# **Advanced Planning Ideas**

## I. Grantor Retained Annuity Trust

a. *Client and Asset Composition.* Most applicable to taxpayers
   i. With complex planning needs; and
   ii. In a low-interest rate environment.

Despite the risks outlined below, the GRAT is a good strategy for estates with portfolios of assets. There is no gain or loss on transfer to GRAT; therefore, no income or gift and estate tax issue. Payment of the annuity to the grantor generates no tax liability. Trusts generate income and capital gains, which are paid by the grantor for income tax purposes. As a low risk option, it can benefit a person who has already used lifetime gift exemption.

b. *Strategy:* The Grantor Retained Annuity Trust ("GRAT") strategy is built around the understanding that the Code recognizes independent tax values for different types of economic interests.
   i. Under §2702, the grantor transfers property to a trust and retains an annuity, expressed either as a fixed dollar amount or percentage of the FMV of transferred property.
   ii. The transfer is limited to a specified time frame, expressed either as a term of years, the life of the grantor, or the shorter of the two.
   iii. The annuity must be paid at least annually, and payment of the annuity may not be contingent on the income of the trust.
   iv. Annuity payments must be funded out of trust principal, and notes, other debt instruments, options or other similar arrangements to pay the annuity are disallowed.
   v. No additional property may be contributed until the annuity term ends and no payments may be made to any person other than the grantor.
   vi. It is also important to avoid splitting gifts when establishing the trust. In a community property state (e.g. Washington or California), if the grantor dies during the term and the property reverts to the estate, the spouse's half-share is completely wasted.
   vii. At the end of the annuity term, all remaining property is transferred to the designated beneficiaries with no further gift tax consequences.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

c. *Valuation:*
    i. The valuation of the annuity is based on the size of the designated annuity payment and the annuity tables under §7520 (based on an interest rate equal to 120% of the applicable Federal midterm rate).
    ii. The value of the remainder component is the excess of the value of the property transferred to the trust less the value of the annuity component.
    iii. At the time the trust is created, the donor is deemed to have made a gift equal to only the value of the remainder component.

d. *Zero-out Strategy*: The annuity is structured so it nearly equals the value of the contributed property, leaving the remainder component with little or no value.
    i. Payment of the annuity to the donor (or donor's estate) is structured for the designated term and the annuity payments are set high enough to create the desired annuity value.
    ii. A short annuity term (minimum = two years) minimizes the mortality risk.
    iii. The short-term annuity can be paired with a "rolling GRAT plan" that, over a 10-year period, will almost always outperform a single GRAT.

e. *Risks:* The GRAT is subject to two potentially damaging risks.
    i. First, a mortality risk destroys all tax objectives if the grantor dies before the end of the designated annuity term, leaving the entire value of the property subject to estate taxes in the grantor's estate under §2036(a).
    ii. Second, the yield risk could result in no net transfer tax benefit if the yield on the property held in trust (including its growth in value) during the annuity term does not exceed §7520 rate.

f. *Pairing with other Strategies:* Gifts of family limited partnerships (FLPs) and family limited liability corporations (FLLCs) assets to the GRAT can significantly decrease the size of the grantor's estate.
    i. The transfer of assets to an entity arrangement facilitates discounted giving. The transfer of assets to an entity via FLP/FLLC units can maximize the donor's annual exclusion amount.
    ii. At the time of the grantor's death, the value of the entity is reduced by way of the minority and lack of marketability discounts, thereby reducing the size of her taxable estate.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

II. Qualified Personal Residence Trust

a. *Client and Asset Composition.* Most applicable to taxpayers
    i. With estates in excess of the applicable state exclusion (Oregon = $1 million and Washington = $2 million);
    ii. Who could make greater use of their gift tax exemption;
    iii. With either a primary residence or a second home
    iv. In a high-interest rate environment

b. *Strategy:* The QPRT strategy allows the grantor to give a personal residence in trust and retain the right to reside in the residence for a defined term.
    i. Specifically permitted under §2702, the QPRT resembles the arrangement of the GRAT, and capitalizes on the two components of real estate –
        1. the fair market value (FMV) of the current right to reside in the real estate; and
        2. the corpus (principal value) of the asset.
    ii. Following expiration of the term, the grantors lease back the property from the trust beneficiaries, thereby providing another vehicle for transfer of assets to the next generation.

c. *Requirements:*
    i. The res of the trust must be a "personal residence," which can be the primary residence of the grantor or a vacation home used by the taxpayer more than the greater of 14 days or 10 percent of the number of days it was rented during the taxable year.
    ii. The trust must distribute any trust income on at least an annual basis and cannot distribute the principal to any beneficiary other than the grantor for the term of the trust.
    iii. The trust cannot hold any property other than the personal residence.
    iv. Any excess additions of cash to the trust must be used solely for trust administration and property maintenance and distributed quarterly and upon termination of the trust.
    v. The QPRT is terminated in the case the property is no longer used as a personal residence or upon sale of the property.
    vi. The trust is prohibited from selling the property to the grantor, grantor's spouse or any other related entity during or at any time after the term expires. Thus, the QPRT results in permanent transfer of property.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

d. *Valuation.* The FMV of the real estate is valued based on the §7520 rate (125% of the federal mid-term rate) as of the month the trust is created.
   i. QPRT rules overvalue the income value of the trust and homes to not typically rent for the amount determined under this rate.
   ii. The rules contain a built-in assumption that the home does not appreciate, which undervalues the true principal value of the trust.
   *iii.* The QPRT formula subtracts the FMV from the value of the principal and gives away the remainder.

e. *Variables.* Two variables affect the resulting lifetime gift.
   i. The longer the term, the greater the retained income factor and retained reversion and the smaller the gift factor.
   ii. The higher the interest rate, the higher the retained income factor and the lower the resulting gift.
   iii. The success of the strategy depends on whether or not the grantors survive the term.
   iv. If the grantor dies, the property is brought back into the estate and taxed as of the date of death, thereby unwinding the entire transaction.

III. <u>Charitable Trusts</u>

a. *Client and Asset Composition.* Most applicable to taxpayers who are -
   i. interested in instilling in descendants a sense of work ethic, community involvement and philanthropic and/or not giving descendants "too much too soon"
   ii. with appreciated assets producing low-income. If an individual owns highly appreciated assets with a low income tax basis, there is often a reluctance to sell the asset because of the capital gains tax, even if the asset is not producing significant income.
   iii. affected by increase of marginal income tax and 3.8% surtax; and
   iv. interested in avoiding income tax on IRAs and qualified retirement plan benefits.

*b. Available Tax Savings*
   i. <u>Income Tax Deduction.</u> A taxpayer is entitled to an income tax deduction for the amount of a gift to a charitable organization.



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1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

1. Maximum income tax rate of 39.6% for married taxpayers with taxable income in excess of $450,000 in 2013.[1]
    a. 33% on taxable income from $223,050 to $398,350
    b. 35% on taxable income from $398,050 to $450,000
    c. Maximum 39.5% rate imposed on single taxpayers above the $400,000 taxable income threshold
2. Surtax of 3.8% on investment income under Affordable Care Act for:
    a. Individuals with net investment income of >$200,000; or
    b. Married couples with net investment income of >$250,000.
3. Capital gain tax rates
    a. Individuals earning $200,000 to $400,000 (18.8%)
    b. Individuals earning >$400,000 and married couples earning >$450,000 (23.8%)
4. Social Security and FICA further increase maximum effective marginal income tax;
5. State income taxes imposed in Oregon and other states raise effective marginal income tax yet higher still.

ii. Estate Tax Deduction

1. Estate tax rate of 40%
2. Estate, gift, and GST exemptions of $5.43 million, indexed for inflation.

c. *Types of Charitable Organizations*

i. Public Charity[2]
ii. Private Foundation[3]
iii. Private Operating Foundation[4]
iv. Community Foundation[5]
v. Donor-Advised Funds

d. *Contribution Limits*

i. Contribution Base Limitation

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[1] I.R.C. §1
[2] I.R.C. §170(c)(2).
[3] I.R.C. §509(a).
[4] I.R.C. §4942(j).
[5] Treas. Reg. §1.170A-9(e)(10).

1. The charitable income tax deduction is limited to a percentage of the "contribution base" of the donor in the year of the gift.
2. "Contribution Base" is defined as adjusted gross income computed without net operating loss carry back.[6]
    a. Fifty-percent limitation: Gifts to public charity.[7]
    b. Thirty-percent limitation: Gifts to private foundation.[8]

ii. <u>Limitation of Gift of Capital Gain Property</u>
1. *Thirty-percent Limitation – Gifts to public charity.*
    a. Must be held for more than one year.
    b. Deduct at cost basis, rather than FMV, if held less than one year (subject to 50% AGI).
2. *Twenty-percent AGI limitation – Gifts to private foundation.*[9]
    a. Cost basis, rather than FMV, of donated property used in determining amount of income tax deduction;
    b. <u>Qualified Appreciated Stock Exception</u>:
        i. Can use FMV of "qualified appreciated stock" donated to a private foundation;
        ii. "Qualified appreciated stock" is defined as stock of a corporation for which market quotations are readily available on an established securities market. The gift cannot exceed 10% of the stock of the corporation.[10]
        iii. Stock subject to Rule 144 does not constitute "qualified appreciated stock."[11]

iii. <u>Charitable Contribution Carry Forward Provisions</u>: Excess contributions may be "carried forward" for five (5) additional taxable years. However, the carry forward provision is limited to one year following the death of the donor.

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[6] I.R.C. §170(b)(1)(F).
[7] I.R.C. §170(b)(1)(A).
[8] I.R.C. §170(b)(1)(B).
[9] I.R.C. §170(b)(1)(D).
[10] I.R.C. §170(e)(5).
[11] PLR 1999247018.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
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jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

iv. <u>3% Floor on Itemized Deductions:</u> In 2013, the 3% floor set on itemized deductions for married taxpayers in excess of adjusted gross income of $300,000 ($250,000 for single taxpayers), was reinstated.[12]
   1. The floor imposed on itemized deductions is the lesser of:
      a. Three-percent of AGI over threshold amount; or
      b. Eighty-percent of the allowable deductions.[13]
   2. The floor does not affect charitable contributions for taxpayers who otherwise have itemized deductions in excess of the 3% floor (and personal exemptions).
   3. The floor on itemized deductions was previously phased out over a five-year period beginning in 2006.

*Types of Charitable Gifts*

v. <u>Outright Gifts.</u>

vi. <u>Charitable Remainder Trusts</u>
   1. *Types:*
      a. Charitable Remainder Annuity Trust
      b. Charitable Remainder Unitrust
         i. Fixed Percentage Unitrust
         ii. Net Income Unitrust
         iii. Net Income Make-Up Unitrust
         iv. Flip Unitrust

   2. *Flexibility:*
      *a.* <u>Qualified Contingencies:</u> Annuity and unitrust payments may terminate on the occurrence of a "qualified contingency," including:
         *i.* Divorce
         *ii.* Remarriage; or
         *iii.* Other event which does not reduce the value of the remainder interest passing to charity.[14]

[12] I.R.C. §68(b).
[13] I.R.C. §68(a).
[14] I.R.C. §664(f).



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b. Right to Change Charitable Beneficiary: The donor may retain the right to change the charitable beneficiary at any time before distribution. Charitable income tax deduction may be affected if a private foundation is substituted for a private charity.[15]
c. Trustee**:** The Grantor may serve as Trustee.

3. *Requirements for Tax Deduction:* In the case the donor or other noncharitable beneficiary has also retained an interest in the property, the charitable interest must be either in the form of a guaranteed annuity, a fixed percentage (redetermined annually) of the annual trust property, or a form of net income unitrust.
   a. Guaranteed Annuity Unitrust:
      i. Fixed Dollar Amount
      ii. Formula Approach
   b. Unitrust Interest: A charitable remainder unitrust must state a fixed percentage of the annual net FMV of all trust assets as the unitrust interest. The unitrust payment must be payable at least annually for a fixed term of years (not to exceed 20 years) or until the death of an individual or the survivor of a group of individuals.

4. *Minimum Payout Rate.* The minimum annuity or unitrust payout amount must be at least five (5) percent.

5. *Maximum Unitrust Rate.* The unitrust rate of the charitable remainder unitrust cannot exceed 50%. This was designed to reduce the use of charitable remainder trust as an income tax avoidance mechanism.

6. *Computation of Value of Remainder Interest:* The actuarial value of the remainder interest projected to pass to a charitable organization following the expiration of the income interest is computed based on the following factors:
   a. Rate of return payable to the income beneficiary;
   b. "Applicable federal rate" in effect at the time of the gift; and

[15] PLR 199750061.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
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jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

*c.* Life expectancy of income beneficiary based on mortality tables.

vii. Charitable Lead Trusts
1. *Charitable Lead Annuity Trust*
2. *Charitable Lead Unitrust*

viii. Charitable Gift Annuity: A private arrangement between a donor and charitable organization under which the donor receives a fixed annuity. The charitable annuity is treated like a bargain sale under §1011(b).

ix. Pooled Income Funds: Maintained by a public charity to receive gifts of cash and marketable securities from a number of donors to be held in a single pool, with separate accounting for each donor.

IV. Family Limited Liability Companies (LLCs)

a. *Client and Asset Composition.* Most applicable to taxpayers
   i. Who are owners in a closely-held company;
   ii. Owners paying income taxes in the high(est) tax brackets;

*b. Advantages*
   i. Protect assets
   ii. Preserve control
   iii. Save taxes
   iv. Enhance performance of other planning tools (e.g. dynasty trusts, structured giving programs, etc.)
   v. Flexibility to accomplish specific, targeted objectives, including:
      1. Shifting income to other family members/next generation (e.g. maximizing use of annual gift tax exclusions and unified credits by transferring units each year to children and/or trust established for grandchildren)
      2. Maximizing wealth scattering gifting opportunities;
      3. Protecting assets from creditors; and
      4. Creating valuation discounts in the owners' estate by repackaging investment assets into discounted limited partnership interests.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

c. *Strategies:*

   i. Formation, Operation and Maintenance

      1. A written agreement among the parties governing the entity forms the Family LLC, generally formed by the first-generation;
      2. As membership units are transferred to other family members, those family members, or trusts established for the benefit of family members, become members in the FLLC;
      3. Complexity of operations depends on the flexibility of the assets held by the FLLC;
         a. For real estate or investment assets, the FLLC operations are likely minimal;
         b. As the FLLC assets increase in complexity, operations become more complex, including factors such as:
            i. Ownership of an operating business;
            ii. Employment of family members; and
            iii. Provision of special allocation benefits to certain family members.

   ii. Requirements

      1. Capital, as distinguished from personal services, must be a material income-producing factor in the FLLC.[16]
         a. Capital can be in the form of tangible or intangible assets.
         b. Income may generally be derived from investment assets or a business that requires substantial inventories or substantial investments in plant, machinery, or other equipment.[17]
      2. Entity must be structured in such a way that each member has dominion and control, a real ownership, in his or her capital interest;
      3. Donors must be adequately compensated for services rendered to the FLLC; and
      4. Operating agreement must not allocate to the done partners (e.g. children or grandchildren) an interest in the partnership's income that is greater than their respective interests in the partnership's capital.
         a. Prohibits allocations of disproportionately large shares to the donees.

   iii. Valuation Discounts

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[16] Treas. Reg. §1.704-1(e)(1)(iv).
[17] Treas. Reg. §1.704-1(e)(2)(ix).



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

1. *Lack of Control (Minority Interest) Discount*: appropriate when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of interest ownership.
2. *Lack of Marketability Discount:* reflects the reality that a willing buyer will pay less for an interest in a closely held business because there is no ready market of future buyers for the interest.
3. No family attribution in valuing the discounts.

iv. <u>Disqualified and Disfavored Assets:</u>

1. Investments that generate income based on services rendered by a family member
    a. Capital, as distinguished from personal services or labor, must be a material income-producing factor in the partnership.[18]
2. The stock of an S-Corporation, since an LLC is not a qualified shareholder of an S-Corporation.[19]
3. Property expected to depreciate.
    a. Transfer of membership interests or units to family members are sheltered from the gift tax through the use of the annual gift tax exclusion or unified credits.
    b. If the property depreciates following the transfer, the gift transfer tax benefits will have been wasted.
4. Family partnership assets expected to generate income tax losses or write-offs, since these assets will want to be retained for income tax benefits to the first-generation;
5. Real estate and other assets subject to a mortgage or other indebtedness, since the transfer may trigger creditor's rights under a due on sale clause or require special consent from the lender.

[18] I.R.C. §704(e)(1); Treas. Reg. §1.704-1(e)(1)(iv).
[19] I.R.C. §1361(b)(1)(B).



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

## Post-Mortem Planning

I. Filing Decedent's Last Income Tax Return

a. *Filing.* A final personal income tax return must be filed for the period beginning with the first day of the decedent's taxable year and ending on the day of his or her death.[20]

i. Same rates and personal exemption apply despite the shortened year;
ii. Due date is the same as if the decedent had lived through the entire taxable year;[21]
iii. If the decedent died without filing taxes for the previous year, the personal representative may need to file an income tax return for the previous calendar year;

b. *Joint Tax Returns.* Under §6013(a)(2), the personal representative may file a joint return if the surviving spouse does not remarry before the end of the year and the length of the tax year of either decedent or surviving spouse has not been shortened by reason of a change of accounting period under §443(a)(1).

i. Advantages: Favorable "split" rates apply to joint returns; lower overall income tax liability, depending on the circumstances; allows parties to take advantage to deductions attributable to a decedent's final taxable year, which do not carry over to the decedent's estate.
ii. Disadvantages: Joint and several liability attaches to the estate and the surviving spouse, which could leave the estate liable for deficiencies and penalties attributable to the negligence or misconduct of the surviving spouse.

II. Disclaimer

a. (Def.) Unequivocal refusal to accept an inheritance or gift to which the disclaimant is otherwise entitled by transfer, either lifetime or at death, or operation of law.

b. If a "qualified disclaimer" is made, the interest in the property generally passes as if the interest had never been transferred to the disclaimant.[22]

[20] I.R.C. §443(a)(2).
[21] I.R.C. §6072(a); Treas. Reg. §1.6072-1(b).
[22] I.R.C. §2518; Treas. Reg. §20.2055-2(c).



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

i. *Timing.* The deadline to make the qualified disclaimer is nine-months after either (1) the date of the transfer; or (2) the date the transferee turns 21.[23] (An extension for purposes of filing the federal estate tax return does not extend the time to make the qualified disclaimer.)
ii. *In Writing.* The disclaimer must be in writing and delivered to the person with the power to transfer the interest, including a legal representative or the person in possession.
iii. *No Acceptance of Benefits.* The disclaimant must not accept the interest disclaimed or any of its benefits.
iv. *Irrevocable & Unqualified.* The disclaimer cannot be revocable and must pass without any control or direction on the part of the disclaimant to the subsequent recipient of the interest.

c. The disclaimer is taken into account for purposes of estate tax charitable and marital deductions.[24]

d. If the disclaimer is not "qualified" under Treas. Reg. §20.2518-1(b), it is disregarded and the disclaimant is treated as having received the interest (and potentially having made a gift to the subsequent recipient of the interest).

e. Appropriate Use of a Disclaimer – The planner must learn of the client's circumstances and be aware of the impact of all of the relevant state laws.[25] Examples of appropriate circumstances could include:
   i. Charitable Planning - pass assets to charity
   ii. Marital Deduction
      1. Fund credit shelter trust
      2. Pass assets to surviving spouse
      3. Increase or decrease gifts to surviving spouse
      4. Disclaim power of appointment to qualify as a QTIP trust
      5. Equalize estates
      6. Spousal rollover of IRA assets
   iii. Skip a Generation

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[23] I.R.C. §2518(b)(2).
[24] Treas. Reg. §20.2056(d)-2(a).
[25] For example, in *Webb v. Webb,* 301 S.E.2d 570 (W.Va. 1983), a son's disclaimer of an intestate interest did not cause the disclaimed property to pass to his mother as intended. Instead, the property passed to the disclaimant's infant daughter, which was unknown to the disclaimant's counsel.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

iv. Estate Tax Credit/Exclusion Amount
    1. Pass exclusion amount to a credit shelter trust
    2. Equalize bequests passing to other beneficiaries

v. Avoid Multiple Estate Administration Proceedings and Unnecessary Taxation

vi. Medicaid Planning

vii. IRA Rollover

III. Alternate Valuation: Two timing regimes exist to value a decedent's gross estate, including:

a. Under §2031, the value of a decedent's gross estate is the fair market value of all of the decedent's property as of the date of his or her death.

b. Under the "alternate valuation method," set forth in §2032, the "value of the ross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate . . . as of the date six (6) months after the decedent's death."

*c. Election*. The election may be made on an estate tax return filed any time within one year after the time provided by law (including extensions) for filing such returns. Thus, the election can be made up to 27 months after death.[26] The election is not available if a federal estate tax return is not required.

*d. Exceptions:*

i. If the decedent's property that is distributed, sold, exchanged or otherwise disposed of within six (6) months after date of death, such property is valued as of the date of such distribution, sale, exchange or other disposition.

ii. If any interest in the decedent's estate which is affected by "mere lapse of time," such interest is valued as of the decedent's date of death with adjustments for any valuation differences not due to mere lapse of time as of the approximate alternate valuation date. Examples include:
    1. Patents
    2. Estates for the life of the person other than the decedent

[26] I.R.C. §2032(d)(2).



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

3. Remainders
4. Reversions
5. Other like properties, interests, or estates.

iii. *Deductions.* To the extent an alternate valuation is elected, deductions are not allowed with respect to an asset if such deductions are already taken into account in determining the alternate value of the asset.

iv. *Reduction of Gross Estate and Estate Tax*. The election is available only when both the values of the gross estate AND the estate tax (after allowable credits) are reduced.[27]

IV. <u>Special Use Valuation:</u> Under §2032A, estates with real estate used in a farming business or other closely-held business, if the property constitutes a substantial part of the total estate assets, provides for an alternative valuation method, which could discount the value up to $750,000 less than the property's FMV.

a. *Requirements include:*

i. Real estate must pass from the decedent to a "qualified heir"
ii. The real estate property must have been used in a family farm or family business on or in which the decedent or a family member worked ("materially participated") for five of the eight years preceding the decedent's death.
iii. The real estate property in the business or farm included in the decedent's estate has to comprise at least 50% of the gross estate AND the real property in the business or farm included in the decedent's estate has to comprise at least 25% of the gross estate. In meeting these tests, two or more qualifying businesses can be combined so long as each has real estate included in the decedent's estate.
iv. The qualified heir (transferee) must consent to remain liable to the IRS for all of the estate taxes saved if, within 10 years, the property is transferred to anyone other than a qualified heir or if the property stops being used for the qualified purpose.

[27] I.R.C. §2032(c).



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
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jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

## V. QTIP Elections

a. Section 2056(b)(7) makes the marital deduction available on an elective basis for the value of the property in which a surviving spouse receives "qualifying income interest for life," defined as:
   i. The surviving spouse is entitled to all of the income for life, payable at least annually; and
   ii. No person has a power to appoint any of the property to a person other than the surviving spouse so long as he or she lives.

b. *Irrevocable*. Once a QTIP election is made, it is irrevocable.[28]

c. *Partial QTIP Election*. The QTIP election can be made with respect to all or part of any separate property (including a trust) in which the surviving spouse as a qualifying income interest for life." Thus, an executor may be authorized to divide a trust into separate shares to reflect the effect of a partial QTIP election.

d. *Formula QTIP Election.* A fractional or formulaic approach automatically adjusts for changes in the value of assets and the allowance, or disallowance, of deductions for federal estate tax purposes.

## VI. Installment Agreement

a. If the estate is unable to pay outstanding tax liabilities, the IRS may be willing to provide an extension of time to pay Form 706 estate tax in **annual** installments.[29]
   i. Maximum amount of time for payment of deferred tax is 10 years.
   ii. The executor may select a shorter period, in which case the deferment will be the period selected.
   iii. Allows executors a 14-year period to pay estate tax attributable to an estate's interest in a closely held business.
   iv. Grants the estate a deferral period to make "interest only" payments for the first four years. The first tax payment along with interest payment is due on the 5th anniversary of the due date of the return.[30]

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[28] Treas. Reg. §20.2056-7(b)(4)(ii).
[29] IRC §6166.
[30] *See* IRM 4.25.2.1.10.



Law Office of Jonathan D. Mishkin, P.C.
1012 SW King Avenue, Suite 202
Portland, OR 97205
(P) (503) 274-7849/ (F) (503) 227-3783
jonathan@jmishkinlaw.com
http://jmishkinlaw.com/

b. *Qualifications:*

i. Decedent was a citizen or resident of the United States on the date of death.
ii. The Value of interest in closely held business must exceed 35 percent of the adjusted gross estate.
iii. The return is **timely** filed and the IRC section 6166 election request was included on the **timely** filed return or an amended return within 6 months of the **unextended** due date of the return.
iv. **Non-deferred tax** must be paid by the return due date, unless the estate has an extension of time to pay under IRC section 6161.



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