WRMarketplace

An AALU Washington Report

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TOPIC: Post-Mortem Liquidity Planning: A Fiduciary's (Limited) Toolbox.

MARKET TREND: In the absence of life insurance, options for fiduciaries to generate needed liquidity for estate taxes and expenses may be limited, creating additional hurdles for estate administration and post-mortem planning.

SYNOPSIS: Lifetime planning with life insurance is an effective and proven method of generating estate liquidity. Post-mortem options in the absence of such planning generally involve the fiduciary selling estate assets, borrowing money, and/or reviewing the availability of certain tax elections that can adjust the value of a decedent's estate or defer tax payments.

TAKE AWAYS: Post-mortem planning options are most effective when undertaken as a part of a broader liquidity strategy implemented during a client's life, often involving life insurance. Without adequate coverage or liquid assets, fiduciaries can face challenges in selling assets or obtaining loans to raise cash. Elections to defer estate taxes or adjust estate valuation are generally limited and technically complicated. Fiduciaries will need to understand the options and make a number of consequential decisions in a shortened time frame (usually before the first estate tax payment is due) while balancing the demands of beneficiaries who may become increasingly impatient as they await distributions.

As discussed in prior *WRMarketplaces* (e.g., *Nos. 17-38, 16-50,* 16-12), lifetime planning with life insurance is an effective and straightforward tool for creating estate liquidity without generating additional income or estate tax liability. When a client dies without adequate liquid resources, fiduciaries must turn to other (and often more complex) options to meet the estate's cash needs. This report reviews some common alternatives.

WHY IS LIQUIDITY SO IMPORTANT?

Estates often have significant liquidity needs after a decedent's passing, including:

- **Federal and/or State Estate Taxes**. Estate taxes are generally due within nine months of the decedent's passing and must be paid in cash.[1]

- **Administration Expenses**. Almost every estate will incur legal and accounting fees, as well as appraisal costs, for many types of property other than cash or marketable securities. Estate also will be subject to the claims of the decedent's creditors and other outstanding debts.

- **Family Support and Educational Expenses**. Depending on the state, a decedent's estate may be subject to statutory support awards or obligations. Fiduciaries also may frequently discover that the decedent was supporting children and grandchildren by paying for health and educational expenses or otherwise supplementing their costs of living.

- **Equalization of Residuary Beneficiaries**. For estates owning illiquid assets such as artwork or other collectables that must be equally divided across a class of beneficiaries, cash may be needed to balance out otherwise unequal shares.

WHAT ARE TYPICAL POST-MORTEM OPTIONS?

1. GENERATING LIQUIDITY

ASSET SALES. Selling estate assets will be one of the first considerations for a fiduciary needing to generate liquidity. While straightforward in concept, fiduciaries should review the following when evaluating estate assets for potential sale:

Potential Benefits. Asset sales work best for estates with sufficient amounts of easily-liquidated assets, such as marketable securities not held in retirement accounts. Taxable gain on such assets, which should receive a stepped-up basis upon the decedent's passing, would apply only on any post-death appreciation. The estate also would not incur debt or interest expense from an asset sale as it would with a loan (see below). Costs incurred in selling assets to pay for estate taxes and expenses may be deductible against the taxable estate as administrative expenses under Internal Revenue Code ("**Code**") §2053 ("**administrative expenses**").[2]

Planning Considerations

Lack of Marketable Assets. Estates concentrated in non-marketable assets face several challenges in asset sales for liquidity. For example:

- Retirement Accounts. Assets held in retirement accounts are typically made payable to a designated beneficiary or directly to a trust created under a decedent's will or revocable trust. As a result, such assets may not be available to the fiduciary to sell to raise cash. Even if available, many retirement account assets do not receive a basis step-up. Beneficiaries generally will be better off receiving those assets in-kind and stretching the withdrawals from accounts over the maximum period allowed by law.

- Closely-Held Businesses. In the absence of a buy-sell arrangement, a decedent's interest in a closely-held businesses can be particularly difficult to sell. The terms of a business's governing documents may restrict a fiduciary's authority to sell the interests or limit the potential purchasers. Even with a buy-sell agreement in place, the purchase price under the agreement may be funded with a promissory note, deferring the estate's receipt of needed liquidity. Depending on the type of business, its size, and projected growth (factoring in the impact of the death of a business owner), the value or market for the business interests also may be limited, particularly if the estate holds a minority stake.

- Real Estate. As with closely-held business interests, the market/value available for real estate depends on numerous factors. The fiduciary also will need to spend time marketing a property to generate the best possible offers. Even where all parties are motivated, it could take months to finalize the details and funding for closing.

Timing Constraints/Market Risk. Liquidity needs can arise fairly soon after a decedent's passing. Funeral and other administrative expenses begin to accrue almost immediately after death, with estate taxes (if any) due within 9 months. The fiduciary, however, must attempt to balance the pressure to sell assets quickly against the market risk of such "forced sales," which may result in sales at reduced values, potentially at a loss.

> *Example 1*: Tom Testator, a Virginia resident, dies unmarried, leaving three adult children (Alex, Brian, and Carly) and a $30 million estate, consisting of $5 million of marketable investments/securities and a 50% interest in ABC Co. ("**ABC**"), a manufacturing company, valued at $25 million. He created no lifetime trusts and made no taxable gifts. His Will leaves everything to his children in equal shares. Applying 2019 laws, Testator's estate owes federal estate tax of $7.44 million.
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> Frank Fiduciary, Testator's cousin, is appointed executor. He can liquidate the securities portfolio to pay part of the estate taxes, but if the stock market is down, he may be selling securities at loss. Liquidating the ABC interests, however, presents additional difficulties. ABC's operating agreement gives the company, then the other owners, 30-day rights of first refusal ("**ROFRs**") to

purchase some or all of Testator's interests before any sale to another party. The exercise price is based on ABC's book value (which may be less than fair market value ("**FMV**")) and is payable via a 5-year promissory note, providing for annual payments and no down payment. So not only must Fiduciary comply with the ROFR procedures, if the estate must sell Testator's interests to the company or other owners, it may receive less than FMV paid over the deferred note period, still leaving the estate without sufficient funds to pay the estate taxes when due.

Disagreements Among Beneficiaries. Beneficiaries may diverge in their desire for business interests to be sold or dispute the value obtained for the sale of an asset, leaving a fiduciary vulnerable to beneficiary conflicts and/or expensive and time-consuming litigation (requiring additional cash from the estate to pay legal and court fees).

LOANS. To generate liquidity, a fiduciary may consider borrowing from one or more potential lenders, such as lifetime trusts created by the decedent, estate beneficiaries, closely-held businesses (i.e., *Graegin* loans), and/or commercial lenders.

Potential Benefits. Borrowing from related party (non-commercial) lenders can provide flexibility for the estate, effectively deferring payments through the use of a loan structure and initially freeing up assets for other estate administration purposes. The loan terms often can be structured more favorably than for commercial loans (e.g., interest charged at the applicable federal rate ("**AFR**"),[3] no prepayment penalty, limited/no collateralization or guaranties). Borrowing on such terms, when available, may be preferable to a forced sale of assets at below market value. Interest on a related party or commercial loan also may be deductible as an administrative expense, if the loan is actually and necessarily incurred in the administration of the decedent's estate (e.g., reasonable and necessary to prevent the forced sale of estate assets).

Planning Considerations

Limited Options. If there are no related parties available or willing to lend on favorable terms, a fiduciary will have to look to commercial lenders. This may result in higher interest rates, additional loan charges/fees, and required guaranties or collateral. Commercial loans also may not be an option if estate assets were already leveraged before the decedent's passing.

Hurdles for Related-Party Loans. The IRS generally subjects loans between related parties to higher scrutiny than commercial loans, making it crucial to document the loan properly, charge adequate interest (at least the minimum AFR for the date and duration of the loan), and comply with all administrative and payment requirements. It may be more difficult to claim the interest deduction as an administrative expense, as there must be evidence that the loan is bona fide and has a non-tax purpose (such as the need to avoid a forced asset sale at a reduced value).[4]

Practical considerations also will apply depending on the identity of the lender. For example, in the case of borrowing from a trust, the trustee will have a fiduciary duty to ensure the loan is a proper trust investment and in the interest of the beneficiaries, which may be challenging if the trust and estate beneficiaries differ. If considering a *Graegin* loan from a closely-held business held by the estate, not only must the loan make business sense, the company also must be able to produce the required liquidity to make the loan (or itself borrow to provide such funds), and the other owners likely will need to agree. Family dynamics can present a concern when borrowing from an individual estate beneficiary, who, for instance, may seek a higher interest rate and/or shorter loan term for making the loan, effectively prioritizing payments to him or her and potentially altering the balance of the estate's distribution.

> *Example 2*: Assume the same facts as Example 1, except the estate has only $3 million of marketable securities and the ABC interest is worth $27 million and cannot be sold. Fiduciary will liquidate the securities portfolio and wants to borrow $4.44 million to pay the remaining estate taxes. Testator's daughter, Carly, has the cash and is willing to make a 3-year loan of $4.5 million to the estate at an annual interest rate of 3%. Although that rate exceeds the then short-term AFR of 1.85%, it is lower than any commercial offering. However, the loan entitles Carly to $135,000 of annual interest from the estate, correspondingly reducing Alex's and Brian's shares of the estate.

Interest Rates. Relying on the availability of future loans presents rate risk. While rates are at historical lows now, no one can predict what they might be when a loan is needed.

Repayment. Unlike asset sales which are a "self-funded" solution, loans must eventually be repaid, and so they provide more of a deferral mechanism than a permanent solution.

2. USING ALTERNATE VALUATION

Code §2032 permits a fiduciary to value estate assets as of the six-month anniversary of the decedent's passing, rather than as of date of death.[5]

POTENTIAL BENEFITS. The Code §2032 election can be a powerful tool for an estate owning certain assets that have decreased within the specified six-month period, particularly if there has been market downturn (either generally or specific to a large asset of the estate), a business has performed poorly since the loss of an owner, etc. Using the alternate valuation reduces the size of the gross estate and the corresponding estate tax liability.

> *Example 3*: Assume the same facts as Example 2. Six months after Testator's passing, ABC has lost its biggest customers, and the FMV of the estate's ABC interest has decreased by 50%, to $13.5 million. Electing the alternate valuation under Code §2032 would reduce the size of Testator's taxable estate to $16.5 million, reducing the estate tax to $2,040,000.

PLANNING CONSIDERATIONS. The alternate valuation must apply to <u>all</u> eligible assets (except for assets disposed of within the six-month period, which will be valued as of the date of disposition). The estate must be subject to federal estate tax, and the alternate valuation must reduce the gross estate's value and the tax due (i.e., it cannot apply to increase the value (and basis of assets eligible for step-up) in a non-taxable estate).[6] The election must be made on a federal estate tax return filed not more than one year after the prescribed due date, including extensions.[7]

3. SPECIAL ELECTIONS FOR CLOSELY-HELD BUSINESSES

§303 STOCK REDEMPTION. For estates owning qualifying stock in certain corporations, it may be possible under Code §303 for the fiduciary to have a portion of such stock redeemed by the corporation, with the proceeds treated as received in exchange for full value.

<u>Potential Benefits</u>. A §303 redemption is available if the value of all stock owned by the decedent in the corporation exceeds 35% of the decedent's adjusted gross estate ("**AGE**," the gross estate reduced by deductions for administrative expenses, as well as losses under Code §2054).[8] The election also may apply if a decedent owns eligible stock in more than one corporation, each exceeding 20% of the AGE.[9]

Proceeds received by an estate in a §303 redemption are not treated as dividends (taxable as ordinary income), but as capital gains, the tax on which may be minimal as the gain typically is based on the difference in the stock's FMV as of the decedent's passing (due to the basis step-up) and the date of redemption.[10] Accordingly, the fiduciary can effectively liquidate the shares with limited income tax consequences.

<u>Planning Considerations</u>

Qualifications. As indicated, a §303 redemption is only available in limited circumstances where the estate holds sufficient interest in closely-held businesses. The fiduciary must consider the effective use of estate deductions for administrative expenses and §2054 losses, as these deductions reduce AGE, possibly making it easier to qualify for the §303 redemption. The fiduciary also must proceed cautiously if considering both alternate valuation and Code §303. If the alternate valuation lowers the value of the closely held business interests below that 35% AGE threshold, Code §303 may not be available to the estate.

> *Example 4*: Assume Testator's AGE at passing for §303 purposes includes $3 million of marketable securities, $10.8 million of ABC stock, and $16.2 million in other illiquid assets. ABC represents 36% of Testator's AGE, and Fiduciary is considering a §303 redemption. However, six months after Testator's passing, ABC has lost several customers, and its value has dropped to $10 million. The estate's other asset values have remained stable. If Fiduciary elects alternate valuation, the estate's value is reduced by $800,000, potentially reducing the

estate tax liability by $320,000. However, ABC will now only represent 34.2% of Testator's AGE, making §303 redemption treatment unavailable.

In addition to the technical requirements, the cash received pursuant to a §303 redemption that will qualify for this special treatment is limited to the extent of applicable federal and state estate taxes and other qualifying administrative expenses.[11]

Corporate Participation. A Code §303 redemption will be ineffective if the corporation is unwilling to participate in the redemption or does not have sufficient available cash to redeem the decedent's stock,[12] generally making it a less reliable option without some complementary lifetime planning (e.g., the corporation's acquisition of life insurance to provide liquidity).

CODE §6166 DEFERRAL. As recently discussed in *WRMarketplace 19-16*, Code §6166 provides an estate tax deferral election for estates of decedents holding concentrated positions in qualifying closely held business interests (i.e., over 35% of AGE), which permits payment of the estate tax liability attributable to those business interests over a maximum 14-year period. Notably, there are some overlaps in the considerations for planning for a §303 redemption and a §6166 election, including the impact of using alternate valuation when qualifying for the 35% ownership requirement[13] and the impact of deductions on AGE. *WRMarketplace 19-16* reviews in detail the potential benefits and planning consideration for making a §6166 election.

4. §6161 DISCRETIONARY EXTENSION

Code §6161(a)(1) gives the IRS discretion to extend the time for payment of the tax on any return for a period not to exceed 12 months in the case of estate tax (6 months for other taxes). In addition, under Code §6161(a)(2), the IRS may, for "reasonable cause," extend the time for payment of estate taxes (including any installment payment due under a §6166 election) for one year at a time, for up to 10 years.

According to the instructions to the extension application (Form 4768), the examples of "reasonable cause" include: (1) an estate substantially comprised of rights to receive future payments (i.e., annuities, royalties, receivables, contingent fees) where the fiduciary cannot readily borrow against such assets except under terms inflicting severe losses on the estate; and (2) an estate that does not have sufficient funds to pay taxes, family allowances, and claims without borrowing at an interest rate higher than generally available, and where the fiduciary has made reasonable efforts to convert estate assets into cash.[14]

PLANNING CONSIDERATIONS. As grants of these extensions are discretionary, and extensions for "reasonable cause" will generally involve a subjective facts and circumstances review, the availability of these extensions cannot be assumed. Further, any payment extension granted will be only for the amount of the cash shortage, which must be evidenced on the application form, along with any plan for partial payments to be made during the extension period. The estate also will have to pay interest on the tax deferral at the underpayment rate (although the estate may take a deduction for such interest).

TAKE AWAYS

Post-mortem planning options are most effective when undertaken as a part of a broader liquidity strategy implemented during a client's life, often involving life insurance. Without adequate coverage or liquid assets, fiduciaries can face challenges in selling assets or obtaining loans to raise cash. Elections to defer estate taxes or adjust estate valuation are generally limited and technically complicated. Fiduciaries will need to understand the options and make a number of consequential decisions in a shortened time frame (usually before the first estate tax payment is due) while balancing the demands of beneficiaries who may become increasingly impatient as they await distributions.

NOTES

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[1] The automatic six-month extension of time to file a federal estate tax return, if requested, does not apply to extend the time to pay the estate tax due. As discussed herein, a separate extension must be requested under Internal Revenue Code ("**Code**") §6161 to extend the payment date.

[2] The amounts deductible from a decedent's gross estate as administrative expenses "are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it," and include: (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one. See Treas. Regs §20.2053-3(a) - (d).

[3] Note that the mid-term AFR (for loans with terms over 3 but not exceeding 9 years) is currently lower than the short-term AFR (loans with terms not exceeding 3 years), but historically, this has not been the case.

[4] *See e.g.,* Michael Amoia and Jon Whitacre, "3½ Life Insurance Ideas for Large Real Estate Clients," *WG&L Estate Planning Journal*, May 2019.

[5] Code §2032(a)(2).

[6] Code §2032(a), (c)(1) and (2).

[7] Code §2032(d)(1) and (2).

[8] Code §303(b)(2)(A).

[9] Code §303(b)(2)(B).

[10] Code §303(a) provides that any such redemption otherwise meeting the statutory requirements is treated as a distribution in full payment in exchange for the redeemed stock.

[11] Code §303(a).

[12] BNA Portfolio 808-4th: Estate Planning for Corporate Executives, Detailed Analysis, B. Lack of Liquidity.

[13] *See e.g.*, BNA Portfolio 804-2nd: Probate and Administration of Decedents' Estates, Detailed Analysis, G. Valuation Elections.

[14] See Instructions to Form 4768, "Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes," which refers to examples of reasonable cause as provided in Treas. Reg. §20.6161-1(a) (note this regulation has not yet been updated to reflect the 1976 amendments to §6161, which removed the statutory references to "undue hardship" extensions).