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Post-Mortem Elections

What are post-mortem elections?

When you die, your estate may be subject to a variety of taxes. These taxes include the federal gift and estate tax and the federal generation-skipping transfer tax (GSTT) (collectively referred to here as "estate taxes"), as well as income taxes and state death taxes.

Estate taxes are probably the largest expense your estate may incur. Therefore, it is important for you to understand the many strategies and techniques available that may help you to reduce estate taxes.

In addition, your estate is a separate taxpaying entity. Income earned by your estate is taxable to, and must be paid by, your estate, which can further erode the assets meant to pass to your beneficiaries. Thus, it is important that your personal representative understand how to minimize income taxes.

There are many techniques you can use now, while you are living, to minimize the taxable value of your estate (e.g., transferring your assets to your heirs or beneficiaries through gifting or a private annuity).

In addition to the many inter vivos techniques, there are many post-mortem (after death) techniques that can help keep the value of your estate as low as possible or reduce income tax liabilities. There are 11 post-mortem techniques in particular that you should know about. Even though these techniques are implemented by your personal representative (or others) after your death, you should understand each of them now, because if you believe your estate might benefit from them, there may be things you need to do now to ensure that your estate will qualify after your death.

What are the post-mortem elections that may minimize potential estate taxes?

Disclaimers

A disclaimer allows your beneficiaries to redistribute your property (to some extent) without incurring estate taxes on the redistribution. A disclaimer is a refusal to accept a gift, bequest, or other form of property transfer (e.g., a power of appointment). Once disclaimed, the property is then distributed to the next recipient. The disclaimant is regarded as never having received the property. As a result, no transfer of property is considered to have been made, and no estate taxes are imposed on the disclaimed portion for the disclaiming party. This allows your personal representative and/or beneficiaries to redistribute your property in a more advantageous manner. However, your representative or beneficiaries cannot direct where the property goes--it will pass according to your estate plan as if the disclaiming beneficiary predeceased you.

A disclaimer is not an election, per se, and the requirements to execute a valid disclaimer differ substantially from most other types of elections. However, if disclaimed property passes to a qualified charity, your personal representative must check the appropriate box on Schedule O of your estate tax return (Form 706).

The alternate valuation date

For estate tax purposes, the assets in your estate are generally valued on the date of your death. However, your personal representative can elect an alternate valuation date, which is either (1) six months after your date of death or (2) the date the asset is disposed of. This election can be made only if, as a result of using the alternate valuation date, (1) the value of your estate decreases and (2) your estate tax liability decreases (combined federal gift and estate tax and federal GSTT). If the alternate valuation date is elected, all property in the estate must be valued on the alternate date for both federal gift and estate tax and federal GSTT purposes.

The alternate valuation date is elected by checking a box on Form 706.

Caution: Electing the alternate valuation date may have adverse consequences for your estate (e.g., elimination of other elections or adverse income tax consequences). Before making this election, your executor should assess its impact on the beneficiary. To help your executor with the decision to make the election, you could leave specific instructions in your will or letter of instruction (e.g., make this election only if the estate tax savings flow to the beneficiary who suffers from the income tax consequences).

QTIP election

The QTIP election allows your personal representative to have all or a portion of the assets that qualify for treatment as qualified terminable interest property (QTIP) pass free from estate tax under the unlimited marital deduction. Property for which the election is made is includable in your surviving spouse's gross taxable estate for estate tax purposes. The QTIP election gives your personal representative the power to determine how much of the property will be taxed at your death and how much will be taxed at the death of your spouse.

The QTIP election is made by completing Form 706, Schedule M.

Discount for conservation easements

Your personal representative may elect to exclude from your gross taxable estate up to 40 percent of the value of land (capped at $500,000) that is subject to a qualified conservation easement. You or a member of your family must grant a permanent easement to a qualified organization. If you do not grant the easement during your life, your personal representative can make the contribution for you if given specific authorization in your will. The grant is not tax deductible as a charitable contribution on your income tax return. In addition to the exclusion of part of the value of the land subject to the easement, an estate tax charitable deduction may be available.

The discount for conservation easement election is made by completing Form 706, Schedule U.

Special use valuation

Special use valuation is a method of valuing real property (i.e., real estate) used for farming, or in a closely held or family-owned business, based on its actual use rather than its highest and best use (i.e., fair market value (FMV)). If special use valuation is elected, it must be used for both federal gift and estate tax and federal generation-skipping tax purposes.

You need to know about special use valuation because your estate must pass four tests (and satisfy certain conditions) that will be applied after your death: (1) an ownership requirement, (2) a 50 percent asset test plus a 25 percent real property test, (3) a usage requirement, and (4) a material participation requirement. In addition to your estate passing these tests, other requirements will apply after your death.

The special use valuation method is elected by checking the appropriate box on Form 706 and completing Schedule A-1.

Deferring payment of estate taxes

The Section 6166 election postpones the payment of estate taxes due on a closely held business owner's estate. This election allows the taxes due to be deferred for 5 years and then paid in annual installments over a period of up to 10 years. This allows more time to raise sufficient funds or obtain more favorable interest rates.

You need to know about deferring the payment of estate taxes because your estate must pass two tests (and satisfy certain conditions) that will be applied after your death: (1) an ownership requirement and (2) a 35 percent test. The Section 6166 election is made by checking the appropriate box on Form 706.

Valuation discounts for interests in closely held businesses

If you are an owner of a closely held business interest at the time of your death, your personal representative may elect to use certain valuation discounts, if your business interest qualifies. The two most common discounts are the minority interest discount and the lack of marketability discount. These discounts can sometimes be substantial.

How can your personal representative minimize income taxation of your estate?

Section 303 stock redemption

If you own stock in a C corporation at the time of your death, the Section 303 stock redemption election allows your personal representative to treat certain redemptions as capital transactions instead of as dividends (i.e., ordinary income) as they would normally be treated, as long as the redemptions are used to pay estate taxes, funeral expenses, or certain administrative expenses. The redeemed stock must constitute over 35 percent of the value of your gross taxable estate to qualify for this election.

Selection of fiscal year

Your estate and any trusts in your estate are separate taxpayers for federal income tax purposes. An income tax return must be filed for each taxpayer for each year in which taxable income is recognized (income over $600 per year for estates, income over $300 per year for trusts required to distribute current income, and income over $100 per year for trusts not required to distribute current income). Income earned by estates and trusts are taxed under an unfavorable tax table that very quickly reaches the highest marginal tax rate. The election of the tax year (either fiscal or calendar) for your estate allows your personal representative to divide income into as many taxable years as possible, prevent bunching of income in the first taxable year, or otherwise adopt the taxable year that results in minimizing the tax costs as much as possible.

Partnership asset basis election

The partnership asset basis election (Section 754 election) can be made after the death of one partner to step up the income tax basis of the deceased partner's share of the partnership assets from adjusted basis value to FMV (or estate tax value). This may be advantageous to the partnership for purposes of depreciation, depletion, gain or loss, and distributions. This election is made by the partnership, not the deceased partner's personal representative. However, the deceased partner's personal representative should request that the partnership make the election if it would benefit the decedent's estate.