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Steve Leimberg's Estate Planning
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Subject: Estate Planning At The Movies®: CATCH 22…IRS Showing a Disturbing Recent Pattern of Rejecting One-Year Extensions of Time to Pay Estate Tax When a QTIP Trust Is Part of the Estate Plan on the Death of the First Spouse

"In recent weeks, this author has encountered the arbitrary refusal of the IRS to grant one-year extensions to pay federal estate tax on the death of the first spouse when a qualified terminable interest property (QTIP) election might be made on the death of the first spouse. Several practitioners have reported similar encounters to this author as well.

Such extensions should be granted as a matter of course because the estate will not know until the filing date (preferably as extended) whether the QTIP election will be made, and if elected, whether it will be timely amended. The failure of the IRS to grant a one-year extension of time to pay federal estate tax when a six-month automatic extension of time is timely filed is arbitrary and wrong. Until recently, this author has neither experienced nor heard from practitioners that a one-year extension to pay estate tax had been denied by the IRS in comparable cases involving the death of the first spouse.

*Now, things appear to have changed. Why? Is it change of personnel in the IRS?... lack of awareness of the necessity to grant the extension?... or simply an arbitrary denial? If this trend becomes the norm, the taxpayer is placed in a "Catch 22"[i]—**yes** you have a regulatory right and potential prior transfer tax credit to use **but** you will be given insufficient time to pay estate tax without penalty if you wish to fully utilize all of the time the regulations allow, or hope that the IRS will grant an additional extension to which the taxpayer likely will not receive a response from the IRS until after the initial six-month extension to pay expires.*

This newsletter reviews the importance of obtaining both a six-month extension of time to file the estate tax return and a one-year extension of *time to pay estate tax on the death of the first spouse, including the language that has historically secured the one-year extension of time to pay, and the potential damage done by the IRS when a one-year extension to pay estate tax is not granted."*

Keith Schiller has authored a host of **LISI** newsletters respecting federal estate and gift tax law and the preparation of the Form 706.

Keith Schiller, Esq., shareholder of the **Schiller Law Group**, a PLC, of Alamo California, has more than 43 years of experience with taxation, and estate and business succession planning. Keith works with clients, teaches and consults on estate planning, tax compliance, business succession and trust administration. Keith has contributed over two dozen articles for **LISI**.

Keith is the author of the award-winning book, *Art of the Estate Tax Return — Estate Planning At The Movies®* ("*706 Art*").[ii] The book reveals Keith's best practice pointers, his insights from co-teaching with the IRS for greater than thirteen years, and practical recommendations from over a dozen leading practitioners across the country who contributed to the book. The Second Edition and upcoming 2018 Supplement of *706 Art* is published by Bloomberg BNA Books and is available at http://www.bna.com/bnabooks/aetr. Keith is a member of the Advisory Board for Bloomberg BNA's *Estates, Gifts and Trusts Journal* and the Consulting Board for the *Leimberg Information Services, Inc.* ("LISI") Newsletter. He has taught 11 courses for the CalCPA Education Foundation and received the 2000 and 2010-2011 awards for Outstanding Course Materials. From passion, Keith chaired the Yosemite License Plate Campaign, during which he lobbied passage for the law approving the Yosemite License Plate and directed the state-wide marketing and sales campaign. The Yosemite License Plate has raised in excess of $35 million for the preservation of Yosemite and California conservation.

Also, you can stay current on estate tax law by subscribing to the author's Update Service. To learn more and to subscribe, visit: http//shop.estateplanningatthemovies.com.

Here is Keith's commentary:

EXECUTIVE SUMMARY:

> *When a QTIP Trust is part of the play*
> *extend the time to file and pay.*[iii]

Although QTIP elections are commonly made on the death of the first spouse, on some occasions estates will save money by not making a full QTIP election (or one at all) in preference of obtaining a prior transfer tax credit (PTC). The PTC can be attractive if estate tax is payable on the death of the surviving spouse and the surviving spouse becomes terminally ill or dies after the death of the deceased spouse (yet is not terminally ill as of the death of the deceased spouse).

If the estate will not make a full QTIP election, the filing of a timely estate tax return is particularly important because estate tax will be payable. In that setting, a late filing and late payment penalty will apply. Therefore, it is good practice to always file for an automatic extension of time to file the federal estate tax return. In addition, an extension of time to pay federal estate tax should also be filed, which the author recommends to be extended for one year from the original due date. The one-year extension provides time to raise the funds to pay federal estate tax without penalty if the estate finds itself near the end of the 15-month period from the date of death and decides to not make a full QTIP election. After all, the fact that a surviving spouse can die or become terminally ill may arise at any time during the 15-month period. There is not necessarily any advanced notice. Moreover, even if an estate files an estate tax return prior to the extended due date, an earlier QTIP election can still be timely amended or un-elected at any time before expiration of the extended filing deadline.

As a result, the IRS has been historically reasonable in granting the one-year extension of time to pay federal estate tax in the aforementioned circumstances. However, in recent months this author has encountered and learned of situations in which the IRS is granting extensions of time to pay estate tax for only six months, using the argument that the amount of estate tax payable is known when the estate tax return is filed. This argument misses the point that the estate may not know whether or not a full QTIP election will be made or unmade due to the changing health or death of the surviving spouse. It is possible that the estate may not know until a few weeks or days before the end of the 15-month period from the date of death. Are estates supposed to liquidate assets and raised millions of dollars on what may be a few days' prior notice on pain of a late payment penalty? IRS personnel have suggested to this author that the taxpayer file a further request for extension of time to pay once the decision is made to not QTIP sufficiently to defer the estate tax. However, the taxpayer at that point can only hope an extension will be granted as the IRS will likely not respond until after the initial six-month extension of time to pay has expired.

FACTS:

The decision in estates that may be subject to federal estate tax over whether a QTIP election will be fully or partially made, or not at all, is one of the most important choices facing executors and their estate tax return preparers. The decision can impact basis decisions on the death of the surviving spouse and whether securing a prior transfer tax credit (PTC) may be worth the cost of "prepaying" estate tax on the death of the first spouse. Executors need the full 15 months (i.e., a six-month extension of time to file) to decide whether or not to timely make a QTIP election. Unless they are given a one-year extension of time to pay federal estate tax from the original due date, executors will face late payment penalties and additional administration costs and delay if the decision is made to not fully make the QTIP election. How can an estate be expected to raise money… and potentially millions of dollars at that… on the date or near to the date of the 15-month anniversary of death to avoid the late payment penalty? The answer has historically been that such an expectation is not reasonable.

The IRS has consistently granted the one-year extension of time to pay estate tax in the potential QTIP setting. Recently, this practice has disappeared within the branch of the IRS that considers ruling requests as only-six month, not one-year, extensions are being granted. One-year extensions are being denied despite sound reason and excellent authority (under the regulations and public rulings) to grant the one-year extension. Thus, the IRS has created a *Catch 22* in which a dilemma arises as a result of mutually conflicting or dependent conditions… namely that the taxpayer has a right clearly created by law but that right cannot be practically exercised unless the estate is willing to risk a late payment penalty.

COMMENT:

Overwhelmingly, it is preferable to pay no estate tax on the death of the first spouse. Taxes are generally best deferred and with potential future increase in the exclusion amount, the eventual tax on the death of the surviving spouse may never arise. Furthermore, estate taxes are the "kid's problem" because the tax can be deferred until the death of the surviving spouse.

There are a few occasions, however, in which it may be prudent to pay estate tax on the death of the first spouse. The most common of these would be the multi-marriage estate in which the children from prior marriage(s) are close in life-expectancy or age to that of the surviving spouse. In that instance, the children will receive little or nothing if estate tax is deferred until the surviving spouse dies.

However, even in the one marriage family, or any normal occasion in which it is desired to defer estate tax until the surviving spouse dies, the estate tax return preparer should always submit a timely application with the IRS to file and **pay** estate tax whenever the marital deduction is established or may be created as a QTIP trust.

The additional time allowed by the extensions enables the fiduciary and return preparer to determine whether or not events unfold, up to 15 months after the death of the deceased spouse, which would encourage the payment of estate tax on the death of the first spouse. The most obvious example would arise when the surviving spouse dies or contracts a terminal illness after the death of the first spouse. In that context, the payment of estate tax on the death of the first spouse can save significant estate taxes from the availability of the prior transfer tax credit ("PTC") under Code §2013.

The PTC will arise in the estate of the surviving spouse when the surviving spouse receives a life estate or fixed income interest in the estate of the deceased spouse, provided the trust was estate taxed in the estate of the deceased spouse. In other words, the estate of the first spouse cannot defer all estate tax for this credit to apply. In addition, the PTC is available in the estate of the surviving spouse even though the trust to which the surviving spouse is an income beneficiary is not included in the gross estate of the surviving spouse.

Code §2013 provides for a credit for prior transfers based on a graduated scale when the transferor predeceases the decedent-transferee:

Time Exceeding	Not Exceeding	Percent allowable
-	2 years	100%
2 years	4 years	80%
4 years	6 years	60%
6 years	8 years	40%
8 years	10 years	20%
10 years	-	0%

This value of the life estate (or income interest) that was subject to estate tax on the death of the deceased spouse will receive a PTC based on the life expectancy of the surviving spouse, provided that the surviving spouse's death does not arise in a common disaster, or in the event that the surviving spouse's health at the time of the death of the deceased spouse is projected to be at least a 50% probability that the surviving spouse would not die within one year of the deceased spouse. Reg. §§20.7520-3(b)(3)(i); 20.7520-3(b)(3)(iii). If this probability is not satisfied, or in the event of a common disaster a fact and circumstance analysis will apply.[iv]

When there are successive transfers of property (i.e., property passed through several estates), the credit is allowed only for the transfer from the last transferor to the decedent. When there are multiple transfers from several transferors, each transfer qualified for the credit and the limitations and the credit are determined separately as to each transferor.[v]

<u>PTC is available if a full QTIP election is not made.</u>

The term "property" includes any interest in property (legal or equitable) in which the transferee received a beneficial interest. The transferee is the beneficial owner of property over which the transferor has a general power of appointment (not a limited power only). Reg. Sec. 20.2013.5(b). Bare legal title does not constitute property.

Application of the PTC to trusts or other life interests even though it is not included in the gross estate of the transferee-decedent is well supported by several public rulings.[vi]

The rationale for a life estate qualifying for the prior transfer credit is based on the theories that the life estate produces income that is itself partially reinvested and turns into principal which is taxed when death occurs and/or the life estate allows the life tenant to conserve his other assets which are then taxed when he dies. Rev. Rul. 59-9 provides the longest-term and clearest authority on point in support of the PTC in the context of a marital trust to which a full QTIP election is not made. In that ruling, the decedent (D) was left an income interest from the parent and D died within ten years after the father's death. The value of the property included in the residual trust had been included in the father's gross estate and a federal estate tax was paid thereon. The income interest was not included in D’s gross estate for federal estate tax purposes. The IRS ruled that if property was included in the transferor's gross estate and an estate tax was paid on it, “the credit may be applied to the interest received by the transferee, notwithstanding the fact that such interest is not included in the transferee's estate for federal estate tax purposes.”

Example: The following is an example of the value of the PTC with a $40 million community property estate (i.e., each spouse with a $20 million estate) in the case of a $8,820,000 erstwhile marital trust which is allowed to be estate taxed in the estate of the deceased spouse (i.e., to the extent that a QTIP election is not made and the trust is not shielded by the unified exemption equivalent), for a 75-year old surviving spouse and a 3.4% applicable federal rate (May 2018). If the marital trust has a value of $8,820,000 the value of the income interest is $2,590,875 ($8,820,000 x .29375). The estate tax on the $8,820,000 estate of the deceased spouse is $3,528,000 (40% on the excess over the $11,180,000 basic exclusion amount). (The PTC does not apply to state death taxes.) If the surviving spouse dies within two years of the deceased spouse, the PTC is $1,036,500 ($2,590,875 X. .4); and the successors save overall estate tax in that amount when compared to a full QTIP election on the death of the first spouse.[vii]

Of course, federal estate tax must be payable on the death of the surviving spouse in order to take advantage of the PTC. Thus, if there is no federal estate tax payable (such as a formula charitable gift that eliminates federal estate tax on the death of the surviving spouse) no advantage is gained by not making a full QTIP election on the death of the first spouse.

<u>Obtaining a six-month extension of time to file the Form 706 and one-year extension of time to pay federal estate tax are recommended action for all estates in which the payment of federal estate tax might be possible on the death of the surviving spouse.</u>

Therefore, preparers of Form 706 should secure as much time as possible to decide whether or not estate tax will be fully deferred without causing penalties for late filing or **late payment** to arise during that decision making process. The extension of time to pay federal estate tax is governed by Code §6161 and the regulations thereunder. The importance of obtaining the one-year extension of time to pay has been highlighted as a result of a recommendation made by a former IRS Group Manager while she was employed with the IRS.[viii] This maximum time can be obtained by timely filing an application for an additional six months for the filing of the estate tax return, and an additional twelve months to pay estate tax. The Application for Extension of Time to File, etc. (Form 4768) is used to secure these extensions.

The estate tax return can be filed within nine months of death, if desired, even with an approved extension of time to file and pay estate tax. Given the concern of many clients to move administration to conclusion, or perhaps concern with deemed sale treatment in the funding of a pecuniary gift, there may be valid reason to file within the un-extended time period. However, Regs. §20.2056(b)-7(b)(4) authorizes the taxpayer to revoke a prior QTIP election (or make a QTIP election is not previously elected on the original estate tax return) as long as the supplemental return making the change is timely filed, including extension. By filing for the automatic six-month extension of time to file the estate tax return, the taxpayer receives up to 15 months from the decedent's death to timely file the estate tax return and decide how to determine whether to fully or partially make… or not at all… the marital deduction QTIP election.
This enables the fiduciary and advisors to move forward, with at least the return filing, while preserving the maximum time to undue a prior QTIP election.

This author recommends that these extension applications be filed soon after death so that any last minute rush is avoided and the response is received from the IRS well in advance of filing deadlines in the event that any issues arise.

<u>Suggested language to obtain a one-year extension on the death of the first spouse when a QTIP trust is part of the plan.</u>

The following language has been employed and recommended by this author, with modification to a particular estate, to obtain a one-year extension of time to pay federal estate tax in the non-portability context when filed concurrent with the automatic six-month extension of time to file the estate tax return:

The decedent's estate includes a martial trust to which a QTIP election may be made under Code §2056(b)(7). In the event that a full QTIP election is made, there will be no estate tax payable. In the event that said election is not fully made, there will be/may be estate tax payable. However, that fact may not be known until the return is filed. Unless an extension is granted, the estate will be in the position of having to raise funds or sell property on adversely short notice to pay estate tax and avoid a penalty for late payment that may result in the event the QTIP election is not fully made and the return is timely filed under extension. The QTIP election, once made, is irrevocable. Code §2056(b)(7)(B)(v). However, a QTIP election may be revoked or modified on a subsequent Form 706 filed on or before the due date of the return, including extensions. Reg. §20.2056(b)-7(b)(4)(ii). It is highly possible, and in fact a legal right, for the executor to elect into, or elect out of the QTIP election, within fifteen (15) months of death, on an estate tax return timely filed under extension. Accordingly, it may not be possible to know until the last minute whether or not estate tax will be payable. Furthermore, it would be inappropriate for the IRS to deny this extension request. Rev. Rul. 59-9, 1959-1 C.B. 232, provides that the value of a life estate qualifies for the credit for tax on prior transfers authorized by Code §2013, notwithstanding the fact that it is not included in the gross estate of the transferee decedent. The granting of the extension requested protects this possible prior transfer credit and enables the estate to pay the estate tax liability in accordance with statutory elections, regulatory rights, and public ruling determinations that the IRS has made. Accordingly, the extension is needed in order to avoid undue hardship to the estate. (*Added comment: If the estate is not all cash or sufficiently cash to be able to pay federal estate tax on a moment's notice, then add the following: The estate consists of substantial assets that cannot be readily converted to cash within the time in which the determination of the federal estate tax may become known based on facts that may arise at or near the extended due date for filing the federal estate tax return; thus, leaving the estate unable to utilize the extended filing due date without incurring a late payment penalty. In particular, the estate consists of the following assets and approximate values [list them]).*[ix] Therefore, request is made for an extension of time to pay estate tax to the date that is twelve (12) months after the initial due date for the filing of the estate tax return, to wit, to and including __________, 20___.

<u>Whether out of policy or lack of understanding, the IRS has commenced arbitrary and wrongful denials of the one-year extension request.</u>

In recent weeks it has this author has been advised that different extension reviewers at the IRS have denied a one-year extension of time to pay to different taxpayers filed by different practitioners using the foregoing or similar language. In each instance, either with or without explanation, only a six-month extension was granted. In one instance in which a six-month extension was granted, the IRS reviewer stated that if the estate needs additional time to pay estate tax because it chooses to not make a full QTIP election that the estate can file a request for an extension of time to pay estate tax and "it will be considered then." However, there is no assurance that additional time will be granted to make payment.

However, even if the taxpayer believes that he or she knows how much estate tax will be payable, or none at all, near the end of the 15th month, potential to change that decision at the last minute (such as to pay federal estate tax) will not be known until the end of the period of time, including extension, to timely file. Is the executor supposed to pre-pay estate tax to protect the possibility of electing out of QTIP within the 15-month period, or pay a penalty for late payment if tax is not fully paid within that 15-month period? Without the additional time to pay beyond the extended due date the file, the executor may have to file its final timely estate tax return and then hope that the IRS will grant the extension of time to pay in that circumstance. Why should a penalty rest on the “hope” that an official will do the right thing when the QTIP election (opt in and opt out) and PTC are rights under law and the key facts may not be known until very shortly before the ultimate timely filing deadline? Should not the common sense and historic acceptance of the one-year extension grant be sufficient when the reasonableness of the one year extension is so logical, fair and just to taxpayers?

To make matters worse, the IRS personnel reviewing extension requests offer no compromise. Thus, if an additional six months beyond the filing deadline is not acceptable, then the IRS should provide some other, lesser extension that will not leave the extended deadline for filing and payment co-extensive when late decision making is likely. This removes the pressure on the taxpayer of likely not hearing back from the IRS on the result of the second extension request. Taxpayers are left to hope that a reasonable extension will be granted. However, as the quoted language implies, there are no assurances.

It can take time to sell assets and transmit the funds for timely payment. Selling securities can take time. Few estates keep cash or demand deposits on hand available to disburse on a moment’s notice. Even if the executor believes the amount of estate tax will be zero, the executor will not know until on or near the last day for extended time to file whether the surviving spouse dies, becomes critically ill or determination otherwise exists to not fully make the QTIP election. Finally, if the payment of estate tax within the 15-month period (on possibility of not fully making the QTIP election) exceeds $2 million, the IRS will have to go before the Joint Committee of Taxation to authorize the refund.

Thus, anything short of additional time beyond the 15-month extended time to file the estate tax return amounts to an arbitrary and wrongful denial of the time allowed with a timely-filed estate tax return to effectively elect (or elect out) of a QTIP election, possibly protect the PTC and pay estate tax without penalty. That failure to grant the one-year extension of time to pay results in per se hardship to the estate. The one-year extension provides nothing more than an additional six-months after the extended due date of the estate tax return to pay estate tax without penalty.

To be consistent with the movie theme of this author this recent pattern of denying the one-year extension that has been consistently approved in the potential QTIP setting is dedicated to *Catch 22*—the story of government bureaucracy.

Conclusion

Hopefully, the branch of the IRS that considers extensions of time to pay federal estate tax will recognize the problem they have created by not granting a one-year extension of time to pay federal estate tax when a trust to which a QTIP trust might be made in an estate on which estate tax might be paid on the death of the surviving spouse. The author requests that readers inform LISI if they have encountered instances similar to those experienced by and reported to this author where only six-month extensions of time to pay of only six months on the death of the first spouse when a QTIPable trust is part of the estate plan.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Keith Schiller

CITE AS:

CITATIONS:

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[i]From the film by that name, *Catch 22.* Paramount Pictures and Filmway Productions ©1970. All rights reserved.

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[iii] See, Keith Schiller, *Ode to the Estate Tax Return*, LISI Newsletter #724, September 13, 2004 and Schiller, *Don't QTIP Too Soon*, BNA, Estate Planning, Probate and Trusts Journal (Nov., 2001). The major change in the law since these earlier articles is the elimination of estate tax rates in excess of 40% and the increase in the basic exclusion amount to eliminate federal estate tax on the death of United States citizen or resident alien at a rate below 40%. As a result, there is currently no so-called "bracket ride" that enables estate tax to be payable at rates below 40%.

[iv] See, *Estate of Harrison v . Comr*. 115 TC 13 (2000) arising in the setting of a common disaster.

[v] Reg. Sec. 20.2013-6; *Estate of Meyer* 86-1 USTC Par. 13,650 (3rd Cir. 1986).

[vi] Rev. Rul. 59-9, 1959-1 C.B. 232; Rev. Rul. 77-156, 1977-1 C.B. 269; and Rev. Rul. 75-550, 1975-2 C.B. 357; and, Rev. Rul. 85-111, 1985-2 C.B. 196.

[vii] The author thanks Robert Keebler, CPA and Stephen J. Bigge, CPA of Keebler & Associates, LLP, Green Bay, Wisconsin, for their assistance with this illustration.

[viii] The author thanks now retired IRS Estate and Gift Tax Group Manager Janet Holman for making this recommendation. As an additional point of reference, this author taught federal estate tax return preparation practice for several years with IRS Senior Estate Tax Attorney Joseph Stemach. It was Joe who alerted this author decades ago and the class to errors and omissions claims he had seen against practitioners who failed to obtain additional time to pay federal estate tax in the potential QTIP setting.

[ix] The italicized language is added as a recent suggestion in light of the apparent change by relevant IRS personnel to recognize the per se need for additional time to pay beyond the six-month extension of time to file.