02 Post-mortem

02

POST-MORTEM

Keeping a complex process focused

Company founders often provide the vision and glue that holds a company together. When Tom started his first grocery store in the 1970s, he knew that he wanted to promote locally grown food. He researched and nurtured his vision to grow the organic food market, which ultimately led to his successful chain of organic grocery stores. However, the recent growth and store expansion did not leave him with time to plan for the future leadership succession of his company. So, when Tom, a widower, suddenly died, he still owned a 90% interest in the partnership that held the stores, with his two children owning only 2.5% each and 5% owned by a dynasty trust. The children were left with not only the emotional blow of losing their father, but now also the financial and administrative responsibilities of their father's estate along with planning for the future of the company.

For such a pivotal moment for a family enterprise, in an ideal world, wealthy individuals have prepared for their family's future by leaving a well-constructed estate plan. But, in the real world, some estate plans remain a work in progress for reasons ranging from evolving legislation and complexity to family conflict and indecision. Consequently, post-mortem planning is inevitable; it is merely reduced in scope and complexity where lifetime actions are taken. The more comprehensive the estate plan during life, the fewer actions and decisions that must be taken by executors, trustees, and post-mortem advisors.

For the families and beneficiaries of high-net-worth individuals, settling an estate can be quite extensive, beginning with the process of gathering and determining the value of assets and ending—often many years later—with the distribution of assets. The period in between, called the post-mortem administrative period, often gives rise to complex tax, financial, and other considerations.

Every high-net-worth estate is unique. The type and level of activities required for settling the estate will depend on a host of factors, including the nature

Keeping a complex process focused

of assets and the state of planning that existed at the time of death. For example, the approach for an individual who dies intestate (i.e., without a will or other testamentary declaration) will be very different than the approach for someone who dies with a family office and a private trust company in place. By analogy, an estate's administration is much like playing a hand of cards—much depends on what cards you have been dealt.

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An effective post-mortem administration responds to the estate's unique mix of assets, liabilities, family considerations, and philanthropic directives. A little flexibility and, where necessary, thinking outside of the box can be beneficial to those winding up the decedent's affairs. This article offers a sense of what to expect during the post-mortem administrative period, including the factors that may complicate or simplify it.

What can the family expect to happen during the post-mortem administrative period?

Many activities take place during the post-mortem administrative period, including possibly establishing new trust vehicles and/or new philanthropic vehicles. Therefore, this period often lasts much longer than the estate's beneficiaries expect. There are typically three stages of post-mortem activity.

First, the executor of the estate, should develop a snapshot of the decedent's financial position as of his date of death. Then, the executor must segregate the income and expenses from those assets between activity before death, which is attributable to the final income tax return, and after death, which is attributable to a new legal entity—the estate. The estate then opens its own set of books and maintains these throughout the post-mortem period. Before the estate can pass assets to its beneficiaries, it must satisfy two other groups who have claim to the assets: creditors and tax authorities. Therefore, for Tom's executor, the first stage of post-mortem administration, involves gathering a list of his assets, identifying and satisfying liabilities, and developing the team of advisors who will assist with the timely filing of estate and income tax returns. The executor and beneficiaries also need to make certain decisions that will help them manage the process and make certain tax elections that affect subsequent tax matters.

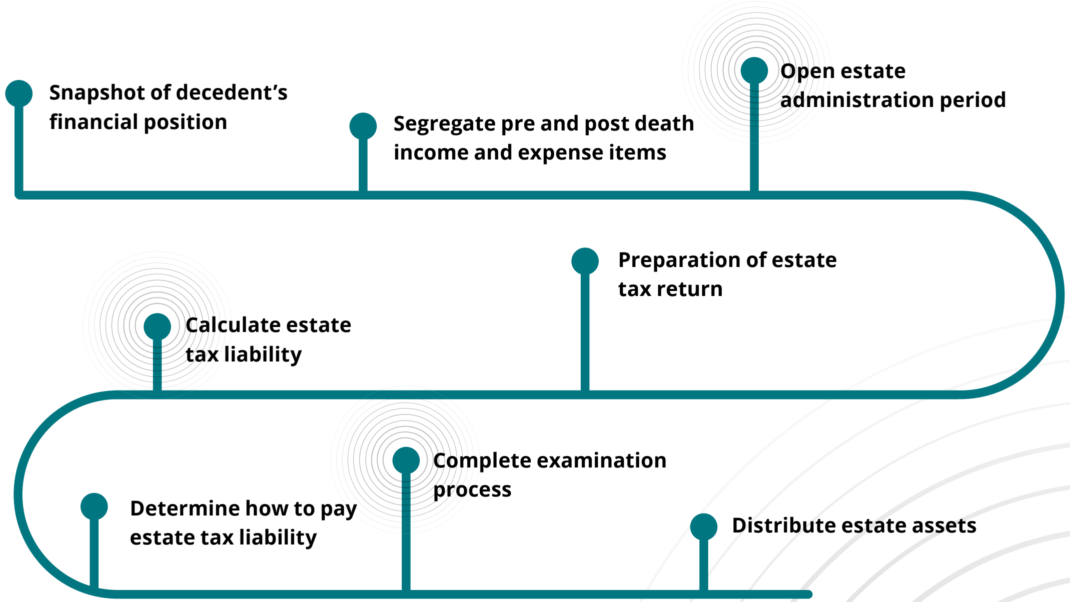
02

POST-MORTEM

Keeping a complex process focused

The second stage involves calculating the estate tax and preparing for its payment. Completing the estate tax return can be a considerable task because of the extensive disclosure requirements. It is even more complicated in situations like Tom's death, when pre-death planning was haphazard or outdated, or if the estate is involved in legal controversies. Considering the high likelihood of IRS examination, the family should consider hiring qualified appraisers to assist in determining the value of assets. Generally, these appraisals will contemplate discounts for lack of control or lack of marketability. Unfortunately, Tom died owning a 90% interest in his partnership, which will likely result in an inflated value of the partnership on his estate tax return, since the value may not be discounted. Ultimately, the estate tax is assessed at forty percent of the taxable estate and is due nine months after date of death. The process of raising cash for paying the estate tax liability often involves considerable time and effort, particularly if it requires selling assets or borrowing funds.

Once the examination process has been completed, the taxes are paid, and there are no outstanding obligations or controversies, the estate will be distributed according to the decedent's testamentary documents as modified by the post-mortem actions that may be taken by the beneficiaries—for example, disclaimers of bequests, etc. Because the liquidation of an estate often occurs years after the date of death, the termination of the estate itself also often gives rise to complicated income tax issues. Without planning in advance, Tom's children may face challenges with these tasks and should seek professional assistance. Additionally, for both themselves and any other heirs, they should be realistic about the timing for disbursement of the assets. In particular, if they do not intend to continue to operate the business themselves, then they will face the additional burden of preparing it for sale.



Keeping a complex process focused

How long does it typically take to settle an estate, and what, if anything, can the family do to expedite the post-mortem process?

For very high-net-worth individuals, in our experience, the post-mortem period can range from three to ten or more years, with the average estate taking approximately five years to settle. The administration of an estate is an organic process that will follow a course of its own, and there is little the beneficiaries can do to influence the timing in a significant way. One important thing a family can do to limit settlement time and costs is to move quickly to develop a complete picture of the decedent's assets and his or her intentions with respect to those assets. Survivors also can influence the duration of the estate by mitigating any controversies before they proceed to court and by planning at an early date, how to fund liabilities, expenses, and taxes.

What are some typical U.S. income and estate tax concerns during the administrative process for an estate?

After death, the income tax landscape for the decedent becomes more difficult. At a minimum, the executor/trustee may be responsible for filing:

- **Final income tax return** (Form 1040),
- **Final gift tax return** (Form 709)
- **Estate tax return** (Form 706),
- **Estate's income tax returns** (Form 1041),
- **Trust income tax returns** (Form 1041) for trusts (e.g., Tom's dynasty trust) which were not recognized as separate taxpayers during the decedent's life,
- **Potential state income or state estate/inheritance tax filings** and/or
- **Potential foreign filing obligations**

The estate will continue to file income tax returns for each year of the post-mortem administrative period. Eventually, the estate will terminate, and some tax filings will cease as assets are distributed to beneficiaries. The complexity of filing obligations is often underestimated by the executors, which may require professional consultation.

As the executors complete the final income tax returns, they should consider planning for any tax attributes which might expire at death. For example, due to the expansion of the business, Tom had an excess business loss (EBL) in 2021 which created a net operating loss (NOL) that was carried forward into 2022. After the death of a taxpayer, both an NOL and any capital loss carryforwards expire. An NOL carryover sustained by a decedent before death does not pass to the decedent's estate, to the beneficiaries under a will, or to

Keeping a complex process focused

the heirs at law, since the decedent and the decedent's estate are different taxpayers for tax purposes. If the decedent was married at death, then the executor may determine the portion of the NOL generated by the decedent versus the surviving spouse. However, Tom was not married at the time of his death. Therefore, any part of an NOL that cannot be deducted on Tom's final income tax return is extinguished for all subsequent taxable years.

It is important to consider the impact of Tom's death on all entities that he owned. For example, the death of a partner also affects the income tax filings for the partnership itself, because the partnership closes its year with respect to the partner. Thus, tax attributes in the year of death are allocated (by any reasonable method including a formal closing of the books) between the partner and the estate. There may be other implications which should be discussed with a professional advisor.

What are the alternatives for paying estate tax liabilities?

As stated previously, generally the estate tax is due nine months from date of death. For many high-net-worth estates, one of the specific considerations in the final phase of post-mortem administration is planning how to pay the estate tax liability. Unless the estate has earmarked cash for this purpose, it usually has two choices: borrow funds to pay the taxes or sell assets to generate cash. There is no expectation that the executor liquidate all assets immediately to pay the liability. Additionally, the executor may file certain elections to defer the tax.

If the estate chooses to borrow funds to pay the tax, often the financing will come from the business. While cash flow from the business can be used over time to pay off the estate tax liability, that may be the biggest cash outflow that the business will ever experience and may potentially result in significantly reduced working capital. Therefore, any plan to utilize cash flow from the business must be carefully examined to determine the impact on the future of the company.

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POST-MORTEM

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Another option for borrowing funds, particularly for high-net-worth families, is to borrow from a related party at market rates, with the interest payments indirectly benefitting family members. Because greater care must be exercised when borrowing directly from a beneficiary, it is more common to borrow from a life insurance trust, from a closely held business, or against real estate. The interest paid to third parties can, if properly structured and documented, be considered a cost of administration that is deductible in determining the estate tax liability, thus decreasing the effective interest rate actually paid. In many cases, families use a combination of sources—government, banks, and related parties—to meet the tax obligations.

If the executor affirmatively elects to defer the tax related to a closely held business, and certain qualifications are met, then, pursuant to section 6166, the estate is allowed to pay off the tax liability apportioned to the business over a period of up to 15 years, at reduced interest rates. However, the government may require the estate to bond for the outstanding liability and has become more assertive in applying liens to estate assets, thus potentially making this avenue more expensive for business owners.

The other alternative, selling assets, also can require careful planning. Sales arising from buy/sell or other owners' agreements can be particularly troubling since the terms of many such agreements, while legally binding, are not necessarily binding for estate tax purposes. Sales proceeds generated through corporate and partnership redemptions are subject to special income tax rules. Some sales transactions can give rise to ordinary income treatment where other options might have permitted capital-gain treatment. Similarly, sales transactions that give rise to losses may complicate the future administration of the trust because losses, unless utilized during the administrative period, generally are suspended until the termination of the estate. Finally, if there are to be excess sales proceeds not needed to pay taxes, liabilities, or the expenses of administration, it may be prudent to retain accounting and investment advisory specialists.

How does the presence of a family business affect the administrative process?

In situations where the ownership of the family business is shared with many beneficiaries, there are frequently issues involving control over the business and its future governance. In Tom's case, his two children only owned 2.5% each of the partnership, but only one of the children was actively involved in the day-to-day business operations. However, Tom's estate plan distributed ownership equally between both of them, which has left them and the family enterprise to struggle with issues such as ongoing roles/responsibilities, control, voting rights, family employment, and the business strategy for the future.

02

Keeping a complex process focused

Essential role of pre-mortem planning

Dealing with death in any circumstances presents emotional, financial, administrative and other burdens. Indeed, the sheer weight of anticipating these issues often makes people hesitant to plan. However, it also makes it essential to do so. From a tax perspective, planning in advance allows the individual to model out the transference of assets to the intended recipients and understand the timing and economic considerations. For a business owner, it allows for peace of mind about how payment of the related estate tax may impact the company and develop a plan to mitigate unintended consequences. Non-tax issues such as family governance of a closely held business can also be discussed openly so that everyone shares in a vision for the future. Ask yourself this question—what will be one's legacy? Ultimately, planning for such a pivotal moment—one's death—both personally and/or financially, can help mitigate the burden on those for whom you care about and creates a path forward.

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