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Advanced Tax (and Related) Issues

A. Estate Tax Update.

1. **Estate Tax Exemptions and Rates.** Washington decedents are potentially subject to both state and federal estate taxes. The Personal Representative[1] of a Washington state decedent's estate is required to file a Washington state estate tax return if the gross estate meets or exceeds the $2.193 million filing threshold/exemption amount as of the date of death (even if no tax is ultimately due, e.g., in the case of a surviving spouse sole beneficiary). If the total gross estate is below the filing threshold, no tax is due, and no estate tax return needs to be filed.

Although the state exemption is indexed to inflation by statute, RCW 83.100.020(1)(b) defines the applicable "consumer price index" to mean the consumer price index for all urban consumers, all items, for the Seattle-Tacoma-Bremerton metropolitan area. That index no longer exists, so until the statute is revised (for example, to refer to the current Seattle-Tacoma-Bellevue Index), the exemption remains fixed at $2.193 million. As of the date of these materials, the Washington State legislature is considering HB 1484 to increase the exemption to $2,659,000 starting August 1, 2023, and to make future adjustments based on an index applicable to Seattle and surrounding areas.

[1] RCW 11.02.005(14) defines "Personal Representative" to include any executor of a testate estate or administrator of an intestate estate.

The current Washington State estate tax applies to taxable estates at an initial rate of 10%, which grows incrementally as the size of the estate increases. The current maximum rate of 20% applies once the Washington Taxable Estate reaches $9,000,000. However, on February 8, 2023, HB 1795 was introduced to the 69th session of the Washington State legislature, which proposes substantial changes to the Washington State estate tax rate structure. Under the proposal, rates would remain unchanged for Washington Taxable Estates with a value of $3,000,000 or less, but taxable estates in excess of $3,000,000 will all be subject to rates higher than the current 20% maximum, with a top rate of 40% applicable to estates in excess of $1 billion. The complete rate change proposal is reproduced below:

If Washington Taxable Estate is at least	But Less Than	The amount of Tax Equals Initial Tax Amount	Plus Tax Rate %	Of Washington Taxable Estate Value Greater than
$0	$1,000,000	$0	10.00%	$0
$1,000,000	$2,000,000	$100,000	14.00%	$1,000,000
$2,000,000	$3,000,000	$240,000	15.00%	$2,000,000
$3,000,000	$4,000,000	$390,000	((~~16.00%~~)) 18.00%	$3,000,000
$4,000,000	$6,000,000	((~~$550,000~~)) $580,000	((~~18.00%~~)) 22.00%	$4,000,000
$6,000,000	$7,000,000	((~~$910,000~~)) $1,020,000	((~~19.00%~~)) 24.00%	$6,000,000
$7,000,000	$9,000,000	((~~$1,100,000~~)) $1,260,000	((~~19.50%~~)) 26.00%	$7,000,000
$9,000,000	$12,500,000	((~~$1,490,000~~)) $1,780,000	((~~20.00%~~)) 28.00%	$9,000,000
$12,500,000	$22,500,000	$2,760,000	29.00%	$12,500,000
$22,500,000	$100,000,000	$5,660,000	30.00%	$22,500,000
$100,000,000	$1,000,000,000	$28,910,000	35.00%	$100,000,000
$1,000,000,000		$343,910,000	40.00%	$1,000,000,000

The federal estate tax filing threshold/exemption is significantly higher. With Revenue Procedure 2022-38, the IRS announced the increase to the estate, gift, and generation-skipping transfer tax exemption[2] amounts from 2022's $12.06 million to 2023's $12.92 million. The rate applicable to amounts in excess of the federal exemption is 40%. The filing threshold is generally met if (i) the total assets owned at death plus (ii) the aggregate value of lifetime taxable gifts for which the decedent filed a Form 709 (federal gift tax return) exceeds the then-applicable amount. Accordingly, Personal Representatives must not only ascertain the gross value of the assets owned at death, but also review previously filed gift tax returns and unreported taxable gifts (for example, gifts made in the decedent's year of death or year prior to death for which returns are due but have not yet been filed) to determine if a Form 706 must be filed.

2. **Clawback.** The current (historically record high) federal exemption amount is scheduled to expire on December 31, 2025, which will reduce the exclusion amount to $5 million (adjusted for inflation from 2011) as of January 1, 2026. It is also possible that new federal estate tax legislation will be enacted to reduce the federal exemption prior to that time. Threat of a looming federal exemption decrease reintroduces the concern of estate and gift tax "clawback." Generally speaking, clawback refers to the concept that tax-free gifts made in years with higher applicable exemptions will later be subject to federal transfer taxes upon subsequent exemption reduction. For example, assume an individual makes

[2] As used herein, the term "exemption" refers generally to the amount a decedent may own before a tax is applied. The more technical term for the federal estate and gift tax exemption is the "applicable credit amount," determined with reference to a decedent's "basic exclusion amount"(currently $12.92 million) plus any deceased spousal unused exemption amount " See IRC 2010.

a large taxable gift in 2023 that utilizes all of the individual's $12.92 million gift and estate tax exemption. Assuming the 2026 $5 million (plus inflation) exemption returns, will the taxpayer then have to pay gift tax (or, if he is deceased, will his estate have to pay estate tax) on the amount by which the $12.92 million gift exceeds the reduced 2026 exemption?

To address the clawback concern, the 2017 Tax Cuts and Jobs Act enacted IRC §2001(g)(2), which directed the Treasury to issue regulations with respect to any difference between the exemption applicable at the time of the decedent's death, and the exemption applicable at the time of any lifetime gifts made by the decedent. Issued in 2018 and finalized in 2019, Reg. 20.2010-1(c), commonly known as the anti-clawback regulation, confirms that the larger exclusion ($12.92 million in 2023) applicable in the year of transfer is generally applied, and the excess value of the transfer over the subsequent (lower) exemption amount will not be clawed back into the estate.

However, on April 27, 2022, the IRS issued Proposed Regulation sec. 20.2010-1(c)(3), an anti-abuse provision that would prevent the anti-clawback special rules from being applied to gifts prior to 2026 that are included in the taxable estate under other rules. For example, assume that in 2023, an individual transfers substantial assets to a four-year grantor retained annuity trust (GRAT), which results in a taxable gift of $12.92 million. The gift is entirely covered by the taxpayer's exemption, and no gift tax is due. However, assume further that the individual dies in 2026 and thus fails to survive the trust term. As a result, the gifted assets (which would have been removed from his taxable estate had he survived the four year term) are included in the decedent's taxable estate. The "anti-abuse" rule serves to disallow the use of the higher $12.92 exemption against those assets

to compute the estate tax, meaning the lower exemption amount in place in 2026 (the year of death) would apply for those purposes.

B. Tax Forms, Deadlines, and Elections.

The primary forms utilized by the Personal Representative of a taxable estate are the "Washington State Estate and Transfer Tax Return"[3] and IRS Form 706.[4] Although Washington state does not have a state-level income tax, estates are additionally required to file a federal income tax return (IRS Form 1041[5]) for each year in which gross income exceeds a de minimis threshold (currently $600).[6]

If required, estate tax returns are due nine months from the date of death, with an optional 6 month automatic extension. Despite the availability of the extension, the tax is due at the nine-month initial filing deadline date (i.e., extensions to file do not extend the deadline to pay the tax). In practice, good faith estimates of the amount due are sent with extension forms, and the Personal Representative later seeks a refund of overpayment, or if the estimated amount was insufficient, makes a final payment (with interest) with the filing of the return.[7] The IRS has the discretion to grant an additional filing extension upon a showing of "good and sufficient cause." The extension generally may not be granted for more than an additional six months (though a Personal Representative who is abroad can request a longer discretionary extension). Requests for an extension of time to file are made by completing Form 4768, "Application for Extension of

[3] https://dor.wa.gov/sites/default/files/2022-02/85_0050e.pdf?uid=639115f271c19.

[4] https://www.irs.gov/pub/irs-pdf/f706.pdf.

[5] https://www.irs.gov/pub/irs-pdf/f1041.pdf.

[6] Tax laws and forms are periodically updated, and all form examples at the included links may be out of date by the publication date of this article. Practitioners must independently confirm they are utilizing the proper form for the proper reporting period.

[7] Significant penalties can apply if the estimated amounts substantially underpay the tax. See, e.g., IRC 6662(g).

Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes." Upon receipt and review of a Form 4768,[8] the IRS determines whether an extension is approved and, if so, the length of the extension.

To obtain the additional extension, a "good and sufficient cause" must be demonstrated. Generally, only causes beyond the taxpayer's control are acceptable.[9] The IRS's consent to additional extension requests will not be granted if there is no reason other than the taxpayer's own laxity.[10] The IRS usually will grant an additional extension in cases where the taxpayer, despite a good effort, cannot get professional help in time to file.

The Department of Revenue will also consider an additional extension up to an additional six months. In order to seek the additional extension, the Personal Representative must attach a statement to the extension form[11] explaining in detail why it is impossible or impractical to file by the due date. However, an additional extension will not be granted unless the Personal Representative is abroad.

In addition to the estate tax returns and extension forms described above, there are many other decisions and elections a Personal Representative must consider when administering an estate. The following discussion is not intended to be exhaustive, particularly with the many issues that arise in preparing estate income tax returns.[12] However, many of the more important tax issues facing a Personal Representative are described below.

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[8] https://www.irs.gov/pub/irs-pdf/f4768.pdf.

[9] Ann 60-90 , 1960-45 IRB 31 Rev Rul 83-27.

[10] Rev Rul 83-27 , 1983-1 CB 337.

[11] https://dor.wa.gov/sites/default/files/2022-02/850048_850052combined.pdf?uid=63b70c83303ae

[12] Although the author regularly prepares gift and estate tax returns, he is not an income tax return practitioner. For attorneys who similarly do not prepare income tax returns, the discussion of estate income tax issues herein is to generally make the attorney aware of potential options to

1. **Selection of the Estate's Tax Year**. Following death, the individual's estate becomes a separate taxpayer, with all income and deductions to be reported on the Form 1041 fiduciary income tax return. Estates are not required to report income and deductions on a calendar-year basis and can instead choose between reporting on a calendar year or a fiscal year basis. The tax-year election is made on the estate's first fiduciary income tax return. Treasury Regulations section 1.441-1(c)(1).[13] A related election to consider is whether to elect a "short period." With some exceptions, IRC §§ 443 and 7701(a)(1), (14) provide that a "short period" is a period of less than 12 months. These elections essentially allow the Personal Representative and advisors to terminate the tax year when it will result in the least amount of tax.

A fiscal tax year is selected when doing so serves to reduce the overall income taxes due at the estate and beneficiary levels (i.e., results in better utilization of the lower income tax brackets that may be available to the estate and beneficiaries), and/or permits greater deferral of income tax payments. Before the election is made, the Personal Representative should project the timing of anticipated income and allowable deductions and then prepare projected income tax returns with different tax years to see the impact of selecting one fiscal year over another. If the attorney is not an income tax preparer, it is highly recommended to insist the Personal Representative engages the services of a

better assist the Personal Representative in fulfilling fiduciary duties. Consider carefully excluding issues related to income tax reporting in the engagement letter, and/or specifying the attorney's understanding that another adviser (e.g., the estate CPA) is responsible for advising the client with respect to those issues.

[13] IRC § 441 defines a taxpayers "taxable year" as the taxpayer's annual accounting period that may be a calendar year or a fiscal year. IRC § 441(e) defines a "fiscal year" as any period of 12 months ending other than in the month of December. IRC § 441(d) defines a "calendar year" as a tax year as ending on December 31.

Certified Public Accountant to handle all income tax related filings and elections. The payment of income taxes, and how that impacts the needs of the estate beneficiaries, must also be considered in selecting a tax year.

2. Final Income Tax Return/Joint Final Personal Income Tax Return with Surviving Spouse. The Personal Representative is generally responsible to ensure that the decedent's final income tax return is filed and any tax liability reflected thereon is timely paid. The Personal Representative will need to determine whether to file the final return (which reports the decedent's income from the beginning of the taxable year of death to date of death) as an individual return or as a joint return with the surviving spouse.[14]

A joint return may only be filed if (1) the decedent was married to the surviving spouse on the date of death (2) the surviving spouse has not remarried before the end of the taxable year in which the decedent passed away,[15] and (3) neither spouse is a nonresident alien at any time during the taxable year.[16] If joint filing is available, the joint return includes the decedent's tax items through date of death, and the surviving spouse's tax items for the entire taxable year.[17]

Filing jointly is generally more favorable, and is the more typical approach. Filing jointly can avoid losing excess deductions, excess capital losses, and excess charitable deductions, particularly when the decedent dies early in the year and does not have sufficient income at date of death to maximize the benefit of those tax items. Additionally, filing a joint return generally subjects the decedent's income to more favorable tax rates than those applicable to married persons filing

[14] See Treasury Regulations section 1.443-1(a)(2).

[15] IRC section 6013(a)(2).

[16] IRC section 6013(a)(1).

[17] Treasury Regulations section1.6013-1(d)(1).

separately (though there can be exceptions justifying separate filing, for example, claiming a medical expense deduction for a lesser earning spouse). That said, when filing jointly, the estate becomes jointly and severally liable for the surviving spouse's tax liability[18]. Accordingly, the Personal Representative should be satisfied that the surviving spouse's post-death (and potentially unknown) income tax responsibilities can and will be satisfied.

3. Allocation of Deductions. Another important decision facing a Personal Representative is whether to take particular deductions on the estate income tax return, or on the estate tax return. Typical expenses incurred during the administration include Personal Representative, attorney, accountant, and appraiser fees; fees incurred in connection with selling real estate and tangible property (though see below for recent developments on that issue), and the costs of insuring and storing estate assets. Most administration expenses can be deducted on either the federal estate tax return or the estate's fiduciary income tax return, but not both. IRC section 642(g). There are, however, notable exceptions. For example, funeral expenses are not deductible on the estate income tax return.

The Personal Representative should generally allocate the deductible expenses between the returns in a manner that results in the greatest amount of overall tax savings. With the current $12.92 million federal estate tax exemption (and also in cases where the marital deduction covers the entire estate), taking deductions on the federal estate tax return provides no federal tax benefit, since there is no federal estate tax liability to offset. In particular, the decedent's final medical expenses are subject to various rules that should be considered (see, e.g.,

[18] IRC section 6013(d)(3).

IRC section 213(c) and 2053(a)(3)).[19] In general, it is important to calculate the impact of deducting the expenses on the final personal income tax return versus on the estate tax return in order to determine which method will result in the lower overall tax paid by the estate.

4. IRC 645 Election for Qualified Revocable Trusts. Pursuant to the election under IRC 645, the income and deductions of the decedent's estate and revocable trust may be reported on a single income tax return. This allows for simplification and greater tax-year selection flexibility (absent the election, the trust generally cannot elect a fiscal year). The election also enables more flexible distributions eligible for charitable income tax deductions, and can enable a longer period in which the trust may hold S corporation interests.

The IRC 645 election must be made by both the Personal Representative and trustee of the revocable trust by attaching IRS Form 8855 to the estate's first income tax return. The election is irrevocable once made, though practitioners must be cautious regarding the date the election may terminate (generally two years from the date of decedent's death if no federal estate tax return is required, or six months after the final determination of estate tax liability. IRC section 645(b)(2)).

[19] If the executor pays the medical expense during the one-year period after the decedent's death, the expense will be deemed paid by the decedent at the time it was incurred, and thus is eligible to be deducted on the final personal return IRC section 213(c)(1). However, in order to be able to deduct the expense on the final personal return, the executor must include a statement attached to the final personal return stating that the amount has not been taken as a deduction on the federal estate tax return and waiving the right to have the amount deemed a deduction on the federal estate tax return at any time. IRC section 213(c)(2). Moreover, the medical expenses may only be deducted on the final personal income tax return if the total of the expenses exceeds 7.5% of the adjusted gross income reported on the return, per IRC section 213(a).

5. **Alternate Valuation Date**. Assets are generally valued on the estate tax return as of the decedent's date of death. However, if the Personal Representative elects to use alternate valuation, the assets are generally valued as of six months after date of death. Alternate valuation is useful if the assets of the estate decrease in value during the six months after death.

The alternate valuation election is generally available if (1) the estate is subject to an estate tax payment liability, and (2) the use of the alternate date would reduce the value of the gross estate and the amount of estate tax due. IRC 2032. If the alternate date is elected, all assets in the estate are valued six months after the date of death, unless an asset is sold, exchanged, distributed to a beneficiary, or otherwise disposed of within six months of death. In those cases, the asset is valued as of the date of the applicable transfer. Due to the requirement that the alternate valuation election must reduce tax due, asset values must be obtained and tax calculated on both the date of death and the alternate valuation date, and must be demonstrated on the return. This can substantially increase administration costs (e.g., qualified business interest appraisals as of both dates), which must be considered by the Personal Representative when determining whether to proceed with the alternate date.

6. **Special Use Valuation**. Generally, assets included in a decedent's gross estate are valued at their "highest and best use." However, certain assets qualify for a reduced value based on their actual special use. An election of the special-use valuation is used to reduce the value of qualified real property included in the gross estate of a decedent. Qualified real property typically is farm or real property used in a business or trade. IRC §2032A.

Property may be valued at a reduced special use rate if (i) the decedent was a U.S. Citizen or resident at the time of death, (ii) the real property is in the United States, and (iii) at the decedent's death, the real property was used by the decedent or a family member for farming, or in a trade or business. Moreover, (iv) the real property must pass from the decedent to a qualified heir of the decedent, (v) and have been owned and used in a qualified manner by the decedent or a member of the decedent's family during five of the eight years before the decedent's death, and (vi) there was material participation by the decedent or a member of the decedent's family during five of the eight years before the decedent's death. Finally, (vii) at least 50% of the adjusted value of the gross estate must consist of the adjusted value of real or personal special use property, and (viii) at least 25% of the adjusted value of the gross estate must consist of qualified real property.

7. IRC 6166 Estate Tax Payment Deferral: When (i) an estate is subject to estate taxes, (ii) liquidity to pay the tax due is an issue, and (iii) there is a closely held business interest in the estate, an IRC 6166 election should be considered. The election is made when filing the estate tax return (including extensions thereof). The IRC 6166 election generally allows a Personal Representative to extend payment of part or all of the portion of the estate tax that is attributable to a closely held business interest (as defined in section 6166(b)(1)). See Treas. Reg. § 20.6166A-1). Once made, the Personal Representative may defer payment of the estate tax for an extended period, and then make the payments in installments. The maximum number of installments is ten, and interest only payments may be made for the first four years after the return due date (determined without extensions). Interest plus an equal installment of tax is paid in each of the following 10 years, for a maximum deferral of fourteen years from

the original return due date. The election is generally available if the gross estate of a U.S. citizen or resident includes the value of an interest in a closely held business, and the value of the interest exceeds 35% of the adjusted gross estate.[20] The maximum amount of the tax eligible for the installments is the portion of the total tax attributable to the value of the closely held business (i.e., the tax attributable to the non-closely held business assets is not eligible for Sec. 6166 deferral).

On the surface, the deferred payment schedule may seem attractive. The estate avoids the immediate burden of a lump-sum payment, which can permit the business to continue operations in as normal a manner as is possible under the circumstances. In the long run, however, there are a number of potential problems:

(a). Interest must be paid on the unpaid amount throughout the payment period.

(b). The IRS places a tax lien (special IRC 6324A lien for taxes deferred under IRC 6166) on the business to ensure all installment payments are met.

(c). The estate remains open and unresolved for the entire installment payment period. This greater debt may negatively affect the company's credit and hinder its ability to borrow and/or otherwise raise funds.

(d). If the business is unable to make any payment on time, the IRS can demand the immediate payment of the full amount. The transfer of one-half or more of an interest in the business assets also terminates the extension period in which case all unpaid taxes are due.

[20] There are alternative methods of qualifying for the election, see e.g., family attribution.

(e). The deferral period does not apply to the non-business assets, so even if the Personal Representative elects this option, the estate still needs enough liquidity to meet administration expenses, cash bequests, state death taxes, and any other federal taxes (e.g., income). There will be additional liquidity needs throughout the deferral period such as accountant and attorney fees.

8. Portability (DSUE) Election. If an estate is not required to file a federal estate tax return, it may still be beneficial for a surviving spouse to file a Form 706 for the sole purpose of making a portability (aka Deceased Spouse's Unused Exemption, or DSUE) election. A portability election allows a surviving spouse to add the unused exemption of his or her deceased spouse to his or her own federal estate and gift tax exemption amount. A portability election must be made on a federal estate tax return for the deceased spouse's estate. This election can be particularly beneficial to spouses with estates under the current federal exemption that will have federally taxable estates under the $5 million plus inflation exemption returning in 2026 under current law (and also guards against any other reduction to the current exemption prior to or after that time). In Revenue Procedure 2022-32, the IRS extended the timeline to file a portability-only estate tax return from two years after the death of the deceased spouse to five years after the death of the deceased spouse.

C. Tax Basis Reporting.

To address historic lack of consistency between values reported on estate tax returns and bases claimed for determining income taxes due on subsequent sales, Congress and the IRS implemented basis filing requirements for estates requiring an estate tax return filing. For Form 706 returns filed after July 31, 2015,

an additional filing requirement (reported on Form 8971) requires the Personal Representative or trustee to report the value of certain estate assets to the beneficiaries/recipients of those assets. The due date for filing a Form 8971 is the date that is no later than the earlier of:

(i) The date that is 30 days after the date on which Form 706 or Form 706-NA is required to be filed (including extensions) with the IRS; or

(ii) The date that is 30 days after the date Form 706 or Form 706-NA is actually filed with the IRS.

Each estate beneficiary (including trustees of trusts) listed on the Form 8971 receives a "Schedule A" disclosing the asset values reported on the estate tax return and either (a) held by the recipient at decedent's date of death; or (b) distributed to the recipient after decedent's date of death. Certain assets such as cash and assets sold by the estate (rather than distributed in-kind to estate beneficiaries) are not required to be reported on Form 8971 and the accompanying Schedule(s) A. If Form 8971 is not timely filed, the IRS has the authority to impose financial penalties.

Form 8971 is generally not required when the gross estate plus adjusted taxable gifts is less than the federal exemption amount, or when the estate tax return is filed solely to make an allocation or election respecting the generation-skipping transfer tax; or to elect portability of the deceased spousal exclusion amount (DSUE).

D. Recording Income, Loss

Particularly with ongoing estates, the Personal Representative also must be mindful of options regarding timing the receipt of income and flow through and allocation of tax attributes. Washington State has adopted the Uniform Principal and Income Act, at RCW 11.104B which governs how the Personal Representative allocates between income and principal. RCW 11.104B.070 ("Fiduciary duties—Power to adjust") generally provides that, unless otherwise provided in the terms of a trust or by applicable law "a fiduciary… without court approval, may adjust between income and principal if the fiduciary determines the exercise of the power to adjust is necessary to administer the trust or estate." A fiduciary is also granted the power to convert to a unitrust approach under RCW 11.104B.120. Moreover, the regulations under Sec. 643 provide fiduciaries with some flexibility in making distributions of capital gains to beneficiaries. See, e.g., Treas. Reg. § 1.643(a)-3(b)(1), which permits the fiduciary to treat certain capital gain receipts as income for trust accounting purposes. Personal Representatives should discuss with their advisors the options available under state law, including the "power to adjust" and "unitrust" provisions, and how those provisions intersect with Regs. Sec. 1.643(a)-3.

E. Allowable Expenses and Gray Areas

1. Funeral and Administration Expenses.

(a). Federal Law - REG-130975-08. In June 2022, the IRS issued REG-130975-08[21] which proposed[22] changes (the "2053 proposed regs.") to

[21] REG-130975-08, https://public-inspection.federalregister.gov/2022-13706.pdf.

[22] Proposed regulations are not effective until after the notice and comment period and issuance of a final regulation, and thus are not entitled to the usual weight accorded to final regulations. See, e.g., *F. W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970); *KTA-Tator, Inc. v. Commissioner,* 108 T.C. 100, 102-103 (1997) ("proposed regulations are afforded no more weight than a position advanced by the Commissioner on brief"). Proposed regulations may

regulations issued under Code Section 2053. Current reg. § 20.2053-1(d)(1) generally requires that deductions from a decedent's gross estate allowed under IRC § 2053 for funeral expenses, administration expenses, and certain claims against the estate be "limited to the total amount actually paid in settlement or satisfaction of that item," though there are exceptions if "the amount to be paid is ascertainable with reasonable certainty and will be paid." Reg. § 20.2053-1(d)(4).

Part II.B of the 2053 proposed regs. requires the value of an expense or claim deductible under IRC § 2053(a) or Reg. § 20.2053-1(a) that is not paid before the third anniversary of the decedent's date of death to be discounted to present value. Claims or expenses paid prior to the third anniversary of the decedent's date of death would occur during the "grace period," and the present value calculation would not be required. 2053 proposed regs., Part II.B. To calculate the present value of the deductible amount, an estate would be required to discount the deductible amount by the applicable federal rate in the month of the decedent's death, compounded annually, until the date or anticipated date of payment. *Id.* The expected date of payment must be estimated "using all information reasonably available to the taxpayer to make a fair and reasonable estimate of the expected date or dates of payment." *Id.*

(b) State Law - Estate Tax Advisory 3232.2022. The Washington State Department of Revenue (DOR) has become increasingly skeptical of large deductions related to the sale of real property, particularly when the property does not need to be sold for the payment of estate taxes. On June 8, 2022, the DOR issued estate tax advisory (ETA) 3232.2022, which more formally

nevertheless offer guidance for how the IRS views a particular issue and what rules may ultimately be imposed in advance of final regulations.

sets forth this position. In the ETA, the DOR indicated that it interprets IRC § 2053 and related regulations to mean that a Personal Representative's determination that selling property is in the best interest of the estate does not, by itself, establish that selling the property was necessary and deductible. Although a Personal Representative's decision to sell estate property may be reasonable and meet the duty of care, deductibility turns on necessity rather than reasonableness. It is not enough that the Personal Representative determines that selling property is in the estate's interest, or that a probate court authorized the sale, or that there was general volatility in the market. The DOR generally will not permit a deduction for selling expenses if the estate has sufficient other liquid assets to pay the taxes, debts, and expenses of administration. The particular facts and circumstances of each individual case will be determinative.

2. **Graegin Loans.** The term, "*Graegin* loan" comes from *Estate of Graegin v. Commissioner*, T.C. Memo 1988-477, the Tax Court decision in which the validity of planning method was first confirmed. A *Graegin* loan is one that generally has a fixed interest rate, a fixed term of years, and a prepayment prohibition. Because the interest payable on the loan is fixed and determinable, the *Graegin* decision and its progeny allow a full, dollar-for-dollar, estate tax deduction for the payment of all interest due under the loan, including future interest, even though much of the interest would not be paid for many years. The *Graegin* loan thus enabled Personal Representatives of illiquid estates to borrow the cash necessary to pay the estate tax or otherwise administer the estate, while potentially avoiding the fire-sale of estate assets to raise the funds necessary to pay the estate tax.

Part III.B.2 of the 2053 proposed regs. will still allow an estate to deduct the interest accrued on *Graegin* loan obligations incurred by the estate, but only if:

(a). The interest accrued under an instrument or contract that constitutes indebtedness under applicable income tax regulations and general principles of federal law;

(b). Both the interest expense and the underlying loan are bona fide[23] in nature; and

(c). The underlying loan and its terms are actually and necessarily incurred in the administration of the decedent's estate and are essential to the proper settlement of the estate.

The 2053 proposed regs. provide a nonexclusive list of factors for considering whether these requirements are met, including: (1) if the interest rate and loan terms were reasonable given all the facts and circumstances; (2) if the lender properly included the loan and interest payments in gross income for federal tax purposes (especially if the lender was family); and (3) if the loan term and payment schedule correspond to the estate's ability to make the payments.

The 2053 proposed regs. acknowledge that some estate loans are bona fide and therefore the interest expense should be deductible, but that they seek to restrict estates that do not have genuine liquidity issues. 2053 proposed regs.

[23] "Whether a note creates a bona fide debtor-creditor relationship is a factual question, an essential element of which is the intent of the debtor to make payment and the intent of the creditor to enforce such payment." GCM 34579 (citing *Anson Beaver*, 55 T.C. 85 (1970)).

§20.2053-3(d)(2). The 2053 proposed regs. further suggest that the interest expense on an estate loan will be deductible if the lender is not a substantial beneficiary of the decedent's estate (or an entity controlled by such a beneficiary) and "when there is no viable alternative" to pay the estates liabilities. 2053 proposed regs., Part III.B.2. On the other hand, the 2053 proposed regs. suggest that the interest expense will not be deductible when the lender is a substantial beneficiary of the estate (or an entity controlled by such a beneficiary) who is either liable for some of the estate tax or whose share of the estate bears the burden of estate tax or other expenses, or if the loan term is extended with a single balloon payment that does not correspond with the estate's ability to satisfy the loan. *Id.*

3. **Requirements for Substantiating the Value of a Deductible Claim.** Generally, an estate may only deduct claims[24] actually paid or ascertained with reasonable certainty. However, exceptions exist for claims and counterclaims in a related matter, and claims totaling not more than $500,000. Reg. §§ 20.2053-4(a), (b), (c). The value of these claims must be supported by a "qualified appraisal" performed by a "qualified appraiser." Reg. §§ 20.2053-4(b)(1)(iv), (c)(1)(iv). Part IV.B of the 2053 proposed regs. changes the requirements for substantiating the value of deductible claims and counterclaims in a related matter and claims totaling not more than $500,000 under Reg. §§ 20.2053-4(a), (b), and (c). Instead of requiring a "qualified appraisal" performed by a "qualified appraiser," the value can be supported by a written appraisal reflecting the current value of the claim when the federal estate tax return is completed. 2053 proposed regs., Part IV.B. The appraisal must:

[24] In this context, a "claim" is "a personal obligation of the decedent existing at the time of the decedent's death." Reg § 20.2053-4(a)(1) .

(a). Take into account post-death events occurring before the deduction is claimed and reasonably anticipated to occur afterwards;

(b). Consider all relevant facts and elements of value that are known or can be reasonably anticipated;

(c). Be prepared, signed, and dated by a person who is qualified to appraise the claim being valued, but who is not (1) a member of the decedent's family, a related entity, or a beneficiary of the decedent's estate or revocable trust; (2) a beneficiary's family member or related entity; or (3) an employee or owner of any of these individuals or entities;[25] and

(d). Describe the appraiser's qualifications to appraise the claim.

4. **Deductibility of amounts paid under a decedent's personal guarantee.** Under Reg. § 20.2053-4(a)(1), payments made to satisfy a decedent's obligation as the guarantor of a debt are deductible if the debt was a personal obligation of the decedent that (i) existed at the time of the decedent's death and (ii) is enforceable against the decedent's estate. The claim is deductible only to the extent that the guarantee was bona fide and "in exchange for adequate and full

[25] This definition of a qualified appraiser and qualified appraisal is different than the definition for charitable contributions.

consideration in money or money's worth."[26] Reg. § 20.2053-4(d)(5). The 2053 proposed regs. include new guidance on the deductibility of amounts paid under a decedent's personal guarantee in the context of a loan made to the decedent/guarantor's closely held business. 2053 proposed regs., Part V.A. Under Part V.B. of the 2053 proposed regs., the requirement that the guarantee be in exchange for adequate and full consideration in money or money's worth is satisfied if, at the time of the guarantee:

(a). The decedent's guarantee made to an entity in which the decedent had control (within the meaning of section 2701(b)(2)) was a bona fide debt; or

(b). The maximum liability of the decedent under the guarantee did not exceed the fair market value of the decedent's interest in the entity.

The amount deductible for the guarantee will be reduced by the decedent's estate's right of contribution or reimbursement, in accordance with Reg. § 20.2053-1(d)(3). 2053 proposed regs., Part V.B.

F. Tax Liens, Audits, Disputes

A Personal Representative must be wary of federal and state tax liens and audits, as well as the risk of disputes and litigation over the estate administration and assets.

1. **Federal Estate Tax Lien:** A federal tax lien is the government's legal claim against property when the taxpayer neglects or fails to

[26] In other words, the decedent must have received a benefit that could be reduced to monetary value in exchange for the guarantee. See *United States v. Stapf*, 375 U.S. 118, 131 (1963) ("Absent such an . . . augmentation of the estate, a testator could disguise transfers as payments in settlement of debts and claims and thus obtain deductions for transmitting gifts.").

pay a tax debt. The lien protects the government's interest in all estate property, including real estate, personal property and financial assets. A federal tax lien exists after the IRS assesses your liability, issues a Notice and Demand for Payment, and the debt remains unpaid within the time proscribed. The IRS then files a public document, the "Notice of Federal Tax Lien."

Liability for the estate tax falls on the estate assets, and Personal Representatives and beneficiaries generally do not have personal liability for estate taxes due. However, if assets are distributed without paying the tax due, the IRS can recover from the personal assets of the Personal Representative. See, e.g., *Estate of Lee v. Commissioner*, TC Memo 2021-92 (estate's Personal Representative was personally liable for the unpaid estate taxes because he made distributions of estate assets with knowledge of the estate tax owed).

2. **State Estate Tax Lien:** RCW 83.100.110 provides that failure to timely pay the estate tax liability results in a lien upon the estate property subject to the tax. The lien generally extends for a 10 year period from the date of the transfer giving rise to the tax, which includes generally "any shifting upon death of the economic benefit in property or any power or legal privilege incidental to the ownership or enjoyment of property." RCW 83.100.020(14). The lien can be extended. The Department of Revenue's lien arises automatically, and requires no separate filing. A Personal Representative (or intestate administrator) who distributes any estate property without first paying or making arrangements for paying (e.g., securing another's payment of, or furnishing security for payment of estate tax due) is personally liable for the taxes due to the extent of the value of any property that was or may have come into the possession of the personal representative. RCW 83.100.120. Additionally, failing to timely notify the state of

the Personal Representative's appointment over an estate when the decedent operated a Washington State business may render the Personal Representative personally liable to DOR to the extent property otherwise would have been available for payment to the state. See e.g., RCW 82.32.240.

3. **Audits**. Though outside the scope of these materials, in making decisions regarding tax filing positions, the Personal Representative must consider audit risk. As of the date of these materials, the IRS has made significant agent hiring increases to curb perceived abuses of the federal tax system. Prudence dictates that the Personal Representative of any federally taxable estate should assume an audit is forthcoming, and plan accordingly. This generally requires accurate and complete record keeping, identifying risky return entries, and considering the potential consequences of the IRS taking a contrary position. Advisors to Personal Representatives should likewise counsel their fiduciary clients of these risks and consequences, and wherever practical, seek beneficiary consent to any position or action that bears any significant risk.

4. **Disputes**. Due to the vast amounts of wealth transferring from the baby boomer generation to its beneficiaries,[27] estate and trust litigation is becoming more commonplace, more complex, and more destructive. Identifying potential problem areas while decedents are living is the best approach, but advisors of estate Personal Representatives must be proactive in assisting their clients in identifying areas of possible dispute. Example can include, (i) known relationship issues between beneficiaries, (ii) prior threats of or actual litigation between beneficiaries and/or between beneficiaries and the decedent, (iii)

[27]Americans aged 70 and above had a net worth of nearly $35 trillion, according to first quarter 2021 Federal Reserve data.

beneficiaries residing in estate property, (iv) beneficiary businesses operated on estate property, and (v) beneficiaries serving as paid or unpaid caretakers of the decedent prior to death. Washington is potentially better suited than other states to address estate and trust litigation due to its Trust and Estate Dispute Resolution Act (aka "TEDRA"), codified at RCW 11.96A. TEDRA offers streamlined approaches to estate and trust dispute matters, including the nonjudicial agreement authorized by RCW 11.96A.220. This statute enables all persons interested in a particular estate matter to resolve it nonjudicially via agreement. Any attorney representing estate and trust fiduciaries should be intimately familiar with the processes and options available under TEDRA, and be prepared to utilize the tools it provides.

G. Taxation of Digital Assets and Virtual Currency.

Virtual currency and other digital assets have become increasingly popular asset classes, particularly for high net worth individuals. Although a comprehensive discussion of these investments cannot be included here, Personal Representatives must be aware of certain aspects of virtual currency[28] and other virtual assets when administering an estate.

First, virtual assets, including virtual assets that are themselves currency (i.e., crypto currency), are property, the sale of which may trigger taxable gain.[29] Second, the value of virtual assets is highly volatile, which can increase the chances of valuation disputes with the tax agencies upon filing estate tax returns. (However, this volatility can, in the case of significant and sudden value loss, provide an estate

[28] "Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and a store of value other than a representation of the United States dollar or a foreign currency…" Rev. Rul. 2019-24.

[29] "For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency." Notice 2014-21.

tax reduction opportunity through the use of the alternate valuation date election discussed above). Third, this volatility can increase risk of disputes with estate beneficiaries. If one or more beneficiaries elect to take a greater portion of the estate's virtual/digital assets in lieu of other more stable asset classes, a sudden drop in value can result in claims against the Personal Representative for breaching fiduciary duties.

More generally, prior to death, individuals should make their Personal Representatives aware of these assets and how to locate and access them. This should include identifying a safe manner in which to obtain the necessary passwords to access digital assets, such as a list attached to a securely stored will. Washington state has adopted RCW 11.120, the "revised uniform fiduciary access to digital assets act," which provides statutory authority for Personal Representatives to access digital assets of decedents, and provides protections for custodians who disclose them.

H. Charitable Bequests. Many decedents include a charitable component to their testamentary giving planning. The presence of charitable beneficiaries can complicate the administration of an estate. A few of these complications are briefly discussed below.

The Personal Representative should ensure that the charitable bequest is structured in a manner that qualifies for the estate tax charitable deduction, and if so, properly report and deduct the bequest on Form 706, Schedule O. Note that split-interest gifts (for example, a lead interest to a non-charitable beneficiary with a remainder to charity) generally will not qualify for the charitable estate tax

deduction unless they independently qualify as charitable remainder or charitable lead trusts.[30]

If a charitable beneficiary has ceased to exist and no alternate distributive direction is provided, Washington courts may apply the doctrine of *cy pres* to direct the bequest to similar institutions. See, e.g., *Puget Sound Nat. Bank of Tacoma v. Easterday*, 56 Wash. 2d 937, 350 P.2d 444, 449, 451 (1960). Washington state Personal Representatives should also consider whether a suitable replacement charity may be identified and agreed to pursuant to an 11.96A.220 TEDRA agreement.

Finally, a Personal Representative must not unnecessarily delay a charitable bequest, since doing so can result in the estate being subjected to the Internal Revenue Code provisions applicable to private foundations. Generally, an estate with both charitable and noncharitable beneficiaries is not considered to be a split-interest trust to which the rules governing private foundations apply. Reg § 53.4947-1(c)(6)(ii). If an estate administration is unreasonably prolonged, the IRS can deem the estate terminated for income tax purposes.[31]

Once the estate is considered terminated for federal income tax purposes, the estate is treated as a split-interest trust between the date on which the estate is deemed terminated and the date on which final distribution of the net assets to the last remaining charitable beneficiary is made. Reg § 53.4947-1(c)(6)(ii). A

[30] The IRS has published revenue procedures with sample instruments for inter vivos and testamentary charitable remainder annuity and unitrusts that the IRS will recognize as satisfying the requirements of §664(d)(1), §664(d)(2), or §664(d)(3). See, e.g., Rev. Proc. 2003-53 and 2005-52.

[31] *See* 1.641(b)-3, Termination of estates and trusts ("the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration").

Personal Representative that prolongs the administration of an estate (for example, to collect on payment of a debt, or to wait to sell assets in more favorable market conditions) should make all efforts to satisfy the charitable bequests promptly. If not, the private foundation rules, and potential excise taxes and penalties thereon (and prohibitions against self-dealing, e.g., a sale of estate real property to a disqualified person) will apply.