" affecting land value *and* "market conditions" (e.g. foreclosure and bank sales).[239] Missouri real property "subclasses" are taxed at 19%, 12%, and 32% of "true value" for subclasses (1) through (3).[240] A Missouri real property owner is due notice in person or by mail when the assessor "increase[s] the valuation."[241] A Missouri assessor's "books are open for inspection" with 2 weeks' published notice.[242]

Missouri allows appeals to the county board of equalization if a taxpayer "thinks himself aggrieved by the assessment of his property."[243] The "aggrieved" property owner files his written appeal for tax relief.[244]

Conclusion

We have surveyed the tax landscape that impacts probate law. Regardless of an estate's size, tax planning is vital for the fiduciary to satisfy the estate (or beneficiary's) best interests. Portability, various other tax elections, and allocating different credits and deductions could be appropriate or tax efficient for some clients. A fiduciary should make these choices with an accountant and attorney to optimize taxes.

A tax idea could be a once in lifetime chance, like withering blades of grass or falling flower petals in the brief, fading sunset, leaving but memories as the seasons change.[245] We serve clients by seizing beneficial opportunities, since as Rudyard Kipling wrote, these moments of possibility "vanish at the morning's breath!"[246]

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231 V.A.M.S. §§137.010 *et seq*.
232 V.A.M.S. §§137.010 et seq.
233 V.A.M.S. §137.010(4) (West 2015 Supp.).
234 V.A.M.S. §137.015.
235 V.A.M.S. §§137.016.1(1), (2) (West 2015 Supp.); Mo. Const., Art X, §4(b).
236 V.A.M.S. §§137.017.1, .4.
237 V.A.M.S. §137.035.
238 V.A.M.S. §§137.075; 137.080; 137.115.1 (West 2015 Supp.).
239 V.A.M.S. §137.076 (West 2015 Supp.).
240 V.A.M.S. §§137.016 (West 2015 Supp.), 137.115.5(1)-(3) (West 2015 Supp.); Mo Const., Art. X, §4(b).
241 V.A.M.S. §137.180.1 (West 2015 Supp.).
242 V.A.M.S. §137.512.
243 V.A.M.S. §137.275.
244 V.A.M.S. §137.385.
245 *Isaiah* 40.8 and *Ecclesiastes* 3.1-8; Walt Whitman, *Leaves of Grass*.
246 Rudyard Kipling, "Possibilities," *Complete Verse* (Doubleday, 1989), 44. Kipling (1865-1936) was England's first Nobel Laureate (1907) and the youngest Literature Laureate.