Post-Mortem Planning: A Primer

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The following information and opinions are provided courtesy of Wells Fargo Bank, N.A.
In an ideal world, all individuals would take the time to create an estate plan, ensuring their thoughts and desires are clearly spelled out, their families are well-cared for after they die, and taxes are minimized regardless of the legislative landscape. Typical estate administration can take 18 months or more to complete; however, certain decisions must be made shortly after a decedent’s death to take full advantage of tax-saving opportunities not just for the estate, but also for the beneficiaries. Regardless of the size or complexity of an estate, post-mortem planning is an essential part of estate administration. Beyond tax planning, post-mortem planning helps create a smooth transition of assets to beneficiaries, and can make up for some of the short-falls that may have occurred during lifetime planning. Effective post-mortem planning takes into consideration the uniqueness of every estate and, when possible, creates flexibility for future unforeseen events.

This paper is intended to provide insight into many of the common questions as it relates to transfer taxes (estate, inheritance, and generation-skipping transfer tax), individual income taxes, and fiduciary income taxes.

What exactly is post-mortem planning?
Post-mortem planning is simply “planning after death.” Typically, post-mortem planning involves making certain elections and other decisions to help minimize tax, and effectively move assets from the decedent’s estate to its beneficiaries. Post-mortem planning may also involve the interpretation of a decedent’s estate planning documents within the confines of federal and state law, as it existed at the time of the decedent’s death.

What are some of the common elections to help minimize federal and state estate and inheritance taxes?
First and foremost, the available techniques will depend on the estate's assets, the documents created by the decedent during his or her lifetime, and the local law at the time of death. That said, certain techniques may be considered for all taxable estates.

If the decedent was married at the time of death and a trust is created for the benefit of the surviving spouse, the assets transferred to that trust may be subject to tax, unless a qualified terminable interest property (QTIP) election is made. The election can only be made on a properly filed estate tax return.

While the QTIP election is fairly well understood and used often for married decedents, the reverse QTIP election is often underutilized. The reverse QTIP election allows the decedent’s generation-skipping transfer (GST) tax exemption amount to be used to protect assets that are held in trust for the surviving spouse from GST taxes later. Without the reverse QTIP election, the decedent’s unused GST exemption amount may be wasted and assets needlessly subjected to GST taxes down the road.

When markets are volatile and asset values decrease after a decedent’s death, the “alternate valuation date” value election may be used to lower the estate taxes due. Generally, the value is measured six months after date of death, or sooner if the asset was disposed of prior to this six-months mark. For decedents who died in the early half of 2008 (prior to the big stock market crash), the alternate valuation date election resulted in millions of dollars of tax savings for the estates.

What if the estate is illiquid and doesn’t have the cash to pay the estate tax?
If an estate does not have the funds available to pay estate taxes on a timely basis, the executor may request an extension of time to pay the taxes under Internal Revenue Code (IRC) Section 6161. If approved, the tax may be paid in installments over a period of up to 10 years with a favorable interest rate. Only the interest would be due for the first four years, extending the total time allotted to pay taxes to 14 years.

Under IRC Section 6166, if an interest in one or more closely held businesses exceeds 35 percent of the adjusted gross estate, and the decedent was a U.S. citizen at death, estate taxes attributable to the closely held business may also be deferred over 14 years. For 2013, the interest rate on the deferred tax is two percent of the tax attributable to the first $1,430,000 of the decedent’s estate. Recently, the IRS has begun requiring estates to bond for the outstanding liability, and has been more aggressive in applying liens against estate assets to ensure the tax obligation is eventually met.
This new requirement has made the technique more expensive for business owners; therefore, care should be taken to analyze the likelihood of being able to pay the tax in the agreed upon installments, lest the estate wants to potentially jeopardize the estate assets.

For high value estates that include successful closely held businesses, it is not uncommon for the closely held business to be “cash rich,” while the estate is “cash poor.” In this case, a special technique using a “Graegin note” may allow the estate to borrow from the closely held business to pay the taxes. If structured correctly, the full amount of the interest payable over the life of the loan may be deductible by the estate on the estate tax return.

**If the estate will not owe any federal estate tax, is post-mortem planning necessary?**

Yes; in fact, sometimes, the most effective planning is for those estates that will not owe any transfer taxes. And it is important to remember that 23 states and the District of Columbia currently levy their own estate or inheritance tax (sometimes both) at various threshold levels. For example, suppose a married decedent dies in 2013 with a $3 million estate. The 2013 federal estate tax exemption amount for decedents is $5,250,000. The portability election can be made to “port” the unused $2.25 million [$5.25 million minus $3 million] exemption amount to the surviving spouse. Assuming the surviving spouse does not remarry, he or she can gift the full $2.25 million to whomever he or she wishes during her life without utilizing any portion of his or her own exemption amount. If the surviving spouse doesn’t use it during his or her life, the executor of the estate can add the decedent’s unused exemption amount to the surviving spouse’s exemption amount to protect the combined amount from federal estate taxes. The election must be made within nine months after the first spouse’s death; otherwise, the $2.25 million exemption is lost forever.

**What if a beneficiary doesn’t want or need the assets of the estate?**

For a variety of reasons, beneficiaries may not want to accept assets that are being left to them from the estate. If the estate transfers the assets to the beneficiary and the beneficiary then gifts the assets, the beneficiary may need to pay gift taxes or use his or her own exemption amount to protect the gift from taxes.

The beneficiary may also choose to disclaim the assets, so they “bypass” the beneficiary altogether. “Qualified” disclaimers must be made in writing within nine months after the qualifying transfer, and the beneficiary must not have received any benefit from the disclaimed asset. If those requirements are met, the asset will be distributed to the successor beneficiary according to the terms of the document (or state law, if the document is silent).

Disclaimers are also a useful technique when estate planning documents were drafted prior to a change in tax law, and the documents did not provide any flexibility for such a change. For example, suppose a decedent dies in 2013 with a $10 million estate, and the document calls for the funding of a credit shelter trust in the amount of $3.5 million, with the remaining amount funding a marital trust. If the decedent dies without utilizing any of the federal exemption, $1.75 million [$5.25 million minus $3.5 million] of the decedent’s exemption amount is “wasted,” and may be subject to transfer taxes at the time of the surviving spouse’s death. With a qualified disclaimer, the full exemption amount ($5.25 million) may be passed on to the intended beneficiaries, free of transfer taxes.

**If no estate or inheritance taxes are due, do I need to be concerned about GST taxes?**

Although GST taxes are an additional “arm” in the transfer tax trifecta, they are often ignored during lifetime planning, largely because of the complexity of the law; even the most experienced estate planning attorneys and CPAs can sometimes misunderstand the application of the law.

One of the most common errors around GST taxes involves irrevocable life insurance trusts (ILITs). Most estate planning attorneys and their clients understand that if life insurance is placed in an ILIT and certain other requirements are met, the face value of the policy will not be includable in the gross estate upon death. However, failure to file a gift tax return in the year the policy is transferred to the trust (and every year that the individual makes contributions to the trust in order to pay the ongoing premiums) can result in unforeseen GST tax consequences during life and after death. Worse yet, failure to address the issue at death could result in dire tax consequences for the beneficiaries decades after the decedent’s death.
What are some issues to consider with regards to individual income tax returns?

1. Should a joint income tax return be filed with the surviving spouse? Would the overall tax be lower if separate returns were filed? Do the estate and surviving spouse want to accept joint and several liability for any known or unknown tax, interest, and penalties of the other party? If separate returns were filed in a prior year, should an amended joint return be filed to lower the overall tax, or have the estate pay any outstanding taxes of the surviving spouse?

2. Should all previously accrued, but unreported, interest on Series E or EE bonds be recognized on the decedent's final individual income tax return? Doing so may avoid tax on the interest forever, if the decedent had enough deductions during the year to offset the interest income. Making the election may also avoid income tax consequences for the beneficiaries of the bonds, who would have to report the interest as “income in respect of the decedent.”

3. If a charity is named as a residual beneficiary, should certain assets be used to satisfy the charitable bequest in order to minimize taxes? For example, if individual retirement account (IRA) assets are distributed to an individual beneficiary, any appreciation over the decedent's basis will be recognized as ordinary income by the beneficiary at the time of distribution. If those assets are distributed to a charity instead, the charity will also recognize the assets as ordinary income; however, no taxes will be due since a qualified charity is a tax-exempt entity.

4. Should medical expenses paid after the decedent’s death be deducted on the decedent’s estate tax return or the decedent’s final individual tax return? The executor can elect to have any medical expenses paid within one year after the decedent’s death on the decedent’s final individual tax return. Furthermore, the election can be made for some or all of the expenses, so the executor can calculate the amount to be deducted on each return in order to minimize taxes.

5. Should partnership or S corporation income received after the decedent’s death be prorated on a daily basis in order to “bunch” income into the decedent’s final individual tax return? Doing so may result in being able to utilize a portion of the decedent’s carryovers (charitable, capital loss, or net operation loss) that can no longer be claimed after the final individual income tax return is filed.

What are some issues to consider with regards to the estate’s fiduciary income tax returns?

1. Should a fiscal year-end be selected for the estate? Doing so may defer the payment of income tax by the estate and recognition of income by the beneficiaries.

2. Should estate administration expenses be deducted on the estate’s fiduciary income tax return (Federal Form 1041) or the estate tax return (Federal Form 706)? For 2013, the estate tax rate is 40 percent; the fiduciary income tax rate for the highest bracket is 39.6 percent. Therefore, for estates that are expected to owe federal estate tax, it may be more advantageous to deduct administration expenses on the estate tax return. On the flip side, if no federal estate tax is due, it may be worthwhile to deduct the expenses on the fiduciary income tax returns. Keep in that mind that state taxes may also be due; therefore, a full analysis of where the deductions will bring the most benefit should be performed. Also, taking the deduction on one return vs. the other may shift the tax burden for the beneficiaries. The executor has a duty to act impartially; therefore, careful navigation of the beneficiaries’ interests must stay at the forefront of the executor’s decision-making.

3. When should fees/expenses be charged? To the extent possible, fees and expenses should only be charged when there is enough distributable net income (DNI) to offset the fees and expenses since any amount that exceeds the DNI do not carry over. In the final year of the estate, the excess fees and expenses will be passed out to the beneficiaries, which they can use as a miscellaneous deduction on their personal income tax returns.

4. Are there any considerations as to when distributions should be made to beneficiaries? Tied in with the DNI concept from above, timing of beneficiary distributions may affect when and who is taxed on the income of the estate. In some cases, taxes can be avoided altogether, either because the distribution income is connected to offsetting deductions or the differing tax brackets for the estate vs. beneficiaries. The timing of distributions has become especially critical given the Health Care and Education Reconciliation Act of 2010, which became effective on January 1, 2013, and subjects some individuals, trusts, and estates to a 3.8 percent Medicare tax on unearned income.
5. If the decedent had a qualified revocable trust, should an IRC Section 645 election be made? Generally, if the beneficiaries are the same for both the estate and the trust, the answer is yes. The intricacies of a Section 645 election are beyond the scope of this paper; however, if a Section 645 election is made to treat the qualified revocable trust as part of the estate, the two entities are treated as one, and all of the advantages of being treated as an estate are now available to the trust. Two such advantages are the ability to elect a fiscal year-end, and avoid the payment of estimated taxes for two years. Furthermore, since the two entities are treated as one for tax purposes, the deductions of one can be used to offset the income of the other.

Summary

Post-mortem planning is an essential part of estate administration, regardless of the size or complexity of the estate. A well-thought out financial and estate plan that was created during life will certainly ease the estate administration at death, but post-mortem planning “fills in the holes” and accounts for the unforeseen changes in tax legislation. Although post-mortem planning cannot necessarily turn back the hands of time to correct all of the errors from the past, remedial efforts taken shortly after death can correct some errors or at least help minimize the negative impact on the beneficiaries for years to come.
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