AUGUST 1993

The Tax Magazine ™

TAXES

Published Monthly By Commerce Clearing House, Inc.

Post-Mortem Returns and Civil Tax Penalty Exposure: A Guide Through The Maze

By Louis S. Harrison and John M. Janiga

Reprinted from the August 1993 issue of TAXES, The Tax Magazine. Published and Copyrighted 1993 by Commerce Clearing House, Inc., Chicago, Illinois 60646. All rights reserved.

Post-Mortem Returns and Civil Tax Penalty Exposure: A Guide Through the Maze

Louis S. Harrison and John M. Janiga advise practitioners on the consequences of noncompliance.

Louis S. Harrison (left), practices in the area of tax and estate planning at the Chicago law firm of Lord, Bissell & Brook and is an Adjunct Professor of Law at DePaul University College of Law. John M. Janiga (right), M.B.A., CPA, J.D., LL.M., is an Assistant Professor at Loyola University, and is a consultant in the area of federal taxation.

© *1993, Louis S. Harrison and John M. Janiga*

I. Introduction

An individual's death does not terminate federal tax return filing requirements. In fact, subsequent to a decedent's death ("post-mortem") income tax returns may be required for the decedent, the decedent's estate, and certain trusts established by the decedent. In addition, required returns may include an estate tax return and a gift tax return.

The statutory, administrative, and judicial law pertinent to each of these returns is diverse and, at times, complex. Consequently, filing risk (e.g., filing a return that is not properly prepared or not timely filed) increases, as does the likelihood for imposition of civil tax penalties[1] on the taxpayer.[2]

Practitioners who engage in post-mortem return preparation need to be sensitive to the connection between improperly or untimely filed returns and the taxpayer's civil tax penalty exposure.[3]

[1] This article does not address the imposition of criminal tax penalties. For a general discussion of criminal tax penalties, see R. Olsen, CCH TAX TRANSACTIONS LIBRARY, Vol. II at ¶¶ 105-220.

[2] This article does not address penalties which may be imposed on return preparers. For a discussion of the return preparer penalties, see Gardner, Willey, and Woehlke, "The Final Return Preparer Regulations," 23 *The Tax Adviser* 208 (1992); Banoff, "Determining and Weighing Valid Legal Authority to Avoid Accuracy-Related and Preparer Penalties: The Proposed Regulations Continue the Controversy," 69 *TAXES* 259 (1991).

[3] Practitioners need to be particularly sensitive to the widespread changes to the Internal Revenue Code's penalty provisions enacted as part of the Improved Penalty Administration and Compliance Tax Act of 1989.

To the extent imposed, penalties will deplete the decedent's estate or trust assets. Moreover, such penalties may expose the practitioner to malpractice claims if the penalties are attributable to practitioner error.

This article provides guidance for minimizing a taxpayer's civil tax penalty exposure with respect to post-mortem returns. Part II identifies the most commonly filed post-mortem returns, and their respective filing thresholds and due dates. Part III then discusses typical noncompliance penalties applicable to such returns. Lastly, Part IV examines penalty issues specific to each of the returns and provides advice for addressing these issues.

II. Post-Mortem Returns: Filing Thresholds and Due Dates

The federal tax returns most commonly required post-mortem include:

(1) Income tax returns for the decedent (Form 1040);

(2) Estate tax returns (Form 706);

(3) Estate income tax returns (Form 1041);

(4) Trust income tax returns (Form 1041); and

(5) Gift tax returns (Form 709).

Whether a particular return is required depends on the facts surrounding the estate and the return filing threshold.

A. Filing Thresholds. Returns are not required unless certain threshold requirements are met. The following chart summarizes these requirements by type of return:

Return	*Federal Form*	*Threshold Requirements for Filing*
1. Federal Income Tax Return	1040	If gross income equals or exceeds: the exemption amount plus the basic standard deduction applicable to such individual plus the additional standard deduction if the individual is age 65 or older (for 1993, $900 if filing as single or head of household, $700 if filing as surviving spouse); or, if the person is entitled to file a joint return, then if gross income, combined with the spouse's gross income, equals or exceeds: twice the exemption amount plus the basic standard deduction applicable to a joint return plus the additional standard deduction for each spouse age 65 or older (for 1993, $700); or, if married but filing separately, then if gross income equals or exceeds the exemption amount. (As discussed below, a final year return should be filed in all events.) Section 6012(a).
2. Federal Estate Tax Return	706	Gross estate exceeds $600,000 (the $600,000 should be reduced by any "adjusted taxable gifts" made during lifetime after 12/31/76, and by the total "specific exemptions" allowed for gifts made between 9/8/76 and 12/31/76). Section 6018(a).
3. Estate Income Tax Return	1041	Every estate subject to administration which has gross income for the taxable year equal to or greater than $600, or which has one or more beneficiaries who are non-resident aliens. Sections 6012(a)(3) and 6012(a)(5).
4. Trust Income Tax Return	1041	Trusts having for the taxable year any taxable income, gross income of $600 or over (regardless of taxable income), or of which any beneficiary is a nonresident alien. Section 6012(a)(4-5).
5. Gift Tax Return	709	Any gift transfer other than: (1) annual exclusion gifts (i.e., gifts of present interests less than or equal to $10,000 per beneficiary) under Section 2503(b), (2) gifts for tuition or to provide medical care under Section 2503(e), or (3) outright gifts which qualify for the marital deduction under Section 2523. Section 6012. For gifts in trust that require a special election to qualify for the marital deduction, referred to as the "qualified terminable interest property election," a gift tax return must be filed. Section 2523(f)(4)(A).

B. Due Dates. After determining which tax returns must be filed, the practitioner should prepare a list of the pertinent return due dates. Based on these dates, appropriate entries to a tickler file can be made to indicate when various steps should begin or be completed.

The following chart summarizes the filing due dates (assuming no extensions) by type of return:

Return	*Federal Form*	*Return Due Date*
1. Federal Income Tax Return	1040	April 15th of the year immediately following the year of decedent's death. Section 6072(a).
2. Federal Estate Tax Return	706	Nine months after date of death. Section 6075(a).
3. Estate Income Tax Return	1041	The 15th day of the 4th month following the close of the estate's fiscal year, Section 6072(a); the fiscal year may close on the last day of any month which precedes the month which contains the beginning of the fiscal year.[4]
4. Trust Income Tax Return	1041	April 15th following the calendar year in which the trust had (1) any taxable income, (2) gross income of at least $600, or (3) a non-resident alien beneficiary (for trusts created under estate planning documents, this will generally not occur until April 15th following the year of funding). Sections 6075(a), 645(a) and 6012(a)(4-5).
5. Gift Tax Return	709	April 15th following the calendar year in which the gift was made, but in no event later than the time (including extensions) for filing the estate tax return (Form 706). Section 6075(b).

Return due dates may be extended upon request in certain cases. Extensions are limited, however, to a maximum of six months.[5]

III. Noncompliance Penalties

If a required post-mortem return is not timely filed or if tax is not timely paid, the Internal Revenue Service ("Service") may impose failure to file or failure to pay penalties. In addition, penalties may be imposed on inaccurately prepared returns and for underpayment of estimated tax.

A. Failure to File and Failure to Pay Penalties. The failure to file penalty may be imposed if a required return is not filed by the due date (including extensions). Generally, the penalty totals five percent of the tax due for each month or part of a month that the return is late, limited to a 25 percent maximum.[6] If the proper tax is paid by the required due date, even if no tax return is filed, there will be no penalty due under this general rule (e.g., 5% of the tax due, zero, is still zero).

Two exceptions modify the general rule. First, with respect to income tax returns, a minimum penalty applies. If the return is filed more than 60 days after the due date (including extensions), the penalty minimally equals the lesser of $100 or 100 percent of the tax due.[7] Second, if the failure to file is the result of fraud, the penalty totals 15 percent of the tax due for each month or part of a month that the return is late, limited to a 75 percent maximum.[8]

The failure to pay penalty may be imposed on any portion of the tax due which remains unpaid as of the return due date. Generally, the penalty totals one-half of one percent of the unpaid tax for each month or part of a month that the tax is late, limited to a 25 percent maximum.[9]

If in any month both the failure to file and failure to pay penalties apply, the failure to file penalty is reduced by the failure to pay penalty.[10] One exception: If the minimum failure to file penalty applies, there is no reduction.[11] In these cases, both penalties are imposed concurrently.

These penalties do not apply to the extent that the failure to file or failure to pay was due to "reasonable cause" (as opposed to willful neglect).[12] The regulations equate reasonable cause with the exercise of "ordinary business care and prudence."[13]

A determination of whether reasonable cause exists depends on the underlying facts and circumstances. Some of the most common reasons which may be considered reasonable cause include:

[4] For example, if an individual dies November 15, 1993, the estate's taxable year begins on November 16, 1993. If the tax year is the calendar year, then the year closes on December 31, 1993. The longest tax year that permissibly may be chosen runs from November 16, 1993 through October 31, 1994. In that case, the return would then be due on February 15, 1995.

[5] IRC Sec. 6081.

[6] IRC Sec. 6651(a)(1).

[7] IRC Sec. 6651(a) (last sentence).

[8] IRC Sec. 6651(f).

[9] IRC Sec. 6651(a)(2).

[10] IRC Sec. 6651(c)(1); see also Reg. §301.6651-1(f), Ex. 2.

[11] IRC Sec. 6651(c)(1).

[12] IRC Sec. 6651(a)(1)-(2).

[13] Reg. §301.6651-1(c)(1).

(1) a death or serious illness of the taxpayer or an immediate member of taxpayer's family;[14]
(2) a casualty or natural disaster which destroys tax records or otherwise prevents compliance;[15]
(3) the inability of the taxpayer to obtain necessary tax records;[16] and
(4) reliance on the advice of a competent tax advisor.[17]

B. Accuracy-Related Penalties. The Service may assess certain accuracy-related penalties if a return reports an incorrect tax due. These include penalties for:
(1) substantial understatement of income tax;
(2) negligence;
(3) substantial estate or gift tax valuation understatement; and
(4) substantial valuation overstatement.

Generally, the penalty equals 20 percent of the underpaid tax attributable to the malfeasance.[18]

The Code provides standardized exception criteria for all of the accuracy-related penalties. Specifically, no penalty is to be imposed with respect to any portion of an underpayment "if it is shown that there was a reasonable cause... and good faith...."[19]

1. Substantial Understatement of Income Tax. A substantial understatement of income tax penalty arises when a return reports an understated tax which exceeds the greater of (1) $5,000 or (2) 10 percent of the correct tax due.[20] The penalty does not apply to any portion of the understatement for which there is or was substantial authority for the tax treatment adopted in the return, or the return (or an attached statement) adequately discloses the facts affecting such treatment.[21]

The determination of whether there is or was substantial authority depends on the facts and circumstances. Sources which generally constitute substantial authority include:
(1) the Code,
(2) final, proposed, and temporary regulations,
(3) judicial opinions,
(4) administrative pronouncements, including revenue rulings and revenue procedures,
(5) private letter rulings, technical advice memoranda, actions on decisions, general counsel memoranda, information or press releases, notices, and any other similar documents published by the Service, and
(6) general explanations of tax legislation prepared by the Joint Committee on Taxation (the "Blue Book").[22]

Adequate disclosure can be made by using Form 8275 ("Disclosure Statement") or, in some situations, by meeting revenue procedure requirements. The currently effective requirements are identified in Revenue Procedure 92-23.[23] Among other things, this revenue procedure indicates that certain forms may need to be attached to the return in order to establish adequate disclosure for certain deductions. For example, in order to establish adequate disclosure, Form 8283 ("Noncash Charitable Contributions") must be attached to the return if a deduction in excess of $500 is claimed for non-cash charitable contributions, and Form 3903 ("Moving Expenses") must be attached to the return to support a moving expense deduction.

2. Negligence. A negligence penalty applies if the Service determines that an underpaid tax resulted from negligence or disregard of rules or regulations. The term "negligence" is defined as "any failure to make a reasonable attempt to comply with the provisions" of the Code.[24] It also includes the failure to exercise "ordinary and reasonable care" in preparing the return, to keep adequate books and records, or to properly substantiate items, and taking a position with respect to an item that "lacks a reasonable basis."[25] Negligence may be found, for example, if a return fails to report income shown on an information return such as a Form 1099-INT or Form 1099-DIV, or if a taxpayer fails to make a reasonable effort to ascertain the correctness of what would seem to be a "too good to be true" deduction, credit, or exclusion.[26]

The phrase "disregard of rules or regulations" means "any careless, reckless, or intentional disregard."[27] The terms "careless" and "reckless" suggest

[14] See *Hayes v. Com.*, CCH Dec. 28,423(M), 26 TCM 393 (illness of taxpayer and his family). See also, I.R.M. (20)333.1 (July 27, 1992).

[15] See, e.g., I.R.S. Notice 89-107, 1989-2 CB 445 (Hurricane Hugo); I.R.S. Notice 92-44, 1992-2 CB 373 (Hurricane Iniki). See also, I.R.M. (20)333.2 (July 27, 1992).

[16] See I.R.M. (20)333.3 (July 27, 1992).

[17] See *U.S. v. Boyle*, 85-1 USTC ¶ 13,602, 469 US 241 (1985). See also I.R.M. (20)333.7 (July 27, 1992).

[18] IRC Sec. 6662(a).

[19] IRC Sec. 6664(c)(1).

[20] IRC Sec. 6662(d)(1).

[21] IRC Sec. 6662(d)(2)(B).

[22] Reg. §1.6662-4(d)(3)(ii). See also Statement of Managers on Revenue Provisions of Conference Agreement on HR 3299, released by Senate Finance Committee, November 21, 1989.

[23] Rev. Proc. 92-23, 1992-1 CB 737.

[24] IRC Sec. 6662(c).

[25] "Reasonable basis" is defined as a return position that is "arguable but unlikely to prevail in court." Reg. §1.6662-3(b)(1).

[26] Id.

[27] IRC Sec. 6662(c).

a failure on the part of the taxpayer to make any reasonable attempt to consult the rules and regulations in taking a return position, whereas the reference to "intentional disregard" connotes a situation in which the taxpayer knowingly takes a position contrary to the rules and regulations.[28] For these purposes, rules and regulations include Code provisions, final and temporary regulations, and revenue rulings and notices (other than those of proposed rule-making) published in the Internal Revenue Bulletin.

3. Substantial Estate or Gift Tax Valuation Understatement. The substantial estate or gift tax valuation understatement penalty arises when a reported property value is 50 percent or less of the value determined to be correct ("correct value"), and the underpaid tax attributable thereto exceeds $5,000.[29] A reported property value of 25 percent or less of the correct value increases the normal 20 percent accuracy-related penalty rate to 40 percent.[30]

4. Substantial Valuation Overstatement. A penalty for substantial valuation overstatement may be imposed if a reported property value (or adjusted basis) is 200 percent or more of the correct value (or adjusted basis), and the underpaid tax attributable thereto exceeds $5,000.[31] A reported property value (or adjusted basis) of 400 percent or more of the correct value (or adjusted basis) increases the normal 20 percent accuracy-related penalty rate to 40 percent.[32]

C. Underpayment of Estimated Tax Penalty. An underpayment of estimated tax penalty may be assessed if the income tax paid by the quarterly payment date is less than 25 percent of the required annual payment.[33] The required annual payment represents the smallest of the following amounts: (1) 90 percent of the tax due for the current year[34] or (2) 100 percent of the tax liability for the prior year.[35] The penalty is computed separately for each quarter and is determined by multiplying the quarterly underpayment amount by the federal short-term rate plus three percent.[36]

The underpayment of estimated tax penalty generally applies to trusts and estates in the same manner as individual taxpayers. One significant exception exempts certain grantor trusts (i.e., trusts which are to receive the grantor's residuary estate under a pour-over will) and estates from making quarterly estimated income tax payments for the entity's first two taxable years (i.e., the penalty cannot be applied).[37]

IV. Penalty Issues

Realistically, a practitioner cannot completely eliminate a taxpayer's civil tax penalty exposure with respect to post-mortem returns. What is possible, however, is for the practitioner to minimize this exposure by being sensitive to issues specific to each of returns and by taking appropriate steps to address these issues.

A. Decedent's Final Income Tax Returns. *1. Periods Covered by Returns.* The practitioner should realize an often overlooked point: income tax returns for two years may need to be filed on behalf of a decedent. First, if not already filed, income tax returns will need to be filed for the decedent covering the calendar year prior to death. Second, returns need to be filed for the calendar year which includes the date of death.

For example, if C died on March 1, 1993, the executor of C's estate was required to file C's income tax return for the calendar year 1992 on or before April 15, 1993. Thereafter, C's executor needs to file C's income tax return for the period from January 1, 1993 through March 1, 1993 on or before April 15, 1994. A failure to file for this final, short 1993 year could result in an inadvertent failure to file and failure to pay penalties.

In two cases, a return for the decedent should be filed even though a failure to file would not result in penalties. First, a final return for the year of death should be filed even if the decedent has no surviving spouse and dies early in the year with no taxable income. Otherwise, the Service may continue to

---

[28] A taxpayer may take a position contrary to a revenue ruling or a notice (e.g., will not be deemed to have disregarded the ruling or notice) if the position has a "realistic possibility" of being sustained on its merits.

[29] IRC Sec. 6662(g).

[30] IRC Secs. 6662(h)(1) and 6662(h)(2)(C).

[31] IRC Sec. 6662(e).

[32] IRC Secs. 6662(h)(1) and 6662(h)(2)(A).

[33] IRC Sec. 6654. No penalty is applied if: (1) the taxpayer's estimated tax is less than $500, or (2) the taxpayer had no tax liability for the preceding tax year, the preceding tax year comprised 12 months, and the taxpayer was a U.S. citizen or resident for the entire preceding tax year. Id.

[34] Taxpayers whose income is earned unevenly throughout the year may compute this amount on an annualized basis.

[35] In certain situations, this option is not available. Specifically, taxpayers whose adjusted gross income ("AGI") is greater than $75,000 and whose modified AGI increases by more than $40,000 (over the AGI reported on the prior year return) must determine their required annual payment based on 90% of the tax due for the current year.

[36] IRC Secs. 6621(a)(2) and (b).

[37] IRC Sec. 6654(1).

send notices to the decedent's last known address. The top of that return should denote "Final Return" and the taxpayer's date of death. Second, if the decedent made substantial federal estimated income tax payments, a return should be filed to recover the payments even though the return itself reflects a zero tax liability.

2. Filing Status. If at the date of death the decedent was unmarried, the income tax return filing status, depending on the facts, could either be single, head of household, or surviving spouse. On the other hand, if the decedent was married at the date of death only two filing status options exist: married filing jointly or married filing separately.[38]

In all cases except a joint return, the return will report all income actually or constructively received and all deductions paid (for a cash basis taxpayer) or all income and deductions accrued (for an accrual basis taxpayer) from the first day of the year of death through and including the date of death. If a joint return is filed, it will report the decedent's income and deductions for this period as well as the surviving spouse's income and deductions for the entire year.[39]

The ability to file a joint return may provide control over the income tax liability for the decedent and surviving spouse and, therefore, may be useful in avoiding an underpayment of estimated tax penalty. One way this can be accomplished is by the surviving spouse effectively increasing quarterly payments.

To illustrate, assume (1) K died on June 20, 1993, (2) that he failed to make estimated tax payments attributable to self-employment income on either April 15 or June 15, 1993, and (3) that his surviving spouse, P, files a joint return with K for the tax year ending December 31, 1993. If P is employed, she may be able to cure K's apparent underpayments by having her employer withhold greater amounts—even if done late in the year. Because income tax withheld by an employer is considered to be paid evenly throughout the year, an underpayment situation can be eliminated or minimized.

A joint return may be useful for purposes other than avoiding penalties, such as for tax planning. For example, assume M died on March 1, 1993, with unused capital losses of $20,000 and that her surviving spouse, O, files a joint return for the tax year ending December 31, 1993. Because M's unused capital losses cannot be carried over to future years (i.e., to the estate's income tax returns),[40] O may wish to incur capital gains by the end of 1993 in order to offset those losses on their 1993 joint return.

3. Miscellaneous Issues. The practitioner should attend to a variety of other issues relating to the decedent's final income tax returns. First, the practitioner should secure a copy of the decedent's returns for the year or several years prior to death. These returns will provide insight into the decedent's sources of taxable income, estate assets, and potential tax liability. This should serve to minimize accuracy-related penalties.

Second, the practitioner should ascertain the person responsible for preparing the decedent's final returns. Often the practitioner will be given that responsibility.

If not, the practitioner needs to take extra caution. For example, frequently a surviving spouse or other family member will indicate that he or she will see to the preparation of the return but fails to do so. Similarly, he or she may intend to have the decedent's accountant prepare the returns, but fails to follow-up on the matter. Failure to file could result in penalties if the decedent's tax payments for a given year are less than the tax liability. Therefore, to prevent these situations, the practitioner should send follow-up correspondence to ensure that the individual responsible for handling the returns timely files them.

Third, as soon after the decedent's death as possible, the practitioner should apply for a federal taxpayer identification number for the estate (using Form SS-4) and should notify banks, mutual funds, and related payers, of the decedent's date of death and of the estate's identification number. The practitioner should also request that these payers issue two Form 1099s for the date-of-death year: one for the decedent for income received (if the decedent was a cash basis taxpayer) or accrued (if the decedent was an accrual basis taxpayer) through and including date of death, and one for the estate for income received from the day after the date of death through the end of the year.

If only one Form 1099 is issued, the stated income will not be consistent with the properly reportable income on either the Form 1040 or Form

[38] In limited situations, a married individual may be entitled to file as a head of household under the so-called "abandoned spouse" rules. IRC Secs. 2(b),(c); and 7703.

[39] See Reg. §1.6013-1(d)(1).

[40] Rev. Rul. 74-175, 1974-1 CB 52.

1041. In these situations, an explanation reconciling the difference should accompany the return to lessen the risk of the Service incorrectly attempting to assess a substantial understatement of income tax or negligence penalty. One possible format for the Form 1040 is shown below using decedent L for illustration purposes (the amounts and the estate fiscal year end are assumed):

Attachment to Schedule B—Interest and Dividend Income
Part II Dividend Income

Dividend Income	*Amount*
4. Dividend Income (list name of payor—include on this line capital gains distributions, nontaxable distributions, etc.)	
ABC Stock Fund	$10,861
Less Amount Reported By L's Estate FEIN 00-0000000, Fiscal Year Ending 1-31-93	(9,903)
XYZ, Inc.	12,600
Less Amount Reported By L's Estate FEIN 00-0000000, Fiscal Year Ending 1-31-93	(6,300)
(Total Amount—Entered on Line 5)	$ 7,258

B. The Estate Tax Return. *1. Who Should Prepare the Return?* If the decedent's "gross estate" is greater than $600,000 (reduced by the amount of adjusted taxable gifts[41] and certain amounts allowed as a specific exemption), then a federal estate tax return, known as Form 706, must be filed.[42]

Without a corporate executor, the burden of preparing the estate tax return should be borne by the estate administration practitioner. Because of the potentially large penalties which may result from a late filing, the practitioner should assume from the onset of the administration period that an estate tax return needs to be filed.

For example, assume individual D died on March 1, 1993, at the age of 66. At the time of D's death, she shared the same household with her husband, J, age 68. D owned $700,000 in publicly traded stocks and bonds held solely in her name; a house worth $250,000 owned in joint tenancy with J (with an outstanding mortgage balance of $100,000); $100,000 in life insurance on her life; $30,000 in an IRA; a general power of appointment ("GPOA") over property worth $350,000; a business, set up as a sole proprietorship, worth $500,000; and miscellaneous assets (e.g., automobile, jewelry, paintings) owned outright worth $195,000.

None of her property was held in *inter vivos* trusts and no trusts were created under D's Will. D leaves $400,000 of the property she owned outright to J, and the residue to her daughter, R. The assets were not immediately distributed from the estate to the beneficiaries. Estate administration expenses total $50,000.

Because D's gross estate exceeds $600,000, a federal estate tax return must be filed. Based on the facts presented, D's gross estate totals $2,000,000, calculated as follows:

Stocks and Bonds	$ 700,000
One-half of House (held in joint tenancy)	125,000
Life Insurance	100,000
IRA	30,000
GPOA Property	350,000
Business Property	500,000
Miscellaneous Assets	195,000
	$2,000,000

Her estate will be entitled to a marital deduction of $400,000 for the gift to her husband J, a deduction for $75,000 for one-half of the net value of the residence which passes to J, a deduction of $50,000 for one-half of the mortgage balance, and a deduction of $50,000 for the administration expenses. Therefore, her taxable estate would equal $1,425,000[43] and her tentative tax, assuming no prior adjusted taxable gifts, would equal $523,550.[44] Subtracting from that the $192,800 unified transfer tax credit ("unified credit") which is available to every individual,[45] D's estate would owe $330,750 in federal estate tax.[46]

If the executor were four months late in filing the Form 706 (and in paying the appropriate tax), and no extensions were granted, then the executor would have incurred late filing and payment penal-

[41] The practitioner has to be careful to examine not only the property that is deemed to be included in the gross estate for estate tax purposes at the decedent's death, but also whether the decedent has made any lifetime taxable gifts.

[42] A practitioner who has not before completed an estate tax return may want to consult with or delegate responsibility for preparation to a practitioner more versed in the completion of the Form 706.

[43] The taxable estate is defined as the gross estate minus allowable deductions. IRC Sec. 2051.

[44] Pursuant to the rate schedule contained in Section 2001(b), the tax is computed by adding the tax on $1,250,000, $448,300, to the tax on the excess over $1,250,000, $75,250 [($1,425,000 − $1,250,000) × 43%].

[45] IRC Sec. 2010.

[46] This assumes that D's estate pays no state death taxes. If state death taxes were paid, the federal estate tax would be reduced by the state death tax credit allowable under Section 2011.

ties on behalf of the estate in the amount of $66,150 ($330,750 times five percent per month times four months). The total penalty equals five percent per month because the .5 percent failure to pay penalty reduces the five percent failure to file penalty to 4.5 percent.

2. Filing and Tax Payment Considerations. Form 706 is due within nine months of death. At times, this deadline may create problems because the estate may involve assets, such as stock in a closely held corporation, which are extremely difficult to value within only a nine month period. Extensions are allowed in the filing of an estate tax return, but are discretionary with the Service. The "district director... may, upon a showing of good and sufficient cause, grant a reasonable extension of time for filing the return required by section 6018."[47]

An extension for filing Form 706 does not necessarily extend the tax payment due date. As a result, in order to avoid a failure to pay penalty, the tax due generally must be paid within nine months of death.

There are two situations, however, in which the payment may be deferred. First, if there is "reasonable cause," the Service may grant an extension for up to ten years.[48] Second, an estate may automatically qualify for a deferral under Section 6166.[49] That provision most likely will be applicable if an estate consists of a closely held business. To qualify under that section, the estate must demonstrate that the value of all closely held businesses exceeds 35 percent of the adjusted gross estate.[50] To qualify as a "closely held business" under Section 6166, either 20 percent of the total value of the business must be includable in the decedent's gross estate, or the business must have fewer than 15 partners (if a partnership) or 15 shareholders (if a corporation); further, passive assets held by a business are not included in the Section 6166 qualification calculations.[51]

Section 6166 permits the estate to defer payment of the estate tax attributable to that interest for five years. During that period, the estate pays only interest, and then makes equal principal and interest payments during the following 10 years. Although the economics may not militate in favor of obtaining a deferral, delaying payment may be necessary if the estate is illiquid, cannot readily obtain cash, and could otherwise be in an underpayment penalty situation.

3. Valuing Assets. In preparing the Form 706, the practitioner needs to be careful regarding valuation. Failure to adhere to recognized valuation principles could give rise both to failure to pay and certain accuracy-related penalties.

The applicable valuation date for purposes of including assets on Form 706 is either date of death or the "alternate valuation date ("AVD")," which is six months after the date of death. However, if the AVD is elected, and assets are sold by the estate prior to six months after date of death, then their sale value is included as their value for 706 purposes. An AVD election is available only if the AVD valuation produces a smaller total transfer tax liability than the date of death valuation. (This rule prevents manipulation of the alternate valuation date in order to take advantage of the basis step-up rules under Section 1014.)

The method used for ascertaining the value of an asset varies depending on the type of asset involved. The regulations to Section 2031 contain a description of the appropriate valuation methods for various assets.

One of the most difficult assets to value is an interest in a closely held business. The starting point for the valuation of this interest is Reg. §§20.2031-2(f) and 20.2031-3. Further guidance is provided by Rev. Rul. 59-60 and a host of subsequent cases and rulings.[52] Recently enacted Chapter 14 also provides guidance in certain situations.

This area is one of the most frequent battlegrounds for the IRS. The practitioner should be aware of the flexibility in the valuation process, including the availability of discounts (such as for minority or non-marketable interests), but should also be cognizant of penalty exposure for too aggressive a valuation.

4. The Gross Estate. A practitioner not familiar with the "gross estate" concept should carefully study Sections 2033 through 2044 to determine the gross estate inclusions. Failure to list all gross estate

---

[47] Reg. §20.6081-1(a); see also Form 4768. See Internal Revenue Manual - Audit, §4562.2 for the "eight specific causes for failure to file a return [which]... will be accepted as reasonable."

[48] See Reg. §20.6161-1(a) (Examples 1 through 4) for illustrations of "reasonable cause."

[49] IRC Sec. 6166.

[50] IRC Sec. 6166. The "adjusted gross estate" is the value of the gross estate less deductible administration expenses, debts, accrued tax liability and casualty losses of the estate. Id. IRC Sec. 6166(b)(6).

[51] IRC Sec. 6166(b).

[52] See, e.g., *Central Trust Co. v. U.S.*, 62-2 USTC ¶ 12,092, 305 F2d 393 (ClCt 1962), *Northern Trust v. Com.*, CCH Dec. 43,261, 87 TC 349 (1986), Rev. Rul. 83-120, 1983-2 CB 57.

inclusions on Form 706 may result in a failure to pay and negligence penalties.

The starting point in determining the gross estate is Section 2033, which provides that the "value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death." If the decedent owned property at his or her death, it is included in the gross estate pursuant to Section 2033. But, as illustrated by Sections 2034 through 2044, a less tenuous connection than ownership may result in property being included in the gross estate. The practitioner must analyze all assets over which the decedent had any connection or affiliation.

Referring to the facts in the previous example, all of D's solely owned assets were included in her estate's gross estate (the stocks and bonds, IRA, business property, and miscellaneous property pursuant to Section 2033, and the life insurance pursuant to Section 2042). The gross estate also included property D did not own or did not solely own. D did not own the GPOA property, but it was included in the gross estate by virtue of Section 2041. Since D jointly owned the house with her husband J, Section 2040 required a gross estate inclusion of one-half of its value. In that example, D's connection to the includable property was apparent. The practitioner must be particularly sensitive to less straightforward connections to property which result in gross estate inclusions.

One example of this situation involves Section 2042(2). Under this provision, the face value of any insurance policy on the decedent's life over which the decedent had "incidents of ownership" must be included in the gross estate. "Incidents of ownership" is not limited to ownership in a technical legal sense. It also includes the right to change beneficiaries, the right to cancel the policy, and the right to pledge the policy.[53] Thus, even if the decedent gifted the policy to another, the face value would be a gross estate inclusion so long as the decedent retained one of these rights.

Another example involves Section 2036(a). It requires a gross estate inclusion for property over which the decedent retained control (but perhaps not complete ownership). This would include, for example, the full value of an irrevocable trust established by the decedent under which he or she had retained an income interest.[54] This may also include stock that the decedent had voting control over but no equity interest in.[55]

Yet another example of a relatively indirect connection resulting in a gross estate inclusion is Section 2035. This section causes certain gifts made within three years of death to be included in the gross estate.[56] Moreover, if the decedent paid any gift tax on such transfers, the amount of the gift tax must be included in the gross estate.[57]

These examples are not all-inclusive. They are intended to illustrate the importance of thoroughly investigating any assets with which the decedent may have had some connection before or at death as a means of avoiding penalties.

5. Filing Form 706 as a Precautionary Measure. If the decedent's gross estate is $600,000 or less, no estate tax return needs to be filed. In cases where the gross estate is close to that threshold (e.g., $550,000), the practitioner should consider filing the Form 706 even though no tax will be due. If the Service later determines that additional assets should have been included in the decedent's gross estate resulting in a tax due, at least late filing penalties are avoided.

6. Tax Elections. A number of elections need to be considered when completing the Form 706. For example, if there is a surviving spouse, an election referred to as a "qualified terminable interest property election" may be appropriate.[58] This election allows the property subject to the election (typically a trust in which the spouse is beneficiary) to qualify for the marital deduction. The election will be deemed to have been made if property qualifying for the election is listed and entered as a deduction on Schedule M. Conversely, if the executor does not want a spousal annuity to be treated as "qualified terminable interest property," an election to that effect needs to be made on the Form 706.[59]

Examples of other possible elections are:

(1) whether to take administration expenses as deductions on the estate tax return or on the fiduciary income tax return;[60]

(2) whether to pay tax in installments;

[53] Reg. §20.2042-1(c)(2).
[54] IRC Sec. 2036(a)(1).
[55] IRC Sec. 2036(b).
[56] IRC Sec. 2035(d).
[57] IRC Sec. 2035(c).
[58] IRC Sec. 2056(b)(7).
[59] IRC Sec. 2056(b)(7)(C)(ii).

[60] Expenses incurred in the administration of an estate, such as attorneys fees and compensation to the executor of the estate, may be used as deductions on the estate tax return (Form 706) or on the fiduciary income tax return (Form 1041), but the same deduction may not be used on each return. See, e.g., Reg. §1.642(g)-1. Because the lowest estate tax rate, after the use of the unified credit, is now greater (37%) than the highest marginal income tax rate (31%), the traditional analysis as to where to use these deductions becomes slightly modified. In the case of an estate not subject to estate tax by the use of the unified credit, the fees and compensation need not

(3) the qualified domestic trust election if the surviving spouse is a nonresident alien:
(4) the alternate valuation date election;
(5) special use valuation election for farms and certain closely held businesses under Section 2032A; and
(6) whether and how to allocate the generation skipping transfer tax exemption.

The practitioner should review the decedent's assets to determine if any of these elections should be made. The elections—or the failure to make such elections—could impact dramatically on current and future tax exposure and, consequently, may be important in avoiding a penalty for failure to pay.

C. Estate Income Tax Return. In addition to the estate's death tax return, it may be necessary to file a federal estate income tax return, Form 1041. A 1041 is required for every estate subject to administration which has "gross income" for the taxable year of $600 or more, or which has one or more beneficiaries who are non-resident aliens.[61]

The estate income tax return presents a number of options to the practitioner which may assist in avoiding penalties. One of the most important options is determining the taxable year for the estate. The executor of an estate may adopt any taxable year provided that the year does not end more than twelve months after the decedent's death. Objectives in selecting a taxable year may include deferral (and in some cases, acceleration) of tax,[62] matching of income and deductions, and avoiding the bunching of income.[63]

The practitioner should be very careful in selecting the initial tax year, which is deemed selected via the filing of the first tax return. It is extremely difficult to change a tax year once chosen and can be done only with the permission of the Service.

1. Income Taxation of Estates. Estates are taxed under the complex rules of subchapter J, set forth in Sections 641 through 692. One of the most important general rules is that distributions of accounting income or principal to beneficiaries may result in (1) taxable income to the beneficiaries (i.e., the distribution "carried out" income to the beneficiaries) and (2) an income tax deduction to the trust or estate. This rule is extremely important because a distribution to a beneficiary of taxable income could place that beneficiary in an underpayment of estimated tax penalty situation if the income is not accounted for in estimated tax payments (and the taxpayer has not availed herself of an estimated tax safe harbor). Therefore, the practitioner must know what distributions will carry out taxable income and to advise the beneficiary sufficiently in advance to protect the beneficiary.

As a general rule, the practitioner should assume that any distribution from an estate, whether accounting income or principal, will carry out taxable income to the beneficiaries. Referring to the example in Part IV.B.1., assume D's estate earned taxable income of $10,000 in its first taxable year

(Footnote Continued)

and still should not be taken on the federal estate tax return.

If an estate is not subject to estate tax because of the use of both the unified credit against taxes and unlimited marital deduction, the executor should not automatically elect to use administration expenses as an income tax deduction. Emphasis must be placed on the real benefit attributable to the deferral of the estate tax on the marital deduction portion of the gross estate (and the eventual estate tax exposure of the surviving spouse). For example, if both husband and wife will have large taxable estates, it may be more advantageous to use administration expenses as an estate tax deduction at the death of the first spouse even though use of the unlimited marital deduction will eliminate any estate tax at that time. This conclusion would be bolstered if the surviving spouse's estate is so large that he or she intends to make lifetime taxable gifts. Further, consideration should be given to whether an administration expense will be deemed a "miscellaneous itemized deduction" subject to the 2% adjusted gross income floor. Another factor that may militate in favor of electing to take administration expenses as a deduction on the estate tax return (even when use of the unlimited marital deduction eliminates any estate tax) is the existence of a large amount of municipal bonds or other tax exempts in the estate. (Note: If the estate consists of tax exempts and if an election will be made to use administration expenses on the fiduciary income tax return, then the executor should consider immediately distributing all tax exempts to the marital share to secure full use of the expenses as deductions on the estate income tax return.)

If an estate is subject to estate tax, then use of administration expenses as an estate tax deduction should be worth more than use as an income tax deduction.

[61] IRC Sec. 6012(a)(3) and 6012(a)(5).

[62] Assume D from the example in Part IV.B.1. died February 2, 1993. The representative of D's estate selects a fiscal year ending January 31st. If distributions are made to a calendar year beneficiary on March 2, 1993, the beneficiary does not have to report any income carried out by this distribution until his or her 1994 return due April 15, 1995. But beware, if tax rates are higher in 1995 than 1994, the benefits from this deferral may be lost; worse, the deferral may turn out to be detrimental.

[63] Assume D from the example in Part IV.B.1. died on August 31, 1993. Her estate is probated and later distributed on August 31, 1995. During the period of administration, her estate earned $24,000 of income annually (two thousand per month). If the personal representative had selected a tax year ending July 31, the estate's first year would have included $22,000 of income, second year $24,000 of income, and third year $2,000 of income. Assuming no distributions and no deductions, the marginal tax on the first year's income would cause almost the complete phase-out of the 15% bracket. If the estate had selected February 28 (or 29, as the case may be) as the tax year, the income would have been allocated $12,000 in the first year (6/12 × 24,000), $24,000 in the second year (12/12 × 48,000) and $12,000 in the third year (6/12 × 48,000). There would have been no bunching of income in any one taxable year and the phase-out of the lower bracket in the first year would not have occurred.

following the date of D's death. If during that year the executor made a discretionary distribution to R, the residuary beneficiary, of 100 shares of stock owned by the estate (worth $5,000) that distribution, even though it is of principal, would be treated as taxable income to R under the subchapter J rules.

There are certain distributions from an estate to its beneficiaries which will not carry out taxable income. Consequently, these distributions result in no income to the beneficiaries and no deduction for the estate. The three major types are:

(1) distributions of a specific bequest of money or property;
(2) interest on the late payment of a specific bequest; and
(3) IRD.

Distributions related to specific bequests of money or property do not carry out taxable income, provided the amount or property is payable in three or less installments. These distributions, which generally will be made from an estate (or pour-over trust), do not carry out taxable income, even if there exists unused distributable net income ("DNI").[64]

The interest on the late payment of a specific bequest does not carry out DNI. However, such interest may be deductible by the estate pursuant to Section 163(a) of the Code, and is includable in the beneficiary's gross income without regard to DNI (under Section 61(a)(4)).[65]

Generally, the distribution of IRD property to a beneficiary will not carry out taxable income.[66] IRD consists of income which a decedent was entitled to during his or her lifetime, but which was not reportable by the decedent as income at the time of his or her death. Common examples of IRD include accrued income for services rendered prior to death, post-death bonuses, deferred compensation payments, income from the exercise of a stock option, dividends declared and payable to a shareholder of record prior to death, and accrued but unpaid interest.[67]

IRD is reported at the time of its receipt and is taxable to its recipient. Under Section 691(c) of the Code, there is an income tax deduction for the incremental increase in the estate tax that is attributable to IRD (other than the estate tax attributable to the tax imposed on excess retirement accumulations by Section 4980A(d)). If the estate realizes the income, it may claim the deduction. The two-percent floor imposed by Section 67 on miscellaneous itemized deductions does not apply to the Section 691(c) deduction.

2. Final Year Estate 1041. A final 1041 for the tax year which includes the date on which the estate is closed needs to be filed. Practitioners may ask, "How can an estate be closed if an income tax return needs to be filed subsequent to the closing?" "Wouldn't any tax payment with the return impact the estate and wouldn't the estate be potentially subject to underpayment penalties?" The answers lie in the fact that for the final year, an estate will not have to pay any income tax: all of the taxable income will be carried out to the beneficiaries, to be taxed on their respective returns, and the estate will be entitled to a deduction equal to the full amount.

This point is crucial so that beneficiaries can be adequately forewarned to protect themselves against estimated tax penalties.

D. Trust Income Tax Returns. In addition to an estate Form 1041, the practitioner should be well-versed with trust Form 1041s. If a decedent established under the terms of his or her will a testamentary trust (for example, a Marital Trust) for the surviving spouse, then to the extent that trust is funded and earns amounts exceeding the threshold filing requirements, a trust Form 1041 needs to be filed.

Completion of estate and trust Form 1041s is substantially similar, in that subchapter J rules govern both the taxation of trusts and estates. There are minor differences such as choice of tax year (the estate may elect a tax year other than the calendar

---

[64] IRC Sec. 663(a)(1). Referring to the example in Part IV.B.1., assume J is the beneficiary of a specific bequest of $400,000. If in the first year of administration, D's estate earned $100,000 in taxable income and made only one distribution, the $400,000 bequest to J, this bequest would not carry out taxable income. J would receive the $400,000 without being required to pay any income tax on it, and the estate would be fully subject to income tax on the $100,000 of income earned in its first year of administration. If the specific gift or the bequest of the specific sum of money is to be paid or credited only from the income of the estate or trust, the above rule does not apply and the bequest or gift would carry out DNI. However, if satisfaction of a beneficiary's specific bequest may be payable out of either accumulated income or corpus, this would qualify for exclusion under section 663(a)(1). Reg. §1.663(a)-1(b)(3), Ex. 3.

[65] See Rev. Rul. 73-322, 1973-2 CB 44.

[66] *Rollert Residuary Trust v. Com.*, CCH Dec. 40,009, 80 TC 619 (1983), *aff'd*, 85-1 USTC ¶9139, 752 F2d 1128 (CA-6 1985); see also Rev. Rul. 68-195, 1968-1 CB 305, and IRC Sec. 643(e). If IRD property has been distributed by the personal representative in satisfaction of a pecuniary or specific dollar bequest, the distribution by the estate may accelerate recognition of all of the income in the IRD, thereby causing a (possibly unexpected) increase in the estate's taxable income. For example, as a result of Section 691(a)(2) of the Code, when the right to receive future IRD is transferred to fund a pecuniary bequest, the estate may realize income before actually receiving the IRD. See Reg. §1.691(a)-(4)(a).

[67] See, e.g., Reg. §1.691(a)-2(b), Exs. 1 - 5.

year whereas a testamentary trust must use the calendar year), estimated tax payments (the estate need not begin making estimated tax payments until the third year after the decedent's date of death, whereas a trust generally will be required to make estimated tax payments at its inception), and personal exemption ($600 for an estate versus $300 or $100 for a trust).[68]

E. Gift Tax Returns. If the decedent in the year prior to his or her death made taxable gifts, a Form 709 needs to be filed along with any gift tax due in order to avoid failure to file and failure-to-pay penalties. A gift tax return is not required if gifts are made to the surviving spouse or they are present interest gifts under $10,000 per beneficiary per year. If the surviving spouse consents for gift tax purposes as having made gifts made by the other spouse treated as having been made one-half by each spouse, then a gift tax return will be required to be completed.

1. Cumulative Tax Base. When completing the Form 709, all prior taxable gifts are taken into account in determining the gift tax base.[69] The prior gifts do not end up being taxed more than once because a credit is given for the tax already paid on the prior taxable gifts.[70] The end result of including prior taxable gifts in the gift tax base is to push the current taxable gifts into a higher tax bracket. A failure to include prior taxable gifts in the gift tax base may result in an understated gift tax liability. To the extent that this occurs, the taxpayer risks imposition of a failure-to-pay penalty.

2. Valuing Gifts. Practitioners must be careful in valuing gifts when preparing Form 709. Improperly valued gifts might result in failure to pay and certain accuracy-related penalties.

For gift tax purposes, the valuation date is the date of the gift.[71] In determining value, the regulations provide special rules for certain types of property or property interests.[72]

One particularly difficult valuation problem concerns stock of closely held corporations.[73] In many cases, a reduction (known as a "minority discount") from the otherwise determinable value for such shares may be allowable because the block of shares being valued represent a "minority interest" in the entity.[74]

Practitioners need to be reasonable in establishing the applicable minority discount. Overly aggressive discounts may be disallowed by the Service and ultimately result in penalties.

V. Conclusion

The diversity and complexity of postmortem returns leads to significant civil tax penalty exposure. In order to minimize a taxpayer's exposure, practitioners must determine the postmortem returns that need to be filed and their respective due dates. Additionally, practitioners should assess and appropriately respond to the penalty issues pertinent to each of the returns.

---

[68] For a detailed discussion of these differences, see Harrison, "Estates and Trusts File the Same Return, But Use Different Rules," 47 *Taxation for Accountants* 172 (1992).

[69] IRC Sec. 2502(a)(1).

[70] IRC Sec. 2502(a)(2).

[71] IRC Sec. 2512(a).

[72] See, e.g., Reg. §25.2512.2 (stocks and bonds), Reg. §25.2512-3 (business interests), Reg. §25.2512-5 (annuities, life estates, terms for years, remainders, and reversions), and Reg. §25.2512-6 (life insurance and annuity contracts).

[73] For an extensive discussion of this issue, see Janiga and Harrison, "Valuation of Closely Held Stock for Transfer Tax Purposes: The Current Status of Minority Discounts for Intrafamily Transfers in Family-Controlled Corporations," 69 *TAXES* 309 (1991).

[74] See, e.g., *Whittemore v. Fitzpatrick*, 54-2 USTC ¶ 10,976, 127 FSupp. 710 (D.C.-Conn.); Ward v. Com., CCH Dec. 43,178, 87 TC 78 (1986); Rev. Rul. 93-12.